Great expectations, predictable outcomes and the G20's response to the recent global financial crisis

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Great Expectations, Predictable Outcomes and the G20's Response to the Recent Global Financial Crisis: When Matters Relating to Liquidity Risks Become Equally as Important as Measures Addressing Pro cyclicality.

ABSTRACT

The meeting of the Governors and Heads of Supervision on the 12 September 2010, their decisions in relation to the new capital framework known as Basel III, as well as the endorsement of the agreements reached on the 26 July 2010, once again, reflect the typical situation where great expectations with rather unequivocal, and in a sense, disappointing results are delivered. The outcome of various consultations by the Basel Committee on Banking Supervision, consultations which culminated in the present Basel III framework, also reflect the focus on measures aimed at addressing problems attributed to Basel II, that is, measures aimed at mitigating pro cyclicality. This is rather astonishing given one critical lesson which has been drawn from the recent Financial Crisis: namely, that capital measures on their own, were and are insufficient in addressing and averting the Financial Crisis. Furthermore, banks which have been complying with capital adequacy requirements could still face severe liquidity problems.

As well as an increase of the minimum common equity requirement from 2% to 4.5%, the recent agreement and decisions of the Governors and Heads of Supervision also include the stipulation that banks hold a capital conservation buffer of 2.5% - hence consolidating the stronger definition of capital (as agreed in the previous meeting held by the Governors and Heads of Supervision earlier in July 2010).

Key Words: Pro cyclicality, liquidity, capital, Basel III, countercyclical, forward looking provisioning, financial regulation, financial crises.

This paper considers and highlights why matters related to pro cyclicality and capital measures should not constitute the sole focus of attention of the G20's initiatives. In so doing , it kicks off with a section which introduces the topic "pro cyclicality", a subsequent section which is aimed at highlighting the importance of liquidity risks, and a third section which highlights the degree of prominence that the G20[1] has accorded to these respective issues: namely pro cyclicality and liquidity risks. Having considered these aims, the paper finalises with a concluding section.

I. Pro cyclicality

Pro cyclicality is a term used to denote the tendency for periods of financial/economic downturns or booms to be further exacerbated by certain economic policies.

An example of a "fundamental" source of pro cyclicality as provided by the Committee of the European Banking Supervisors(CEBS),[2] is attributed to "excessive risk-taking during periods of expansion, which results in the build up of vulnerabilities".

Recommendations Put Forward and Highlighted as Means of Addressing Pro cyclicality

The Basel Committee has proposed the building up of buffers aimed at addressing and mitigating pro cyclical effects through a combination of counter cyclical capital charges, forward-looking provisioning and capital conservation measures.

The promotion of financial stability through more risk sensitive capital requirements, constitutes one of Basel II's primary objectives.[3] However some problems identified with Basel II are attributed to pro cyclicality and to the fact that not all material credit risks in the trading book are adequately

1 The Group of 20 (Finance Ministers and Central Bank Governors) works and collaborates with international bodies such as the Financial Stability Board and the Basel Committee on Banking Supervision.

2 Furthermore, the CEBS defines pro cyclicality as comprising "mechanisms through which the financial system can amplify business fluctuations that are particularly disruptive during an economic downturn or when the financial system is faced with pressures." See Committee of European Banking Supervisors, "Position Paper on a Counter Cyclical Capital Buffer" July 2009 at page 34

3 For further objectives, see , Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies. < http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf > at page 22 of 47

accounted for in the current capital requirements.[4] The pro cyclical nature of Basel II has been criticised since "capital requirements for credit risk as a probability of default of an exposure decreases in the economic upswing and increases during the downturn"[5] – hence resulting in capital requirements which fluctuate over the cycle. Other identified[6] consequential effects include the fact that fluctuations in such capital requirements may result in credit institutions raising their capital during periods when its is costly[7] for them to implement such a rise – which has the potential of inducing banks to cut back on their lending. It is concluded that "risk sensitive capital requirements should have pro cyclical effects principally on undercapitalised banks."[8]

Regulators will be able to manage systemic risks to the financial system during such periods when firms which are highly leveraged become reluctant to lend where more market participants such as credit rating agencies, could be engaged in the supervisory process. The Annex to Pro cyclicality in the Accompanying Document amending the Capital Requirements Directive[9] not only importantly emphasises the fact that regulatory capital requirements do not constitute the sole determinants of how much capital banks should hold, but also highlights the role of credit rating agencies in compelling banks to increase their capital levels even where such institution may be complying with regulatory requirements.

