

## While You Were Away: An Update on Financial Regulation Developments

Around the world, it has been a very busy summer for those working on financial regulation, including the passage of the US Dodd-Frank Act, the publication of the UK Treasury's consultation paper on the reform of the UK regulatory framework and broad agreement by the Group of Governors and Heads of Supervision on the Basel Committee's capital and liquidity reform package. This summary gives you a quick update on these and other regulatory developments that have occurred over this summer.

Legislators and regulators pushed to meet deadlines, notably those imposed by the summer G20 meetings and their timetable. However, meeting these deadlines required significant compromise on many of the key issues, as well as postponing the resolution of much of the detail.

In early June, the **International Monetary Fund** issued a paper addressing **cross-border resolution mechanisms and enhanced coordination**. The theme is that the recent financial crisis has given renewed urgency to the need for resolution systems for financial institutions, which both safeguard financial stability and limit moral hazard. However, experience demonstrates that these systems will not be effective unless progress is also made in developing a framework that applies on a cross-border basis. Since many systematically important financial groups operate globally, an uncoordinated application of bank resolution across different countries and financial systems will only increase the level of confusion and disorder.

Two possible solutions have been discussed. The first is the establishment of an international treaty that would oblige countries to defer to the resolution decisions to the jurisdiction where the financial institution has its main activities. The second solution emphasises the "de-globalisation" of financial institutions so that they fit more comfortably within the national resolution frameworks in which they operate. In contrast, the IMF proposes a new approach introducing a pragmatic framework for enhanced coordination, to which countries would subscribe that are in a position to satisfy its requirements. National authorities would continue to retain the discretion to act independently if, in their judgement, such action is more consistent with the interests of creditors and supportive of financial stability. The enhanced coordination framework would only be applicable to those countries that have in place "core-coordination standards". The paper concludes that the first to implement are most likely to be the limited group of countries that already meet the standards; however, they could begin cooperating between themselves. The network would then gradually expand as more countries adhere to the standards.

[Resolution of Cross Border Banks - A Proposed Framework for Enhanced Coordination - Link to the Publication](#)

In a July consultation paper, the **United Kingdom's HM Treasury** addressed the **reform of the UK regulatory framework** following the changes proposed by the new UK coalition government. In particular, the consultation paper discusses a revised tripartite model including three supervisory authorities: the Macro Prudential Regulation Authority (MPRA), the Prudential Regulation Authority (PRA), a supervisory authority in charge of the prudential regulation of individual firms, and the Consumer Protection and Markets Authority (CPMA), an authority responsible for consumer protection and the conduct of financial markets. Within the MPRA, the government proposes to include a Financial Policy Committee (FPC) under the authority of the Bank of England. The FPC would be responsible for maintaining financial stability by monitoring and addressing systemic or aggregate risks and vulnerabilities that threaten the financial sector as a whole. The PRA will have

the responsibility of identifying risks and vulnerabilities to which the financial system is exposed and taking corrective actions to protect the broader economy. Finally, the CPMA will focus on consumer protection, promotion of integrity and efficiency in financial markets and regulating the conduct of participants in wholesale markets and market infrastructures such as investment exchanges.

[A New Approach to Financial Regulation: Judgment, Focus and Stability - Link to the Publication](#)

Deadline for consultation responses: 18 October 2010

In July, just preceding the G20 meeting in Canada, the **United States** authorities passed the new **US Dodd–Frank Wall Street Reform and Consumer Protection Act**, known as the **Dodd-Frank Act**, addressing the following main areas:

Consumer protection: The bill gives authority to an **independent consumer protection agency**, which will be housed within the Federal Reserve System, with separate budgets and authority over the examination and enforcement of banks. The agency will also consolidate consumer protection powers which currently fall under various regulatory institutions within the US.

Addressing systemic risk: The bill introduces a new **Financial Stability Oversight Council (FSOC)** which is to be chaired by the Treasury Secretary. The FSOC will include the Federal Reserve Board, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), the National Credit Union Administration (NCUA), the new Consumer Financial Protection Bureau and an independent appointee with insurance expertise.

Ending taxpayer bailouts: The bill asserts that there will be no taxpayer bailouts in the future to cover the costs of failure in the financial system. To this end, the bill emphasises the safeguarding of systemic institutions by proposing to put in place standards for risk management practices for payments, clearing and settlement activities.

