



International Centre for  
Financial Regulation

## **Annual International Regulatory Summit**

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### **Regulation without Borders - G20 Ideals and National Interests**

The Hilton, Amsterdam, Netherlands 8 – 9 November 2010

## **Session Bibliographies**

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### **Working Group III: Bank Regulation**

**9 November 2010****14:15 – 15:30****Working Group III: Bank Regulation**

***“The IMF...and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.” – G20 Washington, November 2008***

This working group will look at the practical issues facing the banking community, including new capital regimes, liquidity, convergence, cross-border crisis resolution, and supervision, especially those surrounding the conflicts between international standards and national implementation. This is a fully interactive working session.

**Session Background and Points for Consideration**

Banks have been at the centre of the regulatory response to this financial crisis. In part this has been based on the observation that a large part of the banking system entered the crisis with an inadequate level and quality of capital. As these deficiencies were revealed, the subsequent liquidity crises deepened and the public authorities stepped in to stabilise financial conditions and re-capitalise a number of systemically important financial institutions. Little wonder then that the core regulatory response as pursued, for example, by the Basel committees (see *Hannoun* for recent summary) has been targeted at improving the amount and quality of capital, linking capital requirements more clearly to risk, greater focus on leverage risks, enhanced risk management measures and transparency (including counterparty risk).

In addition to these micro-prudential steps, the banking sector has also been swept up into a range of macro-prudential proposals aimed at limiting systemic financial risk. These are partly aimed at addressing differences in approach between countries or regions, however they can be regarded in broad terms as considering how risk develops over time (or through the cycle) and how risk is distributed at a given point in time (across sectors/through networks). This then covers procyclicality, systemically important institutions, moral hazard (crisis resolution mechanisms), the robustness of the financial infrastructure (e.g. settlement systems), and the results of innovation.

Questions which this session may consider include:

- Issues arising from the international debate
  - Has an adequate assessment of the aggregate impact of all the proposed measures on capital, leverage and liquidity been carried out? If all the FSB measures are aggregated, what is the aggregate impact on banks costs of capital?
  - What is the impact of that aggregated impact on any nascent economic recovery? Will the implied phase-in time soften the impact?
  - What is the likelihood that the international community will agree and implement a coordinated plan for crisis resolution and wind-down schemes?
  - Does the focus on banks instead of products lay the ground for future problems with ‘under-regulated’ or shadow banking services?
  - What could or should regulators do to offset uncertainty about the final measures and timetable to be adopted?

➤ Detailed issues for banks

- Are we of moving from regulatory 'underlap' to regulatory 'overlap'? How much will regulatory 'overlap' add to banks' costs?
- Is managing counterparty risk more problematic and costly than the proposed capital and leverage ratios? Is there a secondary agenda behind counterparty risk of indirectly shrinking the size of bank balance sheets and the interconnectivity or interconnectedness of the financial system?
- Can and will regulatory changes be staggered in their introduction? What are the pros and cons of gradual vs. 'big bang' implementation?
- Can industry compensation costs be reduced to offset regulatory costs?
- Will the new regulations force changes in business models anyway regardless of measures to separate commercial from investment banking? How disruptive, if at all, will this be?
- Will full implementation of such measures as outlined in the Basel Committee significantly limit return on equity and limit the supply of credit?
- Will enough progress be made on the clarification and harmonisation of standards in order for the Basel deadlines to be met? If not, what then?

**Bibliography:**

The ICFR has prepared a core bibliography on works relating to reform of financial regulation. Many of the works in that bibliography have sections relevant to this topic.

**ICFR (2010): *The New Global Banking Regulations and the Cost of Intermediation Conference***

- **Link to conference proceedings:** <http://www.icffr.org/Research/Conference-Proceedings.aspx>

The conference highlighted the debate around impact of new global banking regulations on banks' costs of capital and real economy. The conference brought together leading academics at a time when the regulatory response to the financial crisis has reached a critical juncture, with imminent decisions on implementation poised to have a lasting impact on banks' costs of capital and business models as well as on wider global economy.

