



Progress on the G-20 Global Financial Regulatory Reform Agenda

March 2010



International Centre for
Financial Regulation

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Financial Stability Board (FSB) Update & Progress: Jan - Feb 2010

Bank Capital and Liquidity

- 9 January 2010, FSB members reaffirmed their support for the timing and direction of the Basel Committee's consultation package of proposals to strengthen global capital and liquidity regulations (*See Ref. No. 1*).
- FSB has proposed that the quantitative impact assessment of the proposals take careful account of the cumulative effect of all elements of the proposed Basel II changes.
- FSB is also coordinating a number of workstreams to assess and propose international policy actions to address system-wide cross-border liquidity risks.

"Too Big to Fail"

- October 2010 (an interim report to be released shortly after the June G-20 Summit), FSB and a number of FSB member bodies are planning to develop a package of measures to address the "too big to fail" problems associated with systemically important financial institutions. Potential measures put forward to date include: specific capital, leverage and liquidity requirements; improved supervisory approaches; simplification of firm structures; strengthened national and cross-border resolution frameworks and changes to financial infrastructure to reduce contagion risks (*Also see: Basel III and the Paradox of Financial Instability, Ref. No. 2*)

Sound Compensation Practices

- 9 January 2010, FSB reaffirmed their commitment to complete a peer review of implementation of the *Principles and Standards for Sound Compensation Practices* by March 2010 as requested by G-20 leaders.



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FSB

Update & Progress: Jan - Feb 2010 (cont...)

Strengthening Accounting Standards

- FSB continues to monitor progress in implementing G-20 and FSB recommendations for improved, converged accounting standards. On 9 January 2010, FSB members welcomed the IASB's plan to continue its enhanced dialogue with prudential authorities and market regulators on financial institution reporting issues, and to conclude its full review of the financial instruments standard by the end of this year.

Strengthen Adherence to International Standards

- 9 January 2010 FSB published the framework for strengthening adherence to international standards (*See Ref. No. 3*). The framework entails the following:
 - FSB member jurisdictions will lead by example.
 - FSB member jurisdictions will undergo periodic peer reviews to evaluate their adherence to international standards in the regulatory and supervisory area.
 - FSB will establish a toolbox of measures to encourage adherence to international cooperation and information exchange standards by all countries and jurisdictions.
- Of particular concern to the FSB is the adherence of jurisdictions to international cooperation and information exchange standards in the financial regulatory and supervisory area. The three key standards here are:
 - BCBS Core Principles for Effective Banking Supervision;
 - IAIS Insurance Core Principles; and
 - IOSCO Objectives and Principles of Securities Regulation.



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Bank for International Settlements (BIS)

Update & Progress: Jan – Feb 2010

The group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee, met on 10 January 2010 at the BIS. They reaffirmed several proposals regarding microprudential and macroprudential regulation to address procyclicality and systemic risk (See Ref. No. 5). On 22 January 2010, the Basel Committee published assessment methodology for compensation practices (See Ref. No. 6).

Provisioning

- In order to develop a robust provisioning approach based on Expected Losses (EL), in August 2009, the Basel Committee developed *Guiding Principles for the Replacement of IAS 39*, which is designed to achieve, among others, the following objectives:
 - Promote adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner; and
 - Address concerns about procyclicality under the current incurred loss provisioning model.The Basel Committee is envisaged to translate the principles into a practical proposal by its March 2010 meeting for subsequent consideration by supervisors and accounting standards setters.

Countercyclical Capital Buffers

- Specific measures may include:
 - Capital conservation measures including actions to limit excessive dividend payments;
 - Share buybacks; and
 - Compensation.

Risk of Systemic Banking Institutions

- The Macroprudential Group has been established by the Basel Committee to address the risk of Systemically Important Banks (SIBs). The evaluation of the pros and cons should be developed for:
 - Capital and liquidity surcharge;
 - Resolution mechanisms; and
 - Structural adjustments.
- This would then form a key input to the FSBs initiatives to address the “too big to fail” problem.



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BIS

Update & Progress: Jan – Feb 2010 (cont...)

Contingent Capital

- The Basel Committee is reviewing the role that contingent capital and convertible capital instruments could play in the regulatory capital framework (*See Ref. No. 5*)
 - Possible entry criteria are to be reviewed for contingent capital and convertible capital instruments to be included in Tier 1 and/or Tier 2.

Liquidity

- Details should be proposed regarding the global minimum liquidity standard including:
 - 30-day liquidity coverage ratio; and
 - Longer term structural liquidity ratio.

Compensation Practices

- The Basel Committee issued *Compensation Principles and Standards Assessment Methodology*. This methodology will foster supervisory approaches that are effective in promoting sound compensation practices at banks and will help supervisors assess a firm's compliance with the FSB's *Principles for Sound Compensation Practices* and related implementation standards. Methodology is structured based on the following themes (*See Ref. No. 6*):
 - Effective governance of compensation;
 - Effective alignment of compensation with prudent risk taking; and
 - Effective supervisory oversight and engagement by stakeholders.