Even though the implementation of higher levels of capital buffers could serve as a means for the management of systemic risks, liquidity requirements have also been acknowledged by many as having a fundamental role to play in mitigating contagion – hence assuming a role which is similar to that of capital buffers. The link between counter cyclical buffers, capital and liquidity standards is further demonstrated through the impact which is generated as a result of the implementation of capital and liquidity standards. Counter cyclical buffer schemes could serve as means of enhancing

4 See ibid at page 23 of 47

5 See Annex on Proc cyclicality, Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies. < http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf> at page 46 of 47

6 As identified in the Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies. See page 46 of 47

7 Liquidity, a topic which will be addressed in the second section of this paper, is also considered to be "highly pro cyclical, growing in good times and drying up in times of stress." During the build up to the present crisis, banks and other financial institutions had an incentive to minimise the cost of holding liquidity. See Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System "Measuring and Funding Liquidity Risk" at page 24 http://www.financialstabilityboard.org/publications/r_0904a.pdf

8 See "Is Basel II Pro Cyclical? A Selected Review of the Literature" Financial Stability Review December 2009 at page 150

9 Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies.< http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf> See page 46 of 47

the following effects which are generated by higher capital and liquidity standards, namely:[10]

- Making the financial system more resilient and:
- Reducing the amplitude of the business cycles within the financial system.

The association between systemic risks and liquidity risks and the rather apparent lack of due recognition accorded to liquidity risks under Basel II, constituted other reasons (apart from pro cyclicality) for the growing criticism of Basel II.

II. Liquidity Risk

The definition of liquidity, as provided by the Bank of International Settlements (BIS), is "the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole."[11]

In their report on "Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk", the Financial Stability Forum (FSF) noted that at the onset of the recent financial crises, the complex response of financial institutions to deteriorating market conditions, was to a large extent, attributed to liquidity shortfalls which reflected "on and off balance sheet maturity mismatches and excessive levels of leverage."[12] This has resulted in an "increasingly important role for liquidity provided by central banks in the funding of bank balance sheets."[13] Furthermore, the FSF highlighted the urgency of both authorities, namely, supervisors (in their monitoring of liquidity risks at banks) and central banks (in their design and implementation of market operations) collaborating in order to " restore the functioning of inter bank lending markets."[14]

As identified in the ECB's Financial Stability Review, "the specific knowledge that banks possess

10 See Basel Committee on Banking Supervision, "An Assessment of the Long Term Economic Impact of Stronger Capital and Liquidity Requirements" Bank for International Settlements Publications August 2010 at page 5 <http://www.bis.org/publ/bcbs173.pdf?noframes=1>

11 Principles for Sound Liquidity Risk Management and Supervision Sept 2008 at page 1 <http://www.bis.org/publ/bcbs144.htm>

12 Report of the Financial Stability Forum on "Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk" http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

13 ibid

14 „In order to counter the transfer of funding liquidity risk by systemically important financial institutions to the public sector" ;ibid

about their borrowers make bank loans particularly illiquid."[15] The connection between liquidity and systemic risks is further highlighted in the Review where it elaborates on possible consequences resulting from a bank's failure, namely:[16] The "destruction" of such specific knowledge which banks have about their borrowers and the reduction of "the common pool of liquidity."[17] Such reduction in the common pool of liquidity may also trigger the failure of other banks – with the result that i) the value of such illiquid bank assets diminishes and ii) further problems within the banking systems are aggravated.[18]

"Endogenous risks" could also be generated depending on the type of information which the bank possesses about their borrowers and how the dissipation of such information to the public, if it has the potential to trigger a bank run, can be prevented.