**Basel Committee on Banking Supervision (BCBS) (2010): *Consultation on Countercyclical Capital Buffer Proposal***

- **Link to the publication:** <http://www.bis.org/publ/bcbs172.pdf?noframes=1>

The Basel Committee on Banking Supervision has issued a proposal for consultation for a countercyclical capital buffer regime. The four key objectives identified by the Committee were set out as follows in the December 2009 consultative document "Strengthening the resilience of the banking sector"<sup>1</sup>: (i) dampen any excess cyclicality of the minimum capital requirement, (ii) promote more forward looking provisions, (iii) conserve capital to build buffers at individual banks and the banking sector that can be used in stress, and (iv) achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth. This consultative document describes the primary objective of the proposed buffer and presents a short overview of how it would operate in practice and subsequently sets out a more detailed description of certain key elements of the proposal. The consultation period ended on 10 September 2010.

**European Central Bank (ECB) (2009): *EU Banking Sector Stability***

- **Link to the publication:** <http://www.ecb.int/pub/pdf/other/eubankingsectorstability2009en.pdf>

In this report, the recent performance of EU banks is reviewed with the identification of the main sources of potential risks to EU banks' stability. The report also assesses banks' ability to withstand adverse shocks. In addition, there is a discussion on the major developments that affected the financial condition of EU banks in 2008 and in the first quarter of 2009, and a presentation of a forward-looking analysis based on various types of quantitative market indicators, with a special focus on the most recent events.

**Organisation for Economic Co-operation and Development (OECD) (2009): *The Elephant in the Room: The Need to Deal with What Banks Do* Financial Markets Trends, Volume 2009, Issue 2**

- **Link to the publication:** <http://www.oecd.org/dataoecd/13/8/44357464.pdf>

It is believed that, in addition to reforms needed in the fields of capital rules, reforms are needed in areas such as dynamic provisioning, better co-operation during a future crisis, centralised trading of derivatives to address contagion and counterparty risk directly. This paper emphasises the need for transparent and comparable accounting rules and for improvements in corporate governance but also highlights two aspects of reform process that are essential to deal with contagion and counterparty risk and that are integral to the 'too big to

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<sup>1</sup> Quotations in all the summaries are from the works summarised

fail' issue: (i) the "imposition of a group leverage ratio foreshadowed at the Pittsburgh Summit to provide the binding constraint that Basel risk-weighted rules have been unable to achieve", (ii) a "Non-Operating Holding Company Structure (NOHC) to address contagion and counterparty risk directly".

### Other Publications:

#### **Haldane A (2009): *Banking on the State***

- **Link to the paper:** <http://www.bis.org/review/r091111e.pdf>

This paper provides an in depth view of the relationship between banks and the state. This culminates in the scale and scope of state support of the banking system which can be translated in the dependency on the state during times of crises. The paper also goes through the many reform proposals regarding the changes involving the banks limits of risk-taking and the changes to the terms of the social safety net to improve its time-consistency.

#### **Llewellyn D (2001): *Working Paper 48: A Regulatory Regime for Financial Stability***

- **Link to the publication:** [http://www.oenb.at/en/img/wp48\\_tcm16-6134.pdf](http://www.oenb.at/en/img/wp48_tcm16-6134.pdf)

The objective of this paper is to suggest a wider paradigm for ensuring financial stability (reducing the probability of bank failures and the costs of those that do occur). The emphasis of the paper is to recognise that the various components of the regulatory regime need to be combined in an overall regulatory structure, and that while all are necessary, none alone are sufficient. The debate on regulation "should rather be about how to optimise the combination of the seven components of the regime". The paper also briefly reviews the New Basel Capital Accord as proposed by the Basel Committee on Banking Supervision in 2001. New Basel Capital Accord is a move in direction of a broader approach to bank regulation and the recognition that other mechanisms (notably an enhanced role for market discipline) are needed.