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International Monetary Fund (IMF) Update & Progress: Jan – Feb 2010

Financial Sector Tax Options

- G-20 leaders tasked the IMF to prepare a report (in time for the G-20 June 2010 meeting in Canada) laying out a range of options countries have adopted as to how the financial sector could make a fair and substantial contribution towards paying for any burdens associated with government interventions to repair the banking system (*See Ref. No. 7*).

There are currently two separate issues under debate:

- Whether and how to recoup the costs of the net support already provided; and
- How to create a mechanism to cope with potential future costs.

Mutual Assessment Process

- In Pittsburgh, in September 2009, IMF was asked to analyse how the G-20's respective national and regional policy frameworks fit together and to develop forward-looking analysis of whether policies pursued by individual G-20 countries are collectively consistent with more balanced trajectories for the global economy. The IMF Executive Board endorsed the framework for the IMF's involvement in the G-20 Mutual Assessment Process (*See Ref. No. 9*). Directors also adopted the general framework for the IMF's staff involvement in this process, including the nature and scope of any IMF staff contribution.



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European Commission

Possible Changes to the Capital Requirements Directive

The possible changes set out below are closely aligned with the expected amendments to the Basel II framework and the introduction of a global liquidity standard which are both currently being drawn up and their respective impact assessed by the Basel Committee (See *Ref. No. 10*).

Liquidity Standards

- The Commission is considering a legislative proposal for two regulatory standards for liquidity risk.
 - **Liquidity Coverage Requirement:** Promoting the short-term resilience of the liquidity risk profile of institutions by ensuring that they have sufficient high quality liquid assets to survive an acute stress scenario lasting for one month.
 - **Net Stable Funding Requirement:** Promoting resilience over the longer-term, by requiring institutions to fund their activities with more stable sources of funding on an ongoing structural basis.

Definition of Capital

- The Commission proposes that the capital structure be revised to comprise:
 - Tier 1 – going concern capital: Core Tier 1 – common equity; and Non-Core Tier 1 – hybrid capital;
 - Tier 2 – gone concern capital
- In simplifying the capital structure, it has been proposed that the distinction between upper Tier 2 and lower Tier 2 for the purposes of capital limits be eliminated. In addition, removing Tier 3 capital from the capital structure has also been proposed.
- The intention is to introduce explicit, higher minimum levels of the ratios of Core Tier 1, Tier 1 and total capital (net deductions) to risk weighted assets.



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European Commission

Possible Changes to the Capital Requirements Directive (cont...)

Leverage Ratio

- The Commission considers that a leverage ratio is required to supplement risk-based minimum capital requirements. The ratio that is being considered is “a non-risk based, gross leverage ratio that is based on going concern regulatory capital, incorporates an institution’s on and off-balance sheet assets and applies at the same level as minimum capital requirements.” (See Ref. No. 10).

Two key elements to the leverage ratio are:

- Measure of capital used – the numerator; and
- Measure of total exposure used (on- and off balance sheet assets) – the denominator.

Counterparty Credit Risk

- The objective of the amendments would be to raise the capital buffers backing counterparty credit exposures, reduce procyclicality and provide additional incentives to move OTC derivative contracts to central counterparties.

Five key areas where possible amendments to the counterparty credit risk framework are envisaged:

- Improved measurement or revised metric to better address counterparty credit risk (including wrong-way risk, mark-to-market losses due to credit valuation adjustments, highly leveraged counterparties etc.);
- A multiplier for the asset value correlation for large financial institutions;
- Collateralised counterparties and margin period of risk;
- Central counterparties; and
- Enhanced counterparty credit risk management requirements.



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European Commission

Possible Changes to the Capital Requirements Directive (cont...)

Countercyclical Measures

- Credit loss provisioning should have the objective of “ensuring that credit institutions make timely and adequate provisions for all credit risks they are exposed to in a countercyclical way.” (See *Ref. No. 10*). An approach to credit loss provisioning should use existing Basel approaches such as the Internal Ratings Based (IRB) method to the maximum extent.
 - The technical group of Member States experts on credit loss provisioning is carrying out a comparative analysis to assess the cyclical impact of the various approaches to expected credit loss provisioning:
 - ❖ The Expected Cash Flow method as proposed by the IASB;
 - ❖ The incurred loss approach of current IAS 39;
 - ❖ The IRB method of the Basel II framework for accounting provisioning.
 - Proposed framework based on capital buffers:
 - ❖ Fixed target buffer (capital conservation buffer) over the regulatory minimum that can absorb losses in the stressed periods;
 - ❖ Countercyclical capital buffer which is designed to achieve broader macroprudential goal of protecting the banking sector from periods of excessive credit growth and support bank lending in the economic downturn.

European Commission Possible Changes to the Capital Requirements Directive (cont...)

Systemically Important Financial Institutions (SIFIs)

- The Commission is currently reviewing the potential policy approaches required to ensure that prudential requirements for SIFIs are commensurate with the risks they pose.
- A package of tougher prudential requirements is said to be needed to reduce the severity and frequency of crises.
- The potential package of measures put forward to date to address the issue of SIFIs includes the development of resolution tools and an effective framework for cross border resolution.