OTC derivatives markets: The bill provides the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) with authority to regulate the over-the-counter derivatives market. The bill requires OTC derivatives to go through central clearing and exchange trading and instructs regulators to collect trade data through clearing houses or trade repositories while imposing capital and margin requirements on dealers.

Credit rating agencies: The bill introduces a new **Office of Credit Ratings** to supervise credit rating agencies. The supervisor, which would fall under the SEC, will require Nationally Recognised Statistical Rating Organisations (NRSROs) to disclose their ratings methodologies. It aims to reduce conflicts of interests. In addition, investors have a right of action against rating agencies in the event of reckless failure.

Securitisation: The bill requires securitisation sponsors and originators to retain at least 5% of the credit risk. In addition, the originators will have to disclose the details and the quality of the underlying assets.

Proprietary trading: Known as ‘the Volcker rule,’ this section seeks to limit the amount of its own capital a bank may invest in ownership of hedge funds and private equity firms. Restrictions will also be placed on non-bank financial institutions supervised by the Fed on the specified trading activities.

The bill has left many of the specifics of the regulation and rule writing to the implementing agencies. Many of them, including the SEC, are seeking public comments on various aspects of the Dodd-Frank initiatives before drafting the rules. Specifically, this link: <http://www.sec.gov/spotlight/regreformcomments.shtml> permits you to submit comments or drafting recommendations for individual provisions of the bill overseen by the SEC.

It is important to note that the Act fails to address some important lessons learnt from the crisis. In a recent Financial Times article, "Failures of the Dodd-Frank Act", Viral Acharya, a member of the ICFR's Academic Panel says: "the Act does not sufficiently discourage individual firms from putting the financial system at risk. Since the failure of systemically important firms imposes costs beyond their own losses, it is not sufficient to simply wipe out their stakeholders. They must pay in advance for contributing to the risk of the system...implicit government guarantees for large parts of the shadow banking sector remain unaddressed. Fannie and the Freddie are the most glaring examples of systemically important financial firms whose risk choices went awry given access to guaranteed debt. There is no attempt at reforming them in the Act."<sup>1</sup>

The **US Treasury** clearly recognizes that **Fannie Mae** and **Freddie Mac**, the two US housing behemoths, were too difficult to tackle in the initial legislation. At a conference held two weeks ago at the Treasury, experts gathered to debate possible solutions to be proposed as legislation next year. The discussion centred on how to ensure retail mortgage finance availability while limiting the scope, activities and future government support for these institutions. Already, the Federal Housing Finance Agency and the boards of Fannie Mae and Freddie Mac have raised underwriting standards to ensure that the loans made since the end of 2008 are of higher credit quality with fees that provide adequate income to cover future losses.

[Highlights of the Dodd-Frank Wall St. Reform and Consumer Protection Act - Link to the Publication](#)

[Secretary of Treasury Tim Geithner's Opening Remarks at the Conference on the Future of Housing Finance - As Prepared for Delivery - Link to the speech](#)

Towards the end of the July the **Basel Committee for Banking Supervision (BCBS)** together with central bank governors and heads of supervision met to review proposed **capital and liquidity requirements**. The committee aims to raise the quality and quantity of capital and liquidity standards whilst reducing leverage, risk taking and pro-cyclicality. In particular, on 26 July, the group reached an overall agreement on the design and liquidity reform package, issuing an Annex which includes the following: the definition of capital, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standard. Jean-Claude Trichet said, "the agreements reached today are a landmark achievement to strengthen banking sector resilience in a manner that reflects the key lessons of the crisis...the Group of Governors and Heads of Supervision have ensured that the reforms are rigorous and promote the long term stability of the banking system. We will put in place transition arrangements that ensure the banking sector is able to support the economic recovery." Clearly, those present were concerned about the impact of raising bank capital too quickly on any economic recovery as deadlines for implementation were lengthened. Efforts at agreeing a leverage ratio and a core stable funding ratio were also effectively pushed into the distant future.

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<sup>1</sup> Financial Times (15 July 2010): "Failures of the Dodd-Frank Act"

[The Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package - Link to the Press Release](#)

In August, the **BCBS** also published a study analysing the **Long-term Economic Impact of the Basel Committee's proposed capital and liquidity reforms**. The study assesses the economic costs and benefits of stronger capital and liquidity regulation in terms of their impact on output. The core conclusion of the report is that the net benefits remain positive for a broad range of capital ratios, while the incremental net benefits from reducing the probability of banking crises gradually declines to become negative beyond a certain range.