#### **Milne A and Onorato M (2006): *Apples and Pears? The Comparison of Bank Economic and Prudential Capital***

- **Link to the publication:** [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=962362](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962362)

This paper examines the relationship between prudential capital and economic capital. Two practical conclusions are drawn from this paper: (i) further development of economic capital allocation requires abandoning the use of return on prudential capital (that is, expected returns relative to the contribution of bank exposures to institution default risk) as a measure of performance, and (ii) neither regulators nor bankers need to be concerned about divergence between various measures of prudential risk and the banks assessment of the actual business cost of accepting risk. The analysis implies that there is "little reason for bankers or regulators to be concerned about discrepancies between prudential, regulatory and economic capital".

#### **Repullo R and Suarez J (2008): *The Procyclical Effects of Basel II - CEMFI Working Paper, No. 0809***

- **Link to the publication:** <ftp://ftp.cemfi.es/wp/08/0809.pdf>

This paper finds that the new, risk-sensitive proposals do indeed change the behaviour of capital buffers from countercyclical to procyclical yet the higher buffers in expansions are insufficient to prevent credit restrictions at the onset of recession. However, they show that "cyclical adjustments in the confidence level [probability of loss absorption] can reduce its procyclical effects without compromising banks' long-run solvency".

**Tarullo D (2008):** *Banking on Basel: The Future of International Financial Regulation*

- **Link to the publication:** <http://bookstore.piie.com/book-store/4235.html>

In this book the author cites 4 areas of concern: compliance costs for banks, the supervisory challenge in evaluating risk models, the supervisory challenge in monitoring bank operation of the Basel II risk assessment process, and difficulties in holding the supervisors themselves accountable for their oversight. He moots a Basel III - this involves speeding up the work to define the kinds of capital that qualifies for Tier 1 or 2, making progress on leverage ratios and subordinated debt requirements, consider the elimination of harmonised detailed internal ratings-based (IRB) approaches (in favour of best practice, individualised solutions for individually active international banks, and finally, improving the monitoring processes in each Basel committee country. His version of the Basel III effectively keeps pillars 1, 2, & 3 and adds a fourth, strengthening the monitoring capacity of the Basel Committee.

**Industry view:****Institute of International Finance (IIF) (2009):** *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation*

- **Link to the publication:** <http://www.iif.com/download.php?id=/11YetxP3hE>

This is a comprehensive study covering many aspects of how to deliver effective regulation, from the perspective of the financial industry itself. While giving its backing to wide scale reform and the aims of the G20, the report does argue for doing this in a way consistent with an innovative and efficient financial system: "it is crucial that the cumulative effects of reform be consistent with market efficiency, avoiding rigidities that could stifle growth, job creation, and innovation, or increase the cost of financial services to customers". The report recognises the need for capital resources to be built in accordance with enhanced Basel II risk-adjusted objectives. Leverage should be closely monitored but the IIF strongly argues for consistency between regimes and looks for some flexibility in implementation: "...the IIF counsels against hardwired 'Pillar 1' ratios, which do not take into account actual portfolio composition and may create misaligned incentives. More nuanced leverage indicators should figure in the 'Pillar 2' supervisory review process". The IIF calls for further impact analysis of proposed capital changes.

**Speeches:****Caruana J (2010):** *Basel III: towards a safer financial system*, Delivered at the 3rd Santander International Banking Conference, Madrid

- **Link to the publication:** <http://www.bis.org/speeches/sp100921.pdf?noframes=1>

This is a speech by Jaime Caruana General Manager at the Bank for International Settlements (BIS). Basel III represents a fundamental strengthening of global capital standards. The new capital standards aim to correct what emerged to be problematic in the crisis; together with the introduction of global liquidity standards, the new capital standards deliver on the core of the global financial reform agenda. The implementation of Basel III will considerably increase the quality of banks' capital and raise the required level of their capital. In addition, it will provide a 'macroprudential overlay' to better deal with systemic risk. Lastly, the new package will allow sufficient time for a smooth transition to the new regime.