According Greater Attention to Liquidity Risks

In February 2008, the Basel Committee on Banking Supervision published a paper titled "Liquidity Risk Management and Supervisory Challenges", a paper which highlighted the fact that many banks had ignored the application of a number of basic principles of liquidity risk management during periods of abundant liquidity.[19]

An extensive review of its 2000 "Sound Practices for Managing Liquidity in Banking Organisations" was also carried out by the Basel Committee as a means of addressing matters and issues arising from the financial markets and lessons from the Financial Crises.[20]

In order to consolidate on the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008, which should lead to improved management and supervision of liquidity risks of individual banks, supervisory bodies will be required "to develop tools and policies to address the pro cyclical behaviour of liquidity at the aggregate level".[21]

In responding to the apparent gaps which exist with Basel II – as revealed by the recent crises,

15 "The Concept of Systemic Risk" Financial Stability Review December 2009 http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?a3fef6891f874a3bd40cd00aef38c64f at page 137
16 ibid
17 ibid
18 ibid
19 Principles for Sound Liquidity Risk Management and Supervision Sept 2008 <http://www.bis.org/publ/bcbs144.htm>
20 ibid
21 See Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk" http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

proposals which are aimed at imposing penalties for the occurrence of maturity mismatches[22] have been put forward.[23] The degree of disparity which exists between the maturity of assets and liabilities is crucial to determining the state of a company's liquidity. Such penalties aimed at deterring the occurrence of maturity mismatches could include "higher capital requirements for banks which finance their assets with overnight borrowing from the money markets than banks which finance similar assets with term deposits."[24]

The inability of bank capital, on its own, to address funding and liquidity problems has been acknowledged by many academics. As a result, further proposals, in addition to the above mentioned amendment to Basel II, have been put forward. These include the coupling of the existing regulatory framework with capital insurance or liquidity insurance mechanisms.

III. Mitigating the Procyclical Effects of Basel II

Basel III and Recent Efforts to Address Pro Cyclical Effects of Basel II

In response to the recent Financial Crisis and to the realisation that capital levels (which banks operated with) during the period of the Crisis were insufficient and also lacking in quality,[25] the Basel Committee responded by raising the quality of capital – as well as its level.[26]

Further consequences of the recent Basel reforms also include:[27]

A tightening of the definition of common equity
Limitation of what qualifies as Tier 1 capital
An introduction of a harmonised set of prudential filters
The enhancement of transparency and market discipline through new disclosure requirements."

The introduction of Basel II resulted in changes being made to the 1988 Basel Capital Accord to

22 A situation which could occur where an undertaking possesses more short term liabilities than short term asset. It could also occur where more assets are held (than liabilities) for medium and long term obligations.

23 See "Is Basel II Pro Cyclical? A Selected Review of the Literature" Financial Stability Review December 2009 at page 148 and particularly Brunnermeier et al whose proposal includes the requirement of greater capital, "not only against the risk of assets, but also against the risk of funding such assets."

24 Ibid at 148

25 "Such a lack in high quality capital resulted in the raised levels of capitals and de leveraging of trading books (by many banks) amidst the Crisis." See H Hannoun, „Towards a Global Financial Stability Framework" Bank for International Settlements Publications, page 10 of 26 <http://www.bis.org/speeches/sp100303.pdf>

26 see ibid at page 11

27 ibid

provide for a choice of three broad approaches to credit risk.[28] This was introduced into Basel II in view of the realisation that "the optimal balance may differ significantly across banks."[29] The increased focus on risk (and particularly credit risk), resulted from growing realisation of the importance of risk within the financial sector. The range of approaches to credit risk – as introduced under Basel II, and which also exists for market risk, consists of the standardised approach (which is the simplest of the three broad approaches), the internal ratings based (IRB) foundation approach and the IRB advanced approach.[30]

Under the standardised approach, regulatory capital requirements are more closely aligned and in harmony with the principal elements of banking risk – owing to the introduction of wider differentiated risk weights and a broader recognition of techniques which are applied in mitigating risk.[31]

However problems with Basel II internal credit risk models (which relate to the fact such banks' internal credit risk models were overly sensitive in their implementation[32] for the calculation of regulatory capital, and generated pro cyclical effects) were realised during the recent Financial Crisis – as particularly exemplified by the case of Northern Rock.