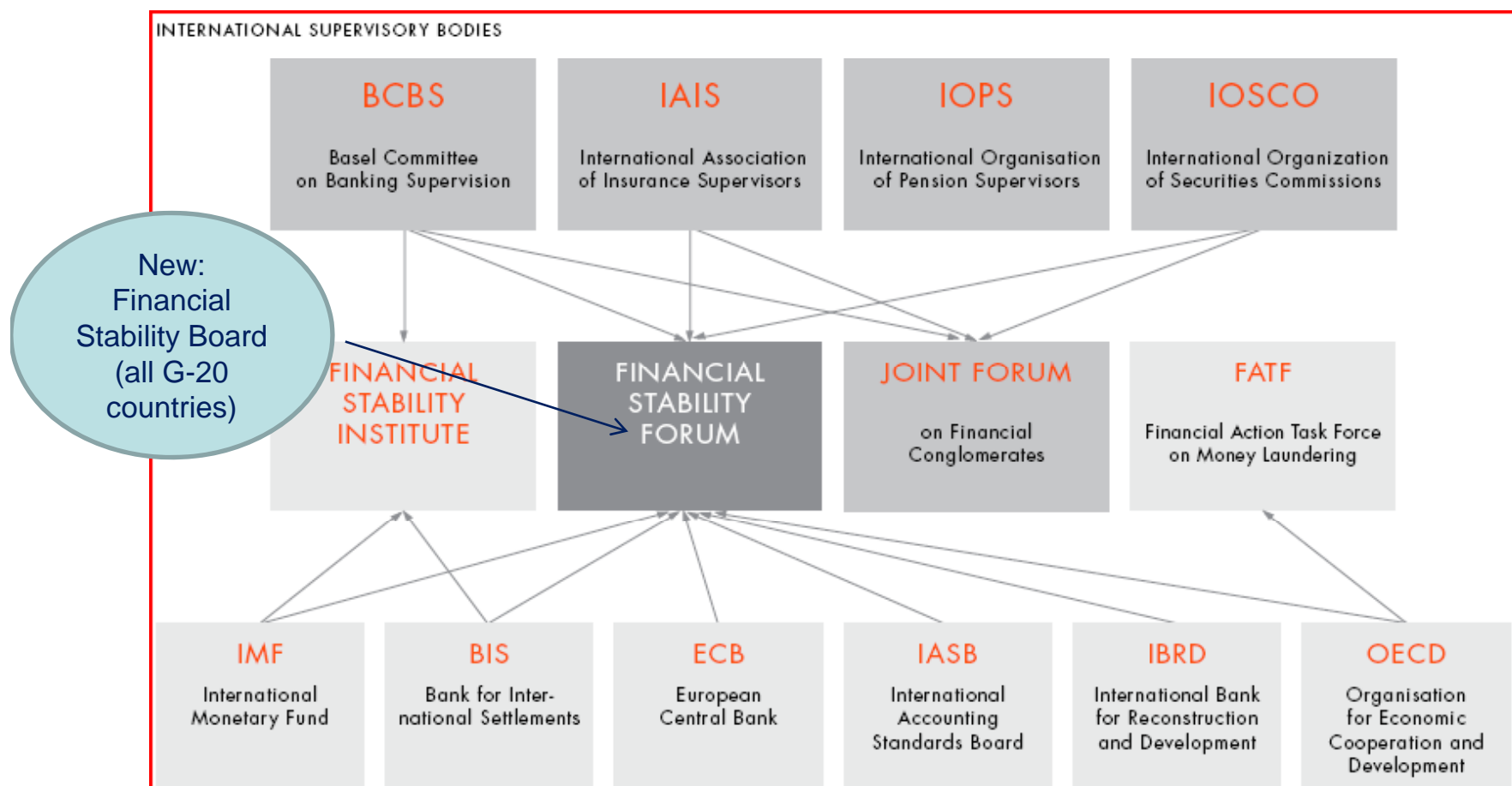
Single Rule Book

- This does not mean uniform rules regardless of specific national circumstances. The necessary differentiation according to national or product circumstances should be encompassed. But simultaneously, the rule must make sure that same things are treated the same way.
- Areas are to be identified where national or other circumstances necessitate a more stringent treatment.
- The Commission has proposed that the European Banking Authority (EBA) should develop draft technical standards on Pillar 2 of the Basel/CRD framework.
- The Commission still “considers that the respective preferential prudential treatment of exposures secured by real estate property should be harmonised (e.g. introducing a “hard test” when waiving the independence criterion for the preferential treatment of exposures secured by mortgages on residential property).



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APPENDIX: International Supervisory Bodies



Source: Austrian Financial Market Authority (See Ref. No. 11)

References

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4. BIS: *Strengthening the Resilience of the Banking Sector*; December 2009
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10. European Commission: *Commission Services Staff Working Document, Possible Further Changes to the Capital Requirements Directive*; February 2010
11. Austrian Financial Market Authority: http://www.fma.gv.at/JBInteraktiv/2006/EN/dl/e_Fig_1.pdf



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Further information may be found at: www.icffr.org.



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