**Hannoun H (2010):** *Towards a Global Financial Stability Framework*, Delivered at the 45th SEACEN Governors' Conference, Siem Reap province, Cambodia

- **Link to the publication:** <http://www.bis.org/speeches/sp100303.pdf?noframes=1>
- **Also see:** *ICFR's comment, Basel III and the "Paradox of Financial Instability" on* <http://icfr.org/getdoc/3c88108f-1e0a-4e7b-b67e-c3bf91d8e34f/Basel-III-and-the--Paradox-of-Financial-Instabilit.aspx>

This is a speech by Herve Hannoun the Deputy General Manager of BIS. In this speech, he firstly sketches what he sees as the traditional framework in order to highlight the needed changes. Secondly, he briefly addresses why we need a global financial stability framework and finally elaborates on how to build such a framework. There is the need to recognise and ensure that all policy areas – prudential, monetary and fiscal – must make a contribution to achieving a stable financial system. Interestingly, the speaker notes that since the crisis erupted, the tendency has been to see the policy response couched in terms of micro and macro-prudential responses, what he labels as Basel III (an enhanced Basel II combined with a macro-prudential overlay).

**Thorat U (2010):** *Risk Management – Priorities for the Indian Banking Sector*, Delivered at the panel discussion on "Risk Management: Priorities for the Indian Banking Sector", Delivered at BANCON – Indian Banking Conclave 2009–10, Mumbai

- **Link to the publication:** <http://www.bis.org/review/r100120f.pdf>

This is a speech by Usha Thorat the Deputy Governor for the Reserve Bank of India. It is believed that the crisis has thrown up some critical issues relevant to risk management policies. The author also turns to the key areas where banks need to focus while planning their businesses for higher growth. The Basel Committee brought out two consultative documents focusing on higher bank capital requirements, liquidity, leverage ratio, measures to deal with procyclicality, in December 2009. This talk assesses the Indian position in this regard.

**Trichet JC (2010):** *Macro-prudential Regulation as an Approach to Contain Systemic Risk: Economic Foundations, Diagnostic Tools and Policy Instruments*, Delivered at the 13th conference of the ECB-CFS Research Network, Frankfurt am Main

- **Link to the publication:** <http://www.ecb.int/press/key/date/2010/html/sp100927.en.html>

This is a speech by the ECB President on macroprudential regulation mainly focused on the relationship between the European Systemic Risk Board (ESRB) and the ECB and their aim to improve macroprudential risk policies. He underlines the various gaps concerning systemic risk, such as some macroeconomic models that, due to their internal financial structure, cannot easily capture widespread financial instability. Other gaps also outlined in this speech were the systemic importance of non-bank financial intermediaries and systemic banking risk.

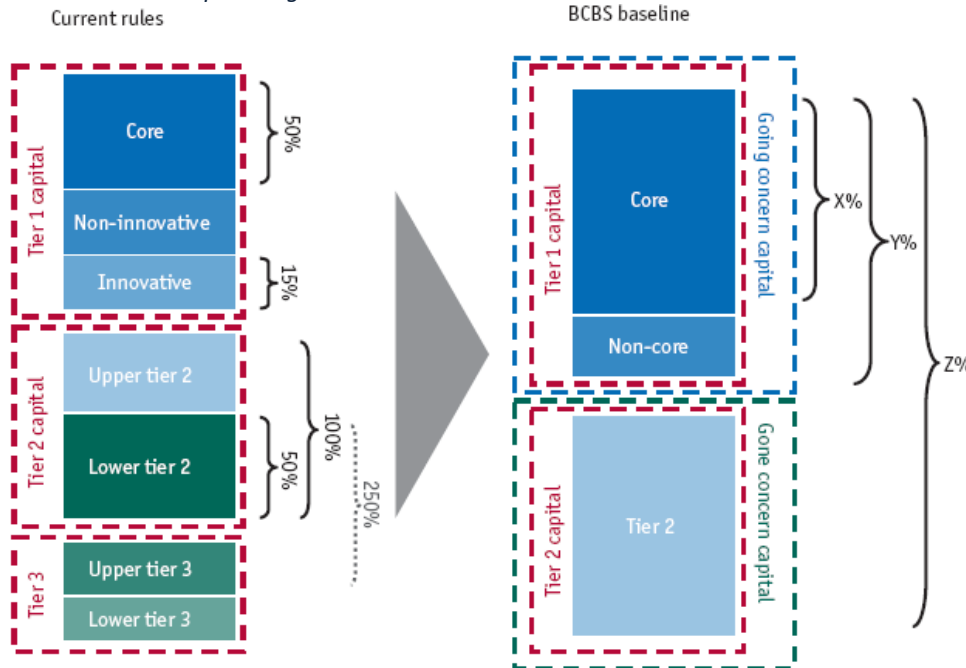
**Wellink N (2010):** *The Basel Committee and Regulatory Reform*, Delivered at the Institute of International Finance 2010 Spring Meeting