Do the recent Basel III efforts reflect a situation where some apparent lessons from the recent Financial Crisis have deliberately been ignored by the G20, or is it yet another case of typical summits which generate great expectations but fail to deliver the expected and correspondingly expected results?

IV. Conclusion

Whilst efforts taken by the Committee appear to have focussed on capital – as evidenced by its Consultative Document on Counter Cyclical Capital Buffer Proposal, more forward looking

28 See Basel Committee on Banking Supervision, Consultative Document Standard Approach to Credit Risk, Supporting Document to the New Basel Accord at page 1 January 2001 <http://www.bis.org/publ/bcbsca04.pdf>

29 ibid

30 ibid; see also Basel Committee on Banking Supervision, Consultative Document "The Internal Ratings Based Approach" Supporting Document to the New Basel Capital Accord" January 2001 Bank for International Settlements Publications <http://www.bis.org/publ/bcbsca05.pdf>

31 As a result, the standardised approach was intended to "generate capital ratios which were more aligned with the actual economic risks that banks are facing, compared to the 1988 Basel Accord – which should improve banks' incentives to enhance their risk measurement and management capabilities and which should also reduce incentives for regulatory capital arbitrage."
See Basel Committee on Banking Supervision, Consultative Document Standard Approach to Credit Risk, Supporting Document to the New Basel Accord at page 1 January 2001 <http://www.bis.org/publ/bcbsca04.pdf>

32 In their implementation to facilitate "the derivation of fundamental inputs for formulas which will determine the level of capital which large banks must retain."

provisions – as well as provisions which at are aimed at addressing losses and unforeseen problems attributed to "maturity transformation of short-term deposits into long term loans", would be greatly welcomed. To an extent, this move could address the problem attributed to liquidity risks.

Further, the Committee of European Banking Supervisors (CEBS) has acknowledged that tools which could be implemented as measures for mitigating cyclicality, exist beyond those measures proposed by the Basel Committee. As a result, it has taken up initiatives in relation to measures such as dynamic provisioning and supplementary measures which include leverage ratios.[33]

Recent efforts aimed at addressing the Fianancial Crisis also include two new liquidity requirements, namely, the Liquidity Coverage Ratio and the Net Stable Funding Ratio (NSFR), respectively serve the purposes of "ensuring that banks have adequate funding liquidity to survive one month of difficult funding conditions (the LCR), and to address the mismatches between the maturity of a bank's assets and that of its liabilities (the NSFR)."[34] Whilst such liquidity requirements would help to address the critical issues arising as a result of maturity mismatches, the implementation of counter cyclical capital buffers – as well as these new liquidity requirements (LCR and NSFR) would be bolstered by introducing more forward looking provisions.

Despite the above liquidity- related efforts, the results and efforts relating to liquidity risks do not correspond to its overwhelming contribution to the recent Financial Crisis. Neither do they accord justice to its significance. The G20's response to recent Crisis could also be regarded as a case aimed at appeasing the needs and demands of various jurisdictions – in relation to those who had favoured tougher rules and those who had appealed for not too stringent rules. Whilst such tendency to appease the needs of different jurisdictions may serve as a formidable weapon in achieving the goal of regulatory convergence, it may also serve as a hindrance in the realisation of the all importance objective of deterring regulatory arbitrage.

Furthermore, given the urgency of addressing liquidity risks and maturity mismatches, the transition periods for implementing the two new liquidity requirements are questionable – even though as with capital, consideration is to be had to the impact of limited transition periods.

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33 Committee of European Banking Supervisors, "Position Paper on a Counter Cyclical Capital Buffer" July 2009 at page 2 http://www.c-ebs.org/getdoc/715bc0f9-7af9-47d9-98a8-778a4d20a880/CEBS-position-paper-on-a-countercyclical-capital-b.aspx

34 See Basel Committee on Banking Supervision, "An Assessment of the Long Term Economic Impact of Stronger Capital and Liquidity Requirements" Bank for International Settlements Publications August 2010 at page 7 <http://www.bis.org/publ/bcbs173.pdf?noframes=1>