The reinforcement of the regulatory system, following the spread of the crisis, aims at lowering the probability of banking crises and their repercussions over other related markets. When putting in place a stronger financial system, its many benefits must be weighed against its probable costs. The study focuses on the long-term impact of these new regulations. The costs are mainly related to the possibility that higher lending rates lead to a downward adjustment in the level of output while leaving its growth rate unaffected. In order to be able to estimate more accurately the impacts of the ongoing crisis and forecast future crises, various studies have been conducted based on historical data and experience. An evaluation of the net benefits is at the base of valuating the long run economic impact.

It is inevitable that the analysis of the macroeconomic benefits and costs is subject to considerable uncertainty. Thus, the report draws on a variety of methodologies and models. Knowing that uncertainty is a key player, the sizeable gap between benefits and costs for a broad range of assumptions still suggest that in terms of the impact on output there is considerable room to tighten capital and liquidity requirements while still achieving positive net benefits. Therefore, although there is a considerable uncertainty about the exact magnitude of the effect, the evidence suggests that higher capital and liquidity requirements can significantly reduce the probability of banking crises.

[An Assessment of the long-term economic impact of stronger capital and liquidity requirements - Link to the Publication](#)

The **Financial Stability Board and BCBS** issued a joint study **"assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements"**. The study suggests that the timing of when the new requirements are phased in is seen as crucial. This is due to the fact that it would determine how banks react to new capital and liquidity standards. A short transition period means that banks may contract their lending with a view to boosting their capital levels while a longer transition period would give banks enough time to retain earnings and to issue more equity. To assist banks with the phasing in of the new proposals, the BCBS and FSB have set up a Macro Assessment Group (MAG) which will be responsible for assessing the macroeconomic effects of the transition to higher capital and liquidity requirements. This group will be made up of experts from regulatory bodies, central banks and other international institutions. The MAG have highlighted that, although it has applied certain models such as value-at-risk and Dynamic Stochastic General Equilibrium, it is impossible to adopt a "one size fits all approach", that incorporates all applicable mechanisms including changes in lending spreads, short-term credit supply constraints and international spillover effects to name a few.

The MAG's assessment presents both quantitative and qualitative factors on the impact of capital and liquidity requirements on growth. The Macro Assessment Group recognises that if capital and liquidity requirements are not phased in gradually, behavioural changes will be made by banks;

especially regarding the nature of their assets, loan covenants and maturities, in order to reduce their risk exposures.

[Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements - Link to the Publication](#)

Also within the G20, **India has launched a review of bank ownership regulation.** In a major step in the evolution of its financial system, the Reserve Bank of India (RBI) launched a discussion paper in August over plans to overhaul bank ownership regulation. This could pave the way for industrial conglomerates to enter the banking sector. Unveiling the proposals, the RBI noted the importance of financial services in promoting growth and that while India's financial system was already well advanced had largely escaped the recent financial crisis unscathed, it was necessary to provide a fully inclusive financial system for the future. This may well require new entrants, perhaps from domestic non-banking groups, and may also involve participation by foreign banks. Such moves of course require careful consideration of regulatory issues ranging from capital requirements to eligible promoters and business models.

[Entry of New Banks In The Private Sector – Discussion Paper - Link to the Publication](#)

And the autumn is looking to be even busier. As we go to press, markets remain focussed on the central bankers' meeting at Jackson Hole, Wyoming, looking for any signals of special stimulus measures from the Federal Reserve given concerns about a double dip recession. Regulators and officials around the world are preparing for the October World Bank-IMF annual meetings and the G20 Meetings in Korea in November. President Sarkozy has laid out the first signs of the French programme for the next presidency of the G20, and EU has a tremendously busy programme of consultations and legislation for the autumn including: a public consultation on possible amendments of the Markets in Financial Instruments Directive (MIFID), a public hearing on commodity derivatives to assist the Commission in developing a coherent and effective policy on that subject, the seventh conference in the Transatlantic Corporate Governance Dialogue (TCGD) and a public hearing on amending the proposal of the Insurance Mediation Directive, amongst others.

[Click here](#) for a link to the ICFR's Regulatory News page, which will provide you with further detail on research and regulatory papers published over the summer. We update this page daily, and recommend you add it to your 'favourites' as a useful resource for news, analysis and commentary on regulatory developments as they occur.