- **Link to the publication:** <http://www.bis.org/speeches/sp100611.pdf>

This is a speech by Nout Wellink the Chairman of the BCBS and the President De Nederlandsche Bank. In his speech he explains the rationale for the Basel Committee's reform programme and describes its key elements. The speech then details the benefits of their programme and the speaker's expectations for finalising their work. The speech concludes with the following remark, "raising minimum capital requirements from their current levels will involve large and permanent net benefits by raising the stability of the system and promoting more sustainable growth". However, the speaker notes that the long term impact of the new rules is not yet clear.

**Appendix:**

1. *Current Capital Regime and BCBS Baseline*



Source: FSA; *Financial Risk Outlook 2010*

2. *The Prudential Policy Dimension*

**Enhanced Basel II + macroprudential overlay = Basel III**

Prudential policy	Example of reform
Microprudential framework: enhanced Basel II	Increase the quantity and improve the quality of capital Adequate capital charges are urgently needed on the trading book Enhance risk management and disclosure Introduce a leverage ratio to supplement risk-weighted measures Address counterparty credit risk posed by OTC derivatives
Macroprudential overlay	<p><i>Address stability over time (procyclicality):</i></p> <ul style="list-style-type: none"> <li>Countercyclical capital charges and forward-looking provisioning</li> <li>Capital conservation rules for stronger capital buffers</li> </ul> <p><i>Address stability at each point in time (system-wide approach):</i></p> <ul style="list-style-type: none"> <li>Systemic capital surcharge for systemically important financial institutions</li> <li>Identify interlinkages and common exposures among all financial institutions</li> <li>Systemic oversight of OTC derivatives (CCP infrastructure)</li> </ul>

Source: Hannoun, BIS (February 2010); *Towards a Global Financial Stability Framework*

3. *Improving the Quality of Tier 1 Capital*

Category of Tier 1	Calculation	Notes
Common equity ("core Tier 1")	Common equity - Goodwill (deduction) = Tangible common equity - Other deductions = Common equity net of deductions	<ul style="list-style-type: none"> <li>• Predominant form must be common shares plus retained earnings and other comprehensive income</li> <li>• No debt-like instruments included in core Tier 1</li> <li>• No "financial innovation" permitted</li> <li>• Net of deductions (goodwill, deferred tax assets, minority interest, investments in own shares, etc)</li> <li>• Deductions are internationally harmonised</li> </ul>
Additional going-concern capital	+ Preference shares Preferred stock  + Other non-dated, loss-absorbing instruments (only limited debt-like features permitted)	<ul style="list-style-type: none"> <li>• Instruments must meet strict entry criteria (eg subordinated, no maturity date, fully discretionary non-cumulative dividends, no incentive to redeem)</li> <li>• Only limited debt-like features permitted (preferred dividends)</li> <li>• Grandfathering of capital instruments under consideration (including government rescue package instruments)</li> <li>• Elimination of the use of innovative hybrid debt instruments</li> </ul>
	= Tier 1 capital (going –concern capital)	<ul style="list-style-type: none"> <li>• Enhanced disclosure of all elements of Tier 1 capital, including all regulatory adjustments, main features, explanation of ratios</li> </ul>
	Contingent convertible bonds (contingent capital)	<ul style="list-style-type: none"> <li>• Under review: some debt in banks' capital structure converts to equity when a predefined threshold is reached</li> </ul>

Source: Hannoun, BIS (February 2010); *Towards a Global Financial Stability Framework*





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