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BASEL III – Responses to consultative documents, vital aspects of the consultative processes and the journey culminating in the present framework

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ABSTRACT

This paper is aimed at providing a comprehensive overview of, and responses to, four very vital components of the consultative processes which have contributed to the new framework known as Basel III. The paper will approach these components in the order of the consultative processes, namely, the capital proposals, the liquidity proposals and the Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability. The capital proposals comprise proposals aimed at strengthening the resilience of the banking sector, the proposal relating to international framework for liquidity risk measurement, standards and monitoring and, the countercyclical capital buffer proposal.

Whilst the capital proposals have been welcomed, there has been growing realisation since the aftermath of the recent Financial Crises that banks which have been complying with capital adequacy requirements could still face severe liquidity problems.

As well as highlighting the importance of introducing counter cyclical capital buffers, the response to the countercyclical proposal draws attention to the need for greater focus on more forward looking provisions, as well as provisions which are aimed at addressing losses and unforeseen problems attributed to “maturity transformation of short-term deposits into long term loans.”

The Basel Committee’s consultative document on the “Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability” sets out a proposal aimed at “enhancing the entry criteria of regulatory capital to ensure that all regulatory capital instruments issued by banks are capable of absorbing losses in the event that a bank is unable to support itself in the private market.”

Amongst other issues addressed, the response to the consultative document highlights why the controlled winding down procedure also constitutes a means whereby losses could still be absorbed in the event that a bank is unable to support itself in the private market.

Key Words: Counter cyclical buffers, liquidity risks, pro cyclical, loan loss provisions, financial crises, bank, regulation, capital, insolvency; financial crises, moral hazard, Basel III.

BASEL III – Responses to Consultative Documents, Vital Aspects of the Consultative Processes and the Journey Culminating in the Present Framework

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Response to Consultative Document on Strengthening the Resilience of the Banking Sector: Proposals to Strengthen Global Capital and Liquidity Regulations

A. Introduction

The 1988 Basel Accord was adopted as a means of achieving two primary objectives namely:²

- „To help strengthen the soundness and stability of the international banking system. This would be facilitated where international banking organisations were encouraged to supplement their capital positions.
- To mitigate competitive inequalities“

The framework was not only oriented towards increasing the sensitivity of regulatory capital differences in risk profiles which exist within banking organisations, but was also aimed at discouraging the retention of liquid, low risk assets.³ Furthermore, it was designed to take into express consideration, off balance sheet exposures when assessments of capital adequacy are undertaken.⁴

Ten years following the conclusion of the agreement on the 1988 Accord, a Working Party was established to evaluate the impact and achievements of the Basel Accord. Two principal issues which were taken into consideration by the Working Party were:⁵ Firstly, whether some banks have been encouraged to hold higher capital ratios than would have been the case if the adoption of fixed minimum capital requirements had not occurred and, whether an increase in capital or reduction of lending has resulted in any increase in ratios. Secondly, an evaluation of the impact of fixed capital requirements on reduced risk taking by banks, in relation to capital, was also to be undertaken.

In response to the first issue, relating to whether an introduction of fixed minimum capital requirements has led to banks maintaining higher capital ratios, some studies which were undertaken, revealed that capital standards, when strictly adhered to, compelled weakly capitalised banks to consolidate their capital ratios.⁶ In response to whether banks adjusted their capital ratios to comply with requirements through an increase in capital or a reduction of risk-weighted assets, research revealed that banks responded to pressures stemming from capital ratios, in a way which they perceived to be most cost effective.⁷ Results obtained in response to an evaluation of the impact of capital requirements on risk taking were inconclusive.⁸ The data available for purposes of measuring bank risk taking, were not only limited, but also complicated the task of making an

²„Capital Requirements and Bank Behaviour: The Impact of the Basle Accord“ Basle Committee on Banking Supervision Working Papers No 1 April 1999 at page 1 < http://www.bis.org/publ/bcbs_wp1.pdf?noframes=1>

³ibid

⁴ibid

⁵ibid

⁶Ibid at page 2

⁷Ibid at page 3

⁸ibid

evaluation thereof.⁹

Other issues which were difficult to evaluate included whether an introduction of minimum capital requirements for banks were detrimental to their competitiveness and whether the Basel Accord facilitated competitive inequalities amongst banks.¹⁰ These evaluative difficulties, respectively, were attributed firstly, to the fact that “long term competitiveness of banking” depends on a variety of factors – most of which are not connected to regulation and secondly, to the available evidence at the time – which was inconclusive – and hence, not sufficiently persuasive.¹¹

I. Amendments to the 1988 Accord

The First Consultative Paper – The Three Pillar Model

In June 1999, as a means of replacing the 1988 Basel Accord, the first consultative paper (on a new capital adequacy framework) was issued by the Basel Committee on Banking Supervision. The First Consultative Paper introduced the “three pillar” model which comprises of “the minimum capital requirements” – that attempt to consolidate the rules established in the 1988 Accord, “supervisory review” and “market discipline” – “as a lever to strengthen disclosure and encourage safe and sound banking practices”.¹² Whilst acknowledging that the 1988 Accord had “helped to strengthen the soundness and stability of the international banking system and enhanced competitive equality among internationally active banks”, it was added that the new framework provided by the first consultative paper was “designed to better align regulatory capital requirements to underlying risks and to recognise the improvements to risk measurement¹³ and control.”

One of the flaws inherent in the 1988 Basel Accord was namely, the fact that it rewarded risky lending since it required banks to set aside the same amount of capital against loans to shaky borrowers as against those with better credits.¹⁴ Apart from the fact that capital requirements were just reasonably related to bank’s risk taking, the credit exposure requirement was the same regardless of the credit rating of the borrower.¹⁵ Furthermore, the capital requirement for credit exposure often depended on the exposure’s legal form – for instance, an on-balance sheet loan was generally subject to a higher capital requirement than an off-balance sheet to the same borrower.¹⁶ In addition to such insensitivity to risk, another problem which resulted from Basel 2 was the unwillingness of banks to invest in better risk management systems.

II. Capital Arbitrage

A general criticism of Basel I relates to the fact that it promoted capital arbitrage. This is attributed to its wide risk categories which provide banks with the liberty to “arbitrage between their

⁹ibid

¹⁰Ibid at page 4

¹¹Ibid at pages 4 and 5

¹²See „Consultative Paper on a New Capital Adequacy Framework“ June 1999 <<http://www.bis.org/press/p990603.htm>>

¹³See remarks of the chairman of the Task Force on the Future of Capital regulation; ibid

¹⁴„Basle bust“ *The Economist* April 13th 2000

¹⁵M Saidenberg and T Schuermann, „The New Basel Capital Accord and Questions for Research (2003) Wharton Financial Institutions Center Working Paper 2003 at page 4

¹⁶ibid

economic assessment of risk and the regulatory capital requirements.”¹⁷ “Regulatory capital arbitrage” involves the practice by banks of “using securitisation to alter the profile of their book and may produce the effect of making the bank’s capital ratios appear inflated.”¹⁸ Such a practice justifies the extension of regulation to the securities markets – rather than being merely confined to the field of banking.

Four principal types of identified capital arbitrage include:¹⁹ cherry picking, securitisation with partial recourse, remote origination and indirect credit.

III. Basel II

Some of the key factors which instigated the introduction of Basel 2 include:²⁰

- „Changes in the structure of capital markets – resulting in the need for the incorporation of increased competitiveness of credit markets in capital requirements
- The need for measures which would facilitate the eradication of inefficiencies in lending markets
- Explosive debt levels which were generated during the economic upturn.“

Under Basel II, and in response to the fact that the measurement of minimum capital was previously based on a general assessment of risk dispersion which did not correspond to specific circumstances of individual institutions, credit institutions will be required to retain more capital if required. Under Pillar 1, the definition of capital and minimum capital coefficient remain unchanged – however, credit institutions will be required to retain more capital if their individual risk situation so demands.²¹ Further advancements under Basel II are illustrated in the areas of risk measurements. The measurement methods for credit risk are more sophisticated than was previously the case. For the first time, a means of measuring operational risk has been set out.²² Under Pillar One, credit and market risk are supplemented by operational risk – which is to be corroborated by capital.²³

B. Basel Committee's Proposals to Strengthen Global Capital and Liquidity Regulations

I. Objectives of the Basel Committee's Proposals to Strengthen Global Capital and Liquidity Regulations²⁴

- “As well as strengthening global capital and liquidity regulations (which would ultimately

¹⁷Capital Requirements and Bank Behaviour: The Impact of the Basel Accord’ Basel Committee on Banking Supervision Working Papers April 1999 at page 21

¹⁸ibid; Bank’s capital ratio may appear inflated “relative to the riskiness of the remaining exposure”, see ibid

¹⁹See ibid at pages 22-24

²⁰See A Saunders and L Allen, *Credit Risk Measurement: New Approaches to Value at Risk and Other Paradigms* (2002) Second Edition Wiley Publishers at page 24

²¹See ‘Basel II: Minimum Capital Requirements’

http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_basel_saeule1.en.php

²²ibid

²³ibid

²⁴See Basel Committee on Banking Supervision, 'Strengthening the Resilience of the Banking Sector' Consultative Document, Bank for International Settlements Publications December 2009 at page 1

facilitate a more resilient banking sector), the Basel Committee's reforms are aimed towards improving the banking sector's ability to absorb shocks arising from financial and economic stress – hence mitigating spill over risks from the financial sector to the real economy.

- The Committee is also striving towards the improvement of risk management and governance as well as strengthen banks' transparency and disclosures. “

II. Key elements of the Basel Committee's proposals

- 1) The quality, consistency, and transparency of capital base will be raised to ensure that large, internationally active banks are in a better position to absorb losses on both a going concern and gone concern basis. (For example, under the current Basel Committee standard, banks could hold as little as 2% common equity to risk-based assets, before the application of key regulatory adjustments).

- As well as recommending an increase in the quality, consistency and transparency of capital base²⁵, the Basel Committee's recognition of the fact that “insufficient detail on the components of capital”²⁶ render “accurate assessment of its quality or a meaning comparison with other banks difficult”, infers its acknowledgement of the importance attributed to enhanced disclosures. Furthermore, the increased importance attached to the role of central counter parties in efforts aimed at reducing systemic risks should also facilitate the process of achieving greater and more enhanced disclosures.

- 2) The risk coverage of the capital framework will be strengthened. In addition to the trading book and securitisation reforms announced in July 2009, the Committee proposes the consolidation of the capital requirements for counterparty credit risk exposures arising from derivatives and securities financing activities. These enhancements are aimed at strengthening the resilience of individual banking institutions and reducing the risk of shocks being transmitted from one institution to another through the derivatives and financing channel. Consolidated counterparty capital requirements should increase incentives to transfer OTC derivative exposures to central counterparties and exchanges.

However there is also a limit to what the capital framework could address. As highlighted by the recent crisis, capital requirements on their own, were insufficient in addressing liquidity and funding problems which arose during the crisis. The importance of enhanced disclosures is also reflected and embodied within the Committee's second objective in relation to its proposal to strengthen the resilience of the banking sector, that is, its endeavours “to improve risk management and governance as well as strengthen banks' transparency and disclosures.”

As a result of the inability of bank capital adequacy requirements, on their own, to address funding and liquidity problems²⁷, the need to focus on Pillar 3 of Basel II, namely, market discipline, is becoming more apparent. There is growing justification for greater measures aimed at extending capital rules to the securities markets. This not only arises from increased conglomeration and globalisation – which increases risks attributed to systemic contagion, but also the fact that „the globalisation of financial markets has made it possible for investors and capital seeking companies to switch to lightly regulated or completely unregulated markets.“²⁸ Furthermore, it is not only

²⁵ See first key element of the proposals being issued by the Basel Committee.

²⁶ See Consultative Document of the Basel Committee for Banking Supervision, “Strengthening the Resilience of the Banking Sector” December 2009 at page 13

²⁷ See M Ojo, 'Extending the Scope of Prudential Supervision: Regulatory Developments During and Beyond the 'Effective' Periods of the Post BCCI and the Capital Requirements Directives', Journal of Advanced Research in Law and Economics July 2010.

²⁸ See Deutsche Bundesbank, „Securities Market Regulation: International Approaches“ Deutsche Bundesbank Monthly Report January 2006 at page 41

argued that „the fact that many banks in a number of countries have chosen to securitise assets is probably largely due to the capital requirements imposed on them“, but also that present rules do not „explicitly cover risks other than credit and market risk“.²⁹

The engagement of market participants in the corporate reporting process, a process which would consequently enhance market discipline, constitutes a fundamental means whereby greater measures aimed at facilitating prudential supervision, could be extended to the securities markets. Through Pillar 3, market participants like credit agencies can determine the levels of capital retained by banks – hence their potential to rectify or exacerbate pro cyclical effects resulting from Pillars 1 and 2. The challenges encountered by Pillars 1 and 2 in addressing credit risk is reflected by problems identified with pro cyclicality, which are attributed to banks’ extremely sensitive internal credit risk models, and the level of capital buffers which should be retained under Pillar Two. Such issues justify the need to give greater prominence to Pillar 3.

As a result of the influence and potential of market participants in determining capital levels, such market participants are able to assist regulators in managing more effectively, the impact of systemic risks which occur when lending criteria is tightened owing to Basel II's procyclical effects. Regulators are able to respond and to manage with greater efficiency, systemic risks to the financial system during periods when firms which are highly leveraged become reluctant to lend. This being particularly the case when such firms decide to cut back on lending activities, and the decisions of such firms cannot be justified in situations where such firms’ credit risk models are extremely sensitive – hence the level of capital being retained is actually much higher than minimum regulatory Basel capital requirements.³⁰

The European Central Bank’s report on “Credit Default Swaps and Counter Party Risk” identifies asymmetrical information as constituting a challenge for non-dealer market participants since in its view, price information is currently limited, as dealer prices are typically set on a bilateral basis and are not available to non-dealers.³¹ Furthermore, the Report also identifies the role played by credit default swaps in the recent financial crises, highlights the contribution of counter risk management in the collapse of Bear Stearns and Lehman Brothers, and also the challenges relating to the management of counter party risk exposures which arise from Credit Default Swaps (CDSs) and other (“over the counter”)OTC derivatives.³²

Furthermore, the ECB recently highlighted that “no disclosure requirements currently exist within the IASB accounting standards with respect to the main counterparties for derivative transactions.” It also states that “added disclosures for large counter parties and those that exceed certain thresholds would be useful in order to enable market participants to better assess their counterparty³³ risk and the potential for systemic spill over effects.”

- 3) The Basel Committee will introduce a leverage ratio as a supplementary measure to the Basel II risk based framework with a view to changing to a Pillar 1 treatment based on appropriate review and calibration. This should help to contain the build up of excessive leverage in the banking system, introduce additional safeguards against attempts to “game”

²⁹Regulation, it is further argued, „may also impact on the relationship between banks and the securities market as a source of finance. So long as the banks are required to set aside 8% capital for loans to the financially soundest companies, direct borrowing in securities markets will probably be a cheaper form of funding for these companies“. See „Basel Committee’s Proposal for a New Capital Adequacy Framework“http://www.norges-bank.no/templates/article_15120.aspx For further information on this see M Ojo, „The Impact of Capital and Disclosure Requirements on Risks and Risk Taking Incentives“ (2010)

³⁰For further information on this, see M Ojo, ' Basel II and the Capital Requirements Directive: Responding to the 2008/09 Financial Crisis' (2009) <http://ssrn.com/abstract=1475189>

³¹ „Credit Default Swaps and Counter Party Risk“ European Central Bank 2009 at page 62

³² ibid at page 36

³³Private sector financial institutions

the risk based requirements, and help address model risk. In order to ensure comparability, the details of the leverage ratio are to be harmonised internationally. – making full adjustments for residual accounting differences.

- 4) The Committee will introduce a series of measures aimed at promoting the build up of capital buffers during good times – which could be drawn upon during periods of stress. A counter cyclical capital framework will contribute to a more stable banking system which will help dampen, instead of amplify, economic and financial shocks. In addition the Committee will be promoting a more forward looking provisioning which is based on expected losses, and which captures actual losses with greater transparency and which is also less pro cyclical than the present model (the “incurred loss” provisioning model).

As was highlighted under the introductory section, the promotion of financial stability through more risk sensitive capital requirements, constitutes one of Basel II’s primary objectives.³⁴ 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 accounted for in the current capital requirements.³⁵ 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”³⁶ – hence resulting in capital requirements which fluctuate over the cycle. Other identified³⁷ 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 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.”³⁸

According to the Financial Stability Forum (FSF), an earlier recognition of loan losses, which could have been facilitated by relevant disclosures about loan loss provisioning, could have reduced pro cyclical effects which occurred during the recent crisis.³⁹ Not only does the FSF propose that amendments be made to the Basel II framework - amendments which are aimed at reducing banks’ disincentives to increase their level of provisions for loan losses, it is also of the opinion that measures aimed at improving market discipline could also help in reducing procyclicality and diversity.⁴⁰ Furthermore, incentives which would encourage banks to retain liquidity could be introduced – however , such incentives should be granted whilst striving to comply with the aims and objectives of Basel – particularly those aimed at enhancing a regulatory framework which is more aligned with economic and regulatory capital. As acknowledged by the Basel Committee, „certain incentives which assume the form of capital reductions are considered to impose minimum operational standards in recognition that poor management of operational risks (including legal risks) could render such risk mitigants of effectively little or no value and that although partial mitigation is rewarded, banks will be required to hold capital against residual risks”. Hence incentives should also adequately account for situations where poor management systems may

³⁴For 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

³⁵See *ibid* at page 23 of 47

³⁶See 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

³⁷As 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

³⁸See “Is Basel II Pro Cyclical? A Selected Review of the Literature” Financial Stability Review December 2009 at page 150

³⁹Report of the Financial Stability Forum on “Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk” at pages 20 and 22

⁴⁰*ibid* at pages 21 and 22

operate in institutions which are supposed to have risk mitigants.

As well as drawing attention to the fact that capital buffers may not actually mitigate the cyclical effects of bank regulation,⁴¹ regulators are also advised to give due consideration to the effects of risk weights on bank portfolio behaviour when implementing regulations.

- 5) As its fifth proposal, a global minimum liquidity standard for internationally active banks is to be introduced by the Committee. This will include a 30 day liquidity coverage ratio requirement which is underpinned by a longer term structural liquidity ratio. The framework will also incorporate a common set of monitoring metrics to assist supervisors in their analysis and identification of risk trends . both at the bank and system wide level. Such standards and monitoring metrics will serve to supplement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision.

III. Other points highlighted by the Committee

- The review of the need for additional capital, liquidity or other supervisory measures aimed at reducing externalities generated by systemically important institutions.
- Recognition that severity of the economic and financial crisis is attributed to the fact that excessive on- and off-balance sheet leverage had been accumulated by banking sectors of many countries whilst many banks were retaining insufficient liquidity buffers. Consequences resulting from this include the inability of the banking system to absorb the resulting systemic trading and credit losses . Further, the banking system was unable to manage the "re intermediation" of large off balance exposures which had accumulated.
- Aggravation of the crisis owing to pro cyclical effects and the interconnectedness of systemic institutions – such interconnectedness being triggered by a range of complex transactions.

Systemic risks and the central role assumed by banks in relation to liquidity serves as greater justification for regulation with respect to banks. "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."⁴²

In relation to the securities markets, information asymmetry appears to constitute a greater basis for regulation. However, the existence of information asymmetry within the banking⁴³sector has the potential to generate systemic effects within the banking sector – consequences whose effects, it could be said, could have greater repercussions than if such were to originate from within the securities markets.

⁴¹See P Agénor and L Pereira da Silva , „Cyclical Effects of Bank Capital Requirements with Imperfect Credit Markets“ World Bank Policy Research Paper 5067 at page 36.They illustrate through their model that capital buffers, by lowering deposit rates, are actually expansionary and that hence, “if capital buffers are increased during an expansion, with the initial objective of being countercyclical, they may actually turn out to be procyclical.” This, in their opinion, is an important conclusion, given the prevailing view that “countercyclical regulatory requirements may be a way to reduce the build up of systemic risks:if the signaling effects of capital buffers are important, “leaning against the wind” may not reduce the amplitude of the financial-business cycle.” For more information on this, also see M Ojo, „The Impact of Capital and Disclosure Requirements on Risks and Risk Taking Incentives“ (2010)

⁴²Report of the Financial Stability Forum on “Addressing Pro cyclical in the Financial System: Measuring and Funding Liquidity Risk” http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

⁴³ According to the Bundesbank, „the economics of information, which is widely applicable to the financial markets, therefore eases the rigorous assumptions about information requirements and market perfection.“ See Deutsche Bundesbank , „Securities Market Regulation: International Approaches“ Deutsche Bundesbank Monthly Report January 2006 at page 36

The link between liquidity and systemic risks as illustrated in the ECB's Financial Stability Review, is attributed to the "destruction of specific knowledge⁴⁴ which banks have about their borrowers and the reduction of the common pool of liquidity."⁴⁵ The importance of the link between liquidity risks and systemic risks within the banking sector is highlighted by the consequences attributed to the reluctance of banks to retain liquidity - given the cost of holding liquidity.⁴⁶ The consequential shortfalls of liquidity as reflected by on and off balance sheet maturity mismatches accentuates the importance of the role assumed by central banks in the funding of bank balance sheets.⁴⁷

1. Mitigating the Procyclical Effects of Basel II

According to a report,⁴⁸ the two principal solutions which have been endorsed by the Turner Review and the DeLarosiere Report, and which are considered to have the potential to reduce pro cyclical effects⁴⁹ induced by the CRD and Basel II, include: 1) The requirement that banks "hold bigger reserves during good times - hence limiting credit and risk expansion in good times and storing up capital to be used during bad times" (2) "Increasing risk-weighting on a range of assets because this also restricts balance sheet expansion".

Another proposal put forward as an optimal means of rectifying Basel II's procyclical effects – as illustrated through the "amplification of business cycle fluctuations", involves the utilisation of a "business cycle multiplier of the Basel II capital requirements that is increasing in the rate of growth of the GDP". Under such a scheme, it is argued, riskier "banks would face higher capital requirements without regulation exacerbating credit bubbles and crunches."⁵⁰

Other mechanisms provided under the CRD as means of mitigating pro cyclicity within the capital requirements framework include:⁵¹

- The use of downturn Loss Given Default (LGD) estimates, PD estimates being based on long data series, technical adjustments made to the risk weight function, stress testing requirements and Pillar 2 supervisory review process. It is acknowledged, however, that more measures may be required to mitigate the procyclical effects of the capital requirements framework. Options provided include those aimed at reducing its cyclical risk

⁴⁴Since specific knowledge which banks possess about their borrowers is considered to be a factor which determines the illiquidity of bank loans; see "The Concept of Systemic Risk" ECB Financial Stability Review December 2009 at page 137 <<http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?05d3164914c6a14bb135222b5c3894fa>>

⁴⁵ibid; According to the Review, the reduction in the common pool of liquidity also has the potential to trigger the failure of banks and could consequently lead to a devaluation of illiquid bank assets and further aggravation of problems within the banking sector.

⁴⁶Report of the Financial Stability Forum on "Addressing Pro cyclicity in the Financial System: Measuring and Funding Liquidity Risk" http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

⁴⁷ibid

⁴⁸The Turner Review :Key Elements of the Turner Review (page 2 of 4) <<http://www.dlapiper.com>>

⁴⁹Exacerbated strains on bank capital is the term used to denote procyclicality ; see ibid International Accounting Standards are also considered to have had a pro-cyclical impact. It is stated that "in particular moving to marking to market accounting, rather than the more traditional marking to maturity, exacerbated volatility in the accounts of banks – with valuation becoming practically impossible for some securities as the market in them disappeared."; ibid

⁵⁰R Repullo, J Saurina, and Carlos Trucharte, "How to Mitigate the Procyclical Effects of Capital Adequacy Rules" <<http://www.eurointelligence.com/article.581+M5ff0e4ba595.0.html>>

⁵¹See 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 http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf Page 46 of 47

sensitivity, measures which enhance its risk capture, and the intentional introduction of counter-cyclical buffers (comprising capital and/or provisions).

2. Financial Stability Forum Recommendations Aimed at Mitigating Procyclicality

In its report⁵² on “Addressing Procyclicality in the Financial System”, the Financial Stability Forum’s recommendations to mitigate mechanisms that amplify procyclicality was extended to three areas:⁵³

i) bank capital framework, ii) bank loan loss provisions as well as iii) leverage and valuation issues.

A summary of the recommendations relating to capital, as provided in the Report of the Financial Stability Forum is as follows.⁵⁴

- “That the Basel Committee on Banking Supervision (BCBS) should strengthen the regulatory capital framework so that the quality and level of capital in the banking system increase during strong economic conditions and can be drawn down during periods of economic and financial stress;
- That the BCBS should revise the market risk framework of Basel II to reduce the reliance on cyclical VAR-based capital estimates;
- The BCBS should supplement the risk-based capital requirement with a simple, non-risk based measure to help contain the build-up of leverage in the banking system and put a floor under the Basel II framework;
- Supervisors should use the Basel Committee's enhanced stress testing practices as a critical part of the Pillar 2 supervisory review process to validate the adequacy of banks’ capital buffers above the minimum regulatory capital requirement;”

“That the BCBS should monitor the impact of the Basel II framework and make appropriate adjustments to dampen excessive cyclicity of the minimum capital requirements;”

“That the BCBS carry out regular assessments of the risk coverage of the capital framework in relation to financial developments and banks’ evolving risk profiles and make timely enhancements.”

3. Risk Management and Governance

“Stress testing is an important risk management tool – particularly for counter party risk management.”⁵⁵

⁵² “Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System”
http://www.financialstabilityboard.org/publications/r_0904a.pdf

⁵³ 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 page 46 of 47

⁵⁴ See “Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System” at pages 2 and 3
http://www.financialstabilityboard.org/publications/r_0904a.pdf

⁵⁵ See Bank for International Settlements, Consultative Document „Strengthening the Resilience of the Banking Sector“ at page 48

According to the Basel Committee,⁵⁶ “ as public disclosure increases certainty in the market, improves transparency, facilitates valuation, and strengthens market discipline, it is important that banks publicly disclose information on a regular basis that enables market participants to make informed decisions about the soundness of their liquidity risk management framework and liquidity position.” The involvement of market participants in the process whereby the Committee strives to facilitate market discipline through the development of “a set of disclosure requirements which will allow such market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence capital adequacy of an institution”⁵⁷ constitutes a vital means whereby effective corporate governance could be facilitated.

Recent reports have revealed the lack of knowledge demonstrated by financial institutions in relation to risks involved when engaged with “businesses and structured credit products.”⁵⁸ The fact that banks “did not adhere to the fundamental tenets of sound financial judgement and prudent risk management” was also highlighted.⁵⁹

Greater efforts have been undertaken to involve market participants by encouraging them to assess a bank’s risk profile. Such proactive efforts are more desirable than “allowing markets to evolve and decide.”⁶⁰ As identified by the Basel Committee, “improvements in risk management must evolve to keep pace with rapid financial innovation.⁶¹ Furthermore, it states that “ this is particularly relevant for participants in evolving and rapidly growing businesses.⁶² Innovation has increased the complexity and potential illiquidity of structured credit products – which in turn, could make such products not only more difficult to value and hedge, but also lead to inadvertent increases in overall risk.”⁶³ “Further, the increased growth of complex investor specific products may result in thin markets that are illiquid – which could expose a bank to large losses in times of stress, if the associated risks are not well understood and managed in a timely and effective manner. Stress tests have been identified as means whereby investors’ uncertainty about the quality of bank balance sheets, could be eliminated.⁶⁴

The Committee's acknowledgement of negative incentives arising from the use of external ratings to determine regulatory capital requirements and proposals to mitigate these incentives ⁶⁵ is well - founded – however, regulators will also be able to manage, with greater ability, systemic risks to the financial system during such periods when firms which are highly leveraged become reluctant to

⁵⁶See Bank for International Settlements „Proposed Enhancements to the Basel II Framework: Revisions to Pillar 3“ (Market Discipline)“ Consultative Document , Basel Committee on Banking Supervision paragraph 73 at page 23

⁵⁷See „Enhancements to the Basel II Framework“ Basel Committee on Banking Supervision publications July 2009 at page 29 <http://www.bis.org/publ/bcbs157.pdf> and < <http://www.bis.org/publ/bcbs157.pdf?noframes=1>>

⁵⁸Ibid at page 10

⁵⁹ibid

⁶⁰See B Arrunada, “The Provision of Non Audit Services by Auditors: Let the Market Evolve and Decide” 1999 International Review of Law and Economics at page 13. According to Arrunada, regulators should not only focus on policies which would improve transparency of information – hence enhancing market incentives, but should strive towards fostering a greater level of competition. Markets, in his opinion, should be the “driving force behind the evolution of the industry” – since regulators are not well equipped with the necessary knowledge and proper incentives which are required for defining an efficient market framework.

⁶¹ See „Enhancements to the Basel II Framework“ Basel Committee on Banking Supervision publications July 2009 at page 12

⁶²ibid

⁶³ibid

⁶⁴See European Commission, “Economic Crisis in Europe: Causes, Consequences and Responses” Section 3.2.1’ Crisis Resolution Policies: Stress Testing of Banks”

<http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf> It is also highlighted in the report that stress tests could serve as “decisive tools in accomplishing this task since they provide information about banks’ resilience and ability to absorb possible shocks.”

⁶⁵ See Consultative Document of the Basel Committee for Banking Supervision, “Strengthening the Resilience of the Banking Sector” December 2009 at page 55

lend where more market participants such as credit rating agencies, could be engaged in the supervisory process.⁶⁶ The Annex to Pro cyclical in the Accompanying Document amending the Capital Requirements Directive⁶⁷ 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.

Further as rightly acknowledged by the Committee, “recent experience has shown that banks’ internal credit models have not performed well. Permitting banks to use their own internal models to estimate the capital requirements for securitisation exposures could increase pressure to permit the use of such models in Basel II more broadly. Thus, while there have been concerns expressed about the use of external ratings under the Basel II framework, including that reliance on external ratings could undermine incentives to conduct independent internal assessments of the credit quality of exposures, the removal of external ratings from the Basel II framework could raise additional issues for determining regulatory capital requirements.”⁶⁸

C. Conclusion

As well as the inability of bank capital adequacy requirements, on their own, to address funding and liquidity problems, the need for greater focus on Pillar 3 of Basel II, namely, market discipline, and growing justification for greater measures aimed at extending capital rules to the securities markets, are factors which are becoming more apparent.

Even though markets should be allowed to evolve, checks and controls should exist to ensure that such market activities are effectively managed and controlled. Management information systems (MIS) and banks’ credit risk models should be flexible (and not overly sensitive) in order to adapt to the evolving market whilst providing for some element of control. The Basel Committee furthermore, acknowledges the role assumed by management information systems and risk management processes in assisting the bank “to identify and aggregate similar risk exposures across the firm, including legal entities, and asset types (eg loans, derivatives and structured products).”⁶⁹

The operation of risk mitigants in bank institutions does not justify a reduction in the capital levels to be retained by such banks – since banks operating with risk mitigants could still be considered inefficient operators of their management information systems (MIS), internal control systems, and risk management processes. The fact that banks possess risk mitigants does not necessarily imply

⁶⁶See M Ojo, 'Extending the Scope of Prudential Supervision: Regulatory Developments During and Beyond the 'Effective' Periods of the Post BCCI and the Capital Requirements Directives' (January 2010), forthcoming in the Journal of Advanced Research in Law and Economics.

⁶⁷Accompanying 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

⁶⁸ See Consultative Document of the Basel Committee for Banking Supervision, “Strengthening the Resilience of the Banking Sector” December 2009 paragraph 185 at page 56; for further information on the strengths and weaknesses of banks’ internal credit models, also see M Ojo, 'The Responsive Approach by the Basel Committee (on Banking Supervision) to Regulation: Meta Risk Regulation, the Internal Ratings Based Approaches and the Advanced Measurement Approaches (2009)<http://mpira.ub.uni-muenchen.de/16752/> and <http://ssrn.com/abstract=1447446>

⁶⁹See „Enhancements to the Basel II Framework“ Basel Committee on Banking Supervision publications July 2009 paragraph 29 < <http://www.bis.org/publ/bcbs157.pdf?noframes=1> > at page 16. The Basel Committee attributes the increased likelihood that different sectors of a bank are exposed to a common set of products, risk factors or counter parties, to the growth of market based intermediation.

that they are complying with Basel Core Principles for effective supervision (particularly Core Principles 7 and 17). Core Principle 7 not only stipulates that “banks and banking groups satisfy supervisory requirements of a comprehensive management process, ensure that this identifies, evaluates, monitors and controls or mitigates all material risks and assesses their overall capital adequacy in relation to their risk profile, but that such processes correspond to the size and complexity of the institution.” Certain incentives which assume the form of capital reductions are considered by the Basel Committee to “impose minimum operational standards in recognition that poor management of operational risks (including legal risks) could render such risk mitigants of effectively little or no value and that although partial mitigation is rewarded, banks will be required to hold capital against residual risks”.

Information disclosure should be encouraged for several reasons, amongst which include the fact that imperfect information is considered to be a cause of market failure – which “reduces the maximisation potential of regulatory competition”, and also because disclosure requirements would contribute to the reduction of risks which could be generated when granting reduced capital level rewards to banks who may have poor management systems.

Response to Consultative Document – International Framework For Liquidity Risk Measurement, Standards and Monitoring

A. Introduction

The Basel Committee's recent focus is reflected through its goals of not only intensifying the “resilience of internationally active banks to liquidity stresses”, but also intensifying international harmonisation of liquidity risk supervision. These efforts are aimed at consolidating recent work which culminated in the issue of the Principles for Sound Liquidity Risk Management and Supervision.⁷⁰

As part of measures aimed at facilitating “further consolidation and promotion of consistency in international liquidity risk supervision”, and in response to the “inaccurate and ineffective management of liquidity risk” – such ineffective management being a prominent feature of the financial crisis, the Basel Committee has developed a minimum set of monitoring tools to be used in the “ongoing monitoring of the liquidity risk exposures of cross border institutions and in communicating these exposures amongst home and host supervisors.”⁷¹

This paper is structured in accordance with identified components which are considered to be essential to the successful implementation of the (two fold) topics of discussion of this paper, namely, monitoring and liquidity risk measurements. The importance of successfully communicating results obtained from monitoring and measuring such risks, and the role of corporate governance in ensuring such effective communication, constitutes a recurring theme throughout this paper. The identified components are as follows: i) Corporate governance (ii) Internal controls (iii) Disclosure (iv) Management of risk (v) Substance over form (vi) Transparency

As well as highlighting the interdependence of these components, the paper also aims to accentuate the importance of individual components. Whilst no hierarchy of importance is assigned to these components, corporate governance and internal controls are two components which are analysed in greater depth (than other components). Furthermore, corporate governance could be accorded a status of greater importance than internal controls having regard to the fact that whilst internal controls relate to a very vital control aspect of an organisation, corporate governance relates to all processes – be it decision making, control, production, performance, within a company/bank.

Disclosure and transparency embody the same goals, whilst the effective management and measurement of risks, and liquidity risks in particular, are aims which the internal control function and management should strive to achieve. The theme “substance over form” draws attention to creative accounting practices and the need for greater emphasis on principles based regulation. Creative accounting and “window dressing” of figures in the financial statements are ever recurring issues arising from corporate collapses – as also recently highlighted by the recent crises which involved Lehman Brothers.

Whilst the danger of formalism lies in the exercise of “creative compliance”,⁷² inherent problems of

⁷⁰See Basel Committee on Banking Supervision, Consultative Document „International Framework for Liquidity Risk Measurement, Standards and Monitoring < <http://www.bis.org/publ/bcbs165.htm>> at page 2

⁷¹ibid

⁷²Creative compliance being the use of rules to escape control without actually violating those rules

anti formalism are considered to include:⁷³

- The fact that citizens have the right to know exactly what is prohibited in advance of behaviour rather than in retrospect
- That broad rules are imprecise and over inclusive
- That anti formalism could result in ineffective control - where it is impossible to implement

Principles based regulation (PBR) is more advantageous than a rules based approach – owing to the fact that off balance⁷⁴ sheet debt could result from the direct application of rules – without being able to consider the substance of the transaction and because the implemented standards do not allow such consideration. As its secondary argument⁷⁵, this paper will seek to demonstrate that detailed rules could still operate within a system of principles based regulation – whilst enabling a consideration of the substance of the transactions which are involved.

Regulatory standards implemented by the Basel Committee in its recent document⁷⁶ provide for “jurisdiction-specific conditions” – for example, the percentage of potential run-off of retail deposits which is partially dependent on the structure of a jurisdiction’s deposit insurance scheme.”⁷⁷ Furthermore, the Committee highlights that “in these cases, the parameters should be **transparent** and clearly outlined in the regulations of each jurisdiction.”⁷⁸ It also adds that this would provide clarity both within the jurisdiction as well as across borders concerning the precise parameters that the banks are capturing in these metrics, and that there was need for public disclosures in respect of regulatory standards.⁷⁹

Good corporate governance would “provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders.”⁸⁰ The dual faceted aspects of corporate governance relate not only to the accountability of management to shareholders, but also to the supervision and monitoring of management performance. Good corporate governance should facilitate effective monitoring, effective management of internal controls and risks, effective disclosure and transparency.

In considering the topics of discussion, namely, liquidity risk measurements and monitoring, this paper will commence with a section dedicated to liquidity risk (and risk measurements), along with developments which have triggered the need for particular monitoring tools - both in response to global developments and with particular reference to the increasing prominence of liquidity risks.

The ever growing prominence and importance of liquidity in prudential supervision constitutes a vital reason which justifies the need for a prudential supervisory framework which does not merely (and excessively) rely on capital adequacy requirements within such a framework.

⁷³V Beattie, S Fearnley and R Brandt *Behind Closed Doors: What Company Audit is Really About* (ICAEW) 2001 at page 11

⁷⁴Off balance sheet items are obligations which are contingent liabilities of a company/bank – and which as a result, do not appear on its balance sheet. Formal distinction between on and off balance sheet items, even though sometimes detailed, depend to an extent on the degree of judgement which is exercised by management.

⁷⁵ The primary theme being the importance of successfully communicating results obtained from monitoring and measuring such risks, and the role of corporate governance in ensuring such effective communication.

⁷⁶ See Consultative Document, „International Framework for Liquidity Risk Measurement, Standards and Monitoring“ at page 2

⁷⁷ *ibid*

⁷⁸ *ibid*

⁷⁹ *ibid*

⁸⁰ See Basel Committee on Banking Supervision “Enhancing Corporate Governance for Banking Organisations” February 2006 at page 4

Some arguments which revolve around the inadequacies of capital adequacy standards include the fact that.⁸¹

“Capital ratios may be of limited value as indicators of actual risk since reported capital positions do not reflect the real causes of most bank failures (the real causes of bank failures being fraud or fast depletion of the banks’ resources). The international minimum ration of 8% lacks any theoretical justification. Risk related measurement of bank assets is not only deeply flawed, but also triggers substantial distortions in the relative demand for bank assets. Since banks are in direct competition with investment firms, so far as securities activities are concerned, the imposition of capital burdens on banks erodes their ability to compete.”

Paragraph 56 of the Basel Committee on Banking Supervision’s Principles for Sound Liquidity Risk Management and Supervision states that

“A bank should have a reliable management information system designed to provide the board of directors, senior management and other appropriate personnel with timely and forward-looking information on the liquidity position of the bank. The management information system should have the ability to calculate liquidity positions in all of the currencies in which the bank conducts business – both on a subsidiary/branch basis in all jurisdictions in which the bank is active and on an aggregate group basis. It should capture all sources of liquidity risk, including contingent risks and the related triggers and those arising from new activities, and have the ability to deliver more granular and time sensitive information during stress events. To effectively manage and monitor its net funding requirements, a bank should have the ability to calculate liquidity positions on an intraday basis, on a day-to-day basis for the shorter time horizons, and over a series of more distant time periods thereafter. The management information system should be used in day-to-day liquidity risk management to monitor compliance with the bank’s established policies, procedures and limits.”⁸²

B. 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.⁸³ 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.⁸⁴ In order to consolidate on the Basel Committee for Banking Supervision’s *Principles for Sound Liquidity Risk Management and Supervision* of September 2008, which should lead to

⁸¹ C Hadjiemmanuil, *Banking Regulation and the Bank of England* Lloyds of London Press 1995 at page 210

⁸² Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision Sept 2008 at page 17 <<http://www.bis.org/publ/bcbs144.htm>> Furthermore, paragraph 57 highlights the importance of a consensus between senior management in relation to a set of reporting criteria aimed at facilitating liquidity risk monitoring. Such reporting criteria should specify “the scope, manner and frequency of reporting for various recipients (such as the board, senior management, asset – liability committee) and the parties responsible for preparing the reports.” “Reporting of risk measures should be done on a frequent basis (eg daily reporting for those responsible for managing liquidity risk, and at each board meeting during normal times, with reporting increasing in times of stress) and should compare current liquidity exposures to established limits to identify any emerging pressures and limit breaches. Breaches in liquidity risk limits should be reported and thresholds and reporting guidelines should be specified for escalation to higher levels of management, the board and supervisory authorities.”

⁸³ Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision Sept 2008 <<http://www.bis.org/publ/bcbs144.htm>>

⁸⁴ *ibid*

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.”⁸⁵

The Principles for Sound Liquidity Risk Management and Supervision of September 2008 are aimed at providing “consistent supervisory expectations” on principal elements such as “board and senior management oversight; the establishment of policies and risk tolerance; the use of liquidity risk management tools such as comprehensive cash flow forecasting, limits and liquidity scenario stress testing; and the maintenance of a sufficient cushion of high quality liquid assets to address contingent liquidity needs.”⁸⁶

The three aspects to pro cyclical⁸⁷ – as highlighted in the Impact Assessment Document amending the Capital Requirements Directive, have the potential to trigger a chain reaction. Starting with remuneration schemes, the impact of these on management incentives, could have a positive or negative effect on bank regulations (such as Basel II or the CRD). Such regulations could then mitigate or exacerbate pro cyclical effects – depending on the effectiveness of capital adequacy rules. A positive effect of such rules would reduce the tendency of banks to cut back on lending during economic “busts” whilst incentives to retain liquidity would be increased – hence reducing the likelihood of the occurrence of maturity mismatches.

The link between liquidity and systemic risks as illustrated in the ECB’s Financial Stability Review, is attributed to the “destruction of specific knowledge⁸⁸ which banks have about their borrowers and the reduction of the common pool of liquidity.”⁸⁹ The importance of the link between liquidity risks and systemic risks within the banking sector is highlighted by the consequences attributed to the reluctance of banks to retain liquidity - given the cost of holding liquidity.⁹⁰ The consequential shortfalls of liquidity as reflected by on and off balance sheet maturity mismatches accentuates the importance of the role assumed by central banks in the funding of bank balance sheets.⁹¹

The link between liquidity and systemic risks is also accentuated under paragraph 77 of the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008. Principle 8 states that:

“A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.”

⁸⁵ “The FSF proposes that the BCBS and CGFS develop a joint research effort to address funding and liquidity risk, starting in 2009. A key component of this research agenda is to define robust measures of funding and liquidity risk, which could assist assessments of liquidity risk by the private sector. Stress tests to gauge the probability and magnitude of a liquidity crisis in different market environments will be considered in this light.” For further information on this, 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

⁸⁶ See Basel Committee on Banking Supervision, Consultative Document “International Framework for Liquidity Risk, Measurement Standards and Monitoring” Bank for International Settlements Publications at page 1

⁸⁷ Namely: systemic aspects, bank regulations and remuneration policies

⁸⁸ Since specific knowledge which banks possess about their borrowers is considered to be a factor which determines the illiquidity of bank loans; see “The Concept of Systemic Risk” ECB Financial Stability Review December 2009 at page 137<<http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?05d3164914c6a14bb135222b5c3894fa>>

⁸⁹ *ibid*; According to the Review, the reduction in the common pool of liquidity also has the potential to trigger the failure of banks and could consequently lead to a devaluation of illiquid bank assets and further aggravation of problems within the banking sector.

⁹⁰ 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

⁹¹ *ibid*

Paragraph 77⁹² elaborates on this by highlighting the reasons why “intraday liquidity management” constitutes an important component of a bank’s “broader liquidity management strategy.” It goes on to state that a bank’s failure to manage intraday liquidity effectively could result in its inability to meet payment obligations as they fall due, - hence generating consequences, not only for its own liquidity position, but also that of other parties. It illustrates how this could occur in two ways, namely:

- “The fact that that counter parties may view the failure to settle payments when expected, as a sign of financial weakness – which in turn could result not only in payments to the bank being delayed or withheld, but also in further aggravation of liquidity pressures.
- It also could leave counterparties unexpectedly short of funds, impair those counterparties’ ability to meet payment obligations, and disrupt the smooth functioning of payment and settlement systems. Given the interdependencies that exist among systems, a bank’s failure to meet certain critical payments could lead to liquidity dislocations that cascade quickly across many systems and institutions. If risk controls are overwhelmed, these dislocations could alter many banks’ intraday or overnight funding needs, including their demands for central bank credit, and potentially affect conditions in money markets. The delay of other less critical payments also might cause other institutions to postpone their own payments, cause many banks to face increased uncertainty about their overnight funding needs and potentially increase the impact of any operational outages.”

Liquidity is considered to be “highly procyclical, growing in good times and drying up in times of stress.”⁹³ During the build up to the present crisis, banks and other financial institutions had an incentive to minimise the cost of holding liquidity.⁹⁴ Given the fact that liquidity could also be pro cyclical and given its role in the recent crisis, perhaps four dimensions to pro cyclicality should have been introduced in the Impact Assessment Document⁹⁵ amending the Capital Requirements Directive – incorporating liquidity as a fourth heading.

The growing importance of formalisation within the bank regulatory framework is also attributed to the gaps which exist within a discretionary based system of bank supervision – as was revealed in the aftermath of Baring Plc’s collapse. The recent crisis has also highlighted the need for formal risk assessment models – as demonstrated by the demise of Lehman Brothers where the failures of auditors to detect balance sheet irregularities (owing to creative accounting practices) was brought to light.

The formal framework for the measurement of capital adequacy at European Community level, as exemplified by the International Convergence of Capital Measurements and Capital Standards(Revised Framework), namely Basel 2, is to be commended, not only because of “the need for a consistent framework for the reporting and comparative analysis of bank capital positions, the demand of regulated institutions for transparency and equality in the application of regulatory standards”, but also because of “the exigencies of the international convergence process – which requires the transparent and uniform implementation of harmonised rules by the regulators

⁹² Principles for Sound Liquidity Risk Management and Supervision Sept 2008 at pages 20 and 21

⁹³ See Report of the Financial Stability Forum on Addressing Pro cyclicalities in the Financial System “Measuring and Funding Liquidity Risk” at page 24

⁹⁴ *ibid*

⁹⁵ 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> See page 44-46

of every country.”⁹⁶

As part of measures aimed at consolidating and “promoting consistency in international liquidity risk supervision”, and in response to the “inaccurate and ineffective management of liquidity risk” – as was prominently highlighted during the recent financial crisis, the Basel Committee has developed a “minimum set of monitoring tools to be used in the ongoing monitoring of the liquidity risk exposures of cross border institutions and in communicating these exposures amongst home and host supervisors.”⁹⁷

The Liquidity Coverage Ratio⁹⁸ and the Net Stable Funding Ratio⁹⁹ are two regulatory standards for liquidity risk which serve the purpose of attaining the objectives of “promoting short-term resiliency of the liquidity risk profile of institutions” (by ensuring that they have adequate high quality liquid resources to survive during periods of extreme stress which last for about one month) and “promoting resiliency over longer-term periods” (through the creation of additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis).¹⁰⁰

In addition to the above-mentioned standards, the Basel Committee recommends that supervisors also implement designated monitoring tools on a consistent basis. Such monitoring tools, along with the standards, are intended to provide supervisors with information which should aid their assessment of liquidity risks attributed to a particular bank.¹⁰¹ These monitoring tools include: Contractual Maturity Mismatch, Concentration of Funding, Available Unencumbered Assets and market – related monitoring tools.¹⁰²

C. Disclosure

As well as the need for greater focus on liquidity risk, there is also the need for greater reliance on disclosure requirements. This will be facilitated through an effective monitoring process whereby identified risks are effectively communicated across all levels of management.

Enhanced transparency does not only have the potential to “improve an understanding of the mechanism at play in structured finance”, but also facilitate the identification of risks and ensure that risks are well controlled.¹⁰³ Risky loans which were “repackaged and sold to institutional investors” – some of whom did not fully comprehend the implications of the transactions they were engaged in (or about to be engaged in), and the inherent risks associated with those transactions, are considered to be contributory factors to the 2007/09 Financial Crisis.¹⁰⁴

Regulators will be able to gain greater access to vital information which is required for effective

⁹⁶ See C Hadjiemmanuil, *Banking Regulation and the Bank of England* Lloyds of London Press 1995 at pages 208-209

⁹⁷ See Bank for International Settlements, Consultative Document “International Framework for Liquidity Risk, Measurement Standards and Monitoring” at page 2

⁹⁸ This ratio „identifies the amount of unencumbered, high quality liquid assets an institution holds that can be used to offset the net cash outflows it would encounter under an acute short-term stress scenario by supervisors.“ *ibid* at page 3

⁹⁹ This ratio measures “the amount of longer-term, stable sources of funding utilised by an institution relative to the liquidity profiles of the assets being funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations.“ *ibid*

¹⁰⁰ *ibid*

¹⁰¹ *ibid* at page 25

¹⁰² *ibid*

¹⁰³ See speech by C McCreevy European Commissioner for Internal Market and Services at the European Parliament 11 Sept 2007 <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/520&format=HTML&aged=1&language=EN&guiLanguage=en>

¹⁰⁴ *ibid*

performance of their functions where duties are imposed on third parties, such as external auditors, in relation to the disclosure of information which is necessary and required for the efficient performance of the regulators' activities – as opposed to a right to report.

The relationship between supervisory authorities and the external auditors of a credit institution and the duties of these auditors was identified as an important lesson from the BCCI case.¹⁰⁵ Because of auditors' access to financial undertakings' accounts and other essential documents and information, they assume a vital position in the overall supervisory process. An analysis of BCCI revealed that measures, additional to those already existing, needed to be taken to eliminate the opaqueness of financial structures and strengthen cooperation between all bodies or persons involved in the supervision of such complex financial structures.¹⁰⁶

As a result, the Basel Committee for Banking Supervision issued “minimum standards” which lay down rules for effective consolidated supervision and cooperation between supervisory authorities. This was not only aimed at strengthening international co operation between prudential supervisors, but also to improve transparency of financial, and in particular, group structures.

D. The Importance of Effective Management of Internal Controls

“Banks identified as having control problems have been characterised by organisational structures in which responsibilities were not clearly defined: hence (1) No senior management monitored the performance of activities (carried out within the organisation) closely to observe unusual activities 2) No senior management had a comprehensive understanding of the activities and how profits were being generated.”¹⁰⁷

The collapse of Barings in 1995 which was attributed not only to lack of quality and employee deception, also brought the issue of internal controls and management systems to the fore.¹⁰⁸ Barings collapse illustrated weaknesses in the bank regulator's supervisory regime - which included flaws within its evaluation of internal controls at banks, flaws inherent in the internal communication within levels of management of the bank regulator, and the weaknesses in the way the bank regulator's existing rules were applied.¹⁰⁹

The Basel Committee categorised into five groups, types of control breakdowns which are characteristic of ailing banks and these are as follows:¹¹⁰

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank¹¹¹

¹⁰⁵ JF Mogg, 'The Bank of England and the Development of Internal Control Systems' in R Kinsella (ed) *Internal Controls in Banking* (Oak Tree Press Dublin 1995) at page 31

¹⁰⁶ *ibid* at page 28

¹⁰⁷ See “Framework for Internal Control Systems in Banking Organisations”, Basel Committee for Banking Supervision 1998 at page 27

¹⁰⁸ Whilst it is contended by some that the problems attributed to Barings focussed round the lack of controls, the system of internal controls which operated were also considered by the regulator at the time (the Bank of England) to be informal but effective. See Barings Bank and International Regulation Volume 1 (12 December 1996) at page xiii

¹⁰⁹ See Treasury Committee, Barings Bank and International Regulation Report No 1 1996 page xv

¹¹⁰ See Framework for Internal Control Systems in Banking Organisations, Basel Committee for Banking Supervision 1998 at pages 6 and 7

¹¹¹ In order to evaluate the quality of internal controls, supervisors could adopt a number of approaches which include i) the evaluation of the work of the internal audit department of the bank (though review of its working papers – including the methodology implemented in identifying, measuring, monitoring and controlling risks). ii) If supervisors are satisfied with the quality of the internal audit department's work, they could use the reports of internal auditors as a

- Inadequate recognition and assessment of the risk of certain banking activities, whether on or off balance sheet
- The absence or failure of key control structures and activities such as segregation of duties, approvals, verifications, reconciliations and reviews of operating performance
- Inadequate communication of information between levels of management within the bank – particularly the communication of information to higher ranked officials (senior management)
- Inadequate or ineffective audit programmes and monitoring activities

E. The Contribution of Corporate Governance to an Effective System of Internal Controls

Various corporate collapses have resulted in changes to financial reporting, corporate governance and audit.¹¹² The emphasis on internal controls and risk management emerged from realisation that due to change in the business environment, even effective safeguards may be insufficient to eliminate all possibilities of failure.¹¹³

Keasy and Wright define corporate governance as the “examination of the structures and processes associated with production, decision making, control and so on within an organisation.”¹¹⁴ The two aspects of governance are considered to be i) Supervision and monitoring of management performance (the enterprise aspect) and ii) ensuring accountability of management to shareholders and other stakeholders (the accountability aspect).¹¹⁵

The feedback effects of corporate governance into the liquidity and systemic risk mechanisms are illustrated thus:

“Poor corporate governance may contribute to bank failures, which could pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macro economic implications, such as contagion risk and impact on payments systems. Furthermore, poor corporate governance could result in markets losing confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn, trigger a bank run or liquidity crisis.”¹¹⁶

primary mechanism for the identification of control problems in the bank (or for identifying areas of potential risk – areas which have not been recently reviewed by the auditors). iii) Further some supervisors may use a self-assessment process in which management reviews the internal controls on a business by business basis whilst iv) other supervisors may require periodic external audits of key areas (given that supervisor defines the scope). Supervisors may ultimately combine one or more of the techniques highlighted under (i) - (iv) with own on site reviews or examinations of internal controls. See *ibid* at pages 22 and 23

¹¹² House of Commons Select Committee on Treasury, Minutes of Evidence submitted by the Institute of Chartered Accountants in England and Wales as part of its inquiry into the arrangements for financial regulation of public limited companies at page 17

¹¹³ *ibid*

¹¹⁴ See K Keasy and M Wright, ‘Issues in Corporate Accountability and Governance: An Editorial’ *Accounting and Business Research*, 23 (91A) at page 291. OECD principles define corporate governance as involving “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders.”

¹¹⁵ V Beattie, S Fearnley and R Brandt *Behind Closed Doors: What Company Audit is Really About* (ICAEW) 2001 at page 26

¹¹⁶ See Basel Committee on Banking Supervision “Enhancing Corporate Governance for Banking Organisations” February 2006 at page 4

As well as a robust system of internal controls (which incorporates internal and external audit functions), the implementation of i) corporate values, codes of conduct, standards of appropriate behaviour and the system used in ensuring compliance with these, ii) a clear allocation of responsibilities and decision making authorities, iii) the establishment of a system which would guarantee efficient interaction and collaboration between the board of directors, senior management and auditors, and iv) special monitoring of risk exposures where conflicts of interest are likely to be high, are considered to be crucial to ensuring that sound corporate governance operates within an organisation.¹¹⁷

Furthermore, sound corporate governance practices are considered to require “ appropriate and effective legal, regulatory and institutional foundations.”¹¹⁸ Even though factors such as the system of business laws and accounting standards which prevail in respective jurisdictions are considered to be factors which operate beyond the scope of banking supervision, the inclusion of four important forms of oversight are considered sufficient not only in ensuring that appropriate checks and balances exist, but that an effective system of corporate governance can be achieved.¹¹⁹ The types of oversight include:

“(1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management, compliance and audit functions. In addition, it is important that key personnel are fit and proper for their jobs.”¹²⁰

The contribution and the role assumed by senior management in ensuring that internal control systems are effectively managed, is reflected through the Principles for the Assessment of Internal Control Systems.¹²¹ The importance of monitoring and the rectification of deficiencies within internal control systems is reflected under principles 10-12.¹²² Principle 10 highlights the importance of monitoring on a frequent and ongoing basis whilst principles 11 and 12 draw attention to the importance of effective collaboration and communication between highly trained competent staff, the board of directors, audit committees and senior management.¹²³

According to paragraph 84 of the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008, internal coordination across business lines is vital towards ensuring that effective controls over liquidity outflows are achieved.¹²⁴ In relation to examples of actions which supervisors could adopt , as means of responding to banks with liquidity risk management weaknesses or excessive liquidity risk, that which “requires actions by the bank to strengthen its management of liquidity risk through improvements in internal policies, controls or reporting to senior management and the board” is considered to have the greatest potential to address deficiencies in a bank’s liquidity risk management process or liquidity position.¹²⁵

¹¹⁷ Basel Committee for Banking Supervision, “ Enhancing Corporate Governance for Banking Organisations” 2006 at page 4

¹¹⁸ *ibid* at page 5

¹¹⁹ *ibid*

¹²⁰ *ibid*

¹²¹ See particularly Principles 1-3 which relate to management oversight and the control culture; *ibid* at pages 2 and 3

¹²² *ibid* at page 4

¹²³ *ibid* at pages 4 and 5

¹²⁴ Paragraph 16, as well as other sections which address and relate to internal and risk controls in particular, are considered to have the greatest importance out of all the sections within the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008

¹²⁵ See paragraph 142 of BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008

As observed by the Basel Committee,¹²⁶ “most banks that have experienced losses from internal control problems did not effectively monitor their internal control systems. Often the systems did not have the necessary built-in ongoing monitoring processes and the separate evaluations performed were either not adequate or were not acted upon appropriately by management.”¹²⁷ Furthermore it highlights that such failures to monitor adequately commence with a “failure to consider and react to day-to-day information provided to line management and other personnel indicating unusual activity – such as exceeded exposure limits, customer accounts in proprietary business activities or lack of current financial statements from borrowers.”¹²⁸

In implementing the regulatory standards and monitoring tools which are highlighted by the Basel Committee in its consultative document,¹²⁹ a supervisory approach which not incorporates the expertise of external auditors, but which is also more inclined to an on site system based approach is recommended. In supporting this view, reference is made to lessons learned from the collapse of Barings where it was noted by the Treasury Committee that “it was due to the discretionary basis of the supervisor’s approach to supervision that there was limited ability to detect events at Barings.”¹³⁰

The regulatory standards and monitoring tools set out in the BIS Consultative Document¹³¹ are therefore supported on the basis of their ability to facilitate a more formal approach to supervision which would reduce the scope for flexibility (scope for creative accounting practices and “window dressing” of balance sheet figures) where an on – site approach to supervision is implemented.

F. On site and Off-site Supervision

Principle 21 of the Basel Core Principles for Effective Supervision, *Supervisory Reporting* states that “Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.”

According to Vieten¹³² bank regulation has followed two trends, namely: supervision has become increasingly formalized and dependent on quantitative tools, and secondly, regulatory duties are being pushed down a regulatory pyramid to include external auditors and to enlist the resources of regulatees.

External auditors, even though they do not constitute by definition, part of a banking organisation, immensely impact the quality of internal controls “through their audit activities – which also includes discussions with management and recommendations for improvement to internal controls.”¹³³ “External auditors provide an important feedback on the effectiveness of the internal

¹²⁶ See “Monitoring Activities and Correcting Deficiencies” Framework for Internal Controls in Banking Organisations, Basel Committee on Banking Supervision 1998 at page 30

¹²⁷ See *ibid* at paragraph 10

¹²⁸ See *ibid* at paragraph 11

¹²⁹ See Consultative Document ,International Framework For Liquidity Risk Measurement, Standards and Monitoring December 2009

¹³⁰ Treasury Committee Barings Bank and International Regulation Report No 1 (1996) at page xiv

¹³¹ Consultative Document ,International Framework For Liquidity Risk Measurement, Standards and Monitoring December 2009

¹³² See HR Vieten, „Banking Regulation in Britain and Germany Compared: Capital Ratios, External Audit and Internal Controls“ (1997) at page 18

¹³³ Framework for Internal Control Systems in Banking Organisations, page 25 Basel Committee on Banking

control system.”¹³⁴

Off site supervision is synonymous with monitoring and involves the regulator’s use of external auditors’ expertise. It also involves the receipt and analysis of financial statements and statistical returns submitted to the supervisors. Off site monitoring often has the benefits of being able to identify potential problems, particularly during intervals between on- site inspections, thereby providing early detection and acting as trigger for corrective action before problems become more serious.¹³⁵

On site work is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors. Furthermore, it is contended that on-site examinations are frequently implemented by banking supervisory authorities which possess the legal basis or other arrangements to direct the scope of the work carried out by external auditors.¹³⁶

Ongoing monitoring is contrasted with separate evaluations. It is highlighted that whilst ongoing monitoring activities not only provide the advantage of “quickly detecting and correcting deficiencies in the system”, but are also most effective “when the system of internal control is integrated into the operating environment and produces regular reports for review,” that separate evaluations usually detect problems “only after the fact.”¹³⁷ However separate evaluations also offer the advantage of providing an organisation with “fresh and comprehensive” insight into the effectiveness of monitoring activities – such activities being undertaken by staff from different departments which include the business function, financial control and internal audit.¹³⁸

G. Monitoring Compliance and Enforcement

Principles Based Regulation

A discretionary based approach to regulation, whilst encouraging greater possibilities for regulatory capture, appears to be more congruent with principles based regulation. However it is possible to implement a system of regulation which combines increased formalised procedures and/or detailed rules - whilst giving due consideration to the substance of transactions.

“Principles provide the framework in which firms can organize their own processes to achieve the outcomes the regulator seeks – the regulator in turn, depends on firms to adopt an attitude to the regulatory regime (which is one which aims to go beyond minimal compliance with rules).”¹³⁹

Principles based regulation is not only advantageous because it allows management of a bank or firm to take into consideration the substance of transactions, but because “principles impose

Supervision 1998

¹³⁴ ibid

¹³⁵ See „The Relationship between Banking Supervisors and Banks’ External Auditors January 2002 paragraph 40 page 11 <<http://www.bis.org/publ/bcbs87.pdf?noframes=1>>

¹³⁶ See Framework for Internal Control Systems in Banking Organisations, Basel Committee for Banking Supervision 1998 at page 23

¹³⁷ ibid at page 20.

¹³⁸ ibid

¹³⁹ See J Black, „Forms and Paradoxes of Principles Based Regulation“ LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 9 <http://www.lse.ac.uk/collections/law/wps/wps.htm> and <http://www.ssrn.com/abstract=1267722>

outcomes to be achieved – not detailed processes for achieving them.”¹⁴⁰ As well as being linked to meta regulation, principles based regulation facilitates a system whereby principles “communicate regulatory objectives and promote behaviour which will achieve those objectives.”¹⁴¹

Principles based regulation, thus, would not only reduce the scope for “creative compliance” – since the substance of transactions should be considered by management, but also has the benefit of providing a more flexible and responsive approach to regulation as the subsequent section will seek to demonstrate.

Principles based regulation is considered to comprise of 3 elements, namely:¹⁴²

- A particular type of rule
- A focus on outcomes and
- A focus on senior management responsibility in ensuring these outcomes are achieved

Furthermore, three forms of principles based regulation, namely: “formal principles based regulation; substantive principles based regulation and full principles based regulation”, have been suggested.¹⁴³ For the purposes of this paper, focus will be restricted to substantive principles based regulation.

Five classes of regulatory practices which could characterise substantive principles based regulation include:¹⁴⁴ “The particular mode of interpretation- that is, the approach taken in the interpretative process; particular enforcement style; an orientation to outcomes; a relocation of responsibilities for working out the practical application of the provisions; and an explicit and developed reliance on management based regulation.”

The effectiveness of rules and regulation is dependent, not only on the monitoring processes and tools used in such processes, but also the effectiveness of the enforcement of those rules. For this reason, focus will be dedicated to the second characteristic of substantive principles based regulation– which is indeed a “critical” and defining feature of principles based regulation.

According to Black, the adoption of the “responsive” enforcement approach is justified on the basis that “neither negotiative approaches nor deterrence based approaches are effective on their own and that instead, regulators should implement a mixture of both, that is, first negotiate, then if the firm still does not deliver substantive compliance, regulators should gradually move up the enforcement pyramid, applying sanctions of increasing severity until it does.”¹⁴⁵ She adds weight to Baldwin’s argument¹⁴⁶ by stating that “those who know what they are meant to be doing and are generally inclined to do it (“the well intentioned and well informed”) , are best dealt with using a negotiating strategy – which is easier to do using principles. In contrast, those who do not know what they are meant to be doing and even if they did, would not be inclined to do it (“the ill intentioned and ill informed”), are best dealt with using a strategy that escalates rapidly up the enforcement pyramid.”¹⁴⁷

¹⁴⁰ *ibid*

¹⁴¹ *ibid* at page 16

¹⁴² See J Black, „Forms and Paradoxes of Principles Based Regulation“ LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 12

¹⁴³ *ibid*

¹⁴⁴ *ibid* at page 17

¹⁴⁵ See also I Ayres and J Braithwaite, *Responsive Regulation* (1992) Oxford University Press

¹⁴⁶ See R Baldwin, *Rules and Government* (1995) Oxford : Clarendon Press

¹⁴⁷ J Black, „Forms and Paradoxes of Principles Based Regulation“ LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 19; She argues that “in a regime with a tough, punitive approach in which every infraction is met with a sanction, principles based regulation (PBR) would not survive – this being the case, because there is greater

This “responsive” approach, it is further argued, “is not contingent on any particular rule design and can operate in systems of i) highly detailed rules, ii) where the rules are mainly principles, iii) where there is a combination of both.”¹⁴⁸

Having considered the forms, attributes and benefits of principles based regulation, the weaknesses inherent in this type of regulation are worth mentioning. Firstly, in relation to the all important aim of ensuring accountability – which should be fostered if adequate monitoring procedures are observed and carried out by the responsible levels of authority. Principles based regulation could serve as a hindrance towards ensuring accountability. In this respect, reference will be made to the seven paradoxes of principles based regulation – which are as follows:¹⁴⁹

- i) The interpretative paradox : Different interpretations attributed to principles could result in imprecise and general terms being accorded very specific interpretations – even though principles are supposed to offer flexibility (where these are characterised by imprecise terms).
- ii) The communicative paradox: Principles, whilst facilitating communication, could also hinder such communication. The paradox is attributed to the distinction between legal use of language and its ordinary use.
- iii) The compliance paradox: Principles provide scope for flexibility in compliance – however this could result in conservative and/or uniform behaviour by regulated firms.
- iv) The supervisory and enforcement paradox: Principles require enforcement to provide them with credibility – however over-enforcement could result in their demise.
- v) The internal management paradox: Principles based regulation has the potential to offer required flexibility for internal control systems to develop – and also the potential to overload them.
- vi) Ethical paradox
- vii) Trust paradox

A detailed consideration of the above mentioned paradoxes highlights the importance of having a clear understanding of the form of principles based regulation which is applicable to a particular bank or business. As highlighted under the substantive principles based regulation, “those who know what they are meant to be doing and are generally inclined to do it (the well intentioned and well informed), are best dealt with using a negotiating strategy.” Hence a more draconian mode of enforcement , that is tougher sanctions, would not be best suited in facilitating compliance by such groups – such sanctions being better reserved for the “ill informed and ill intentioned.” Furthermore, a tough punitive regime is one in which principles are unlikely to survive – even though detailed rules could still be implemented under principles based regulation.¹⁵⁰

Hence the desired level of compliance required within a firm is best achieved having regard to the organisational structure which exists within an organisation – and to whether (as a result of a such determination), that organisation could be considered a suitable candidate for the application of principles based regulation. Clear delegation and segregation of duties within an organisation would not only promote accountability, but would also facilitate a system where principles could be

risk that firms will make the wrong assessment ie one with which the regulator does not agree.” Under principles based regulation, she argues further, “firms are required to think through the application of the provisions to particular situations to a far greater degree than they are with respect to a detailed rule – hence the higher probability that firms would make the wrong assessment .” See *ibid* at page 18

¹⁴⁸ J Black, „Forms and Paradoxes of Principles Based Regulation“ LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 19; It is further argued that “Different rule types make it easier for regulatory officials to deal with certain types of regulated firms.”

¹⁴⁹ See *ibid* at pages 25 -35

¹⁵⁰ Refer to Formal Principles Based Regulation; *ibid* at page 12

applied and also facilitate monitoring procedures. Consequently, monitoring would also facilitate accountability – since frequent reviews and discussions between management and appropriate personnel should increase an understanding of the activities carried out by particular divisions within the organisation.

H. CONCLUSION

Monitoring fosters transparency, which in turn fosters accountability. Monitoring of key risks, as well as periodic evaluations by the business lines and internal audit constitute a vital element of corporate governance – hence the overall effectiveness of a bank’s internal controls should be monitored on an ongoing and frequent¹⁵¹ basis.¹⁵²

Since it is possible for detailed rules to operate under principles based regulation – and since detailed rules constitute a vital element in ensuring that clear delegation and segregation of responsibilities exist within an organisation, it could be said that the level of accountability derived under principles based regulation is dependent on the form of principles based regulation. Under the formal principles based regulation, the level of accountability derived is likely to be greater than that derived under full principles based regulation. As highlighted within the relevant sections of this paper, an approach which combines negotiating and punitive strategies is always considered best – owing to the level of flexibility offered by such an approach. However the organisational structure, culture and several other factors require consideration before substantive principles based regulation is judged to be the optimal approach.

In accordance with Principle 13 of the Principles for the Assessment of Internal Control Systems, “supervisors should require that all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity, and risk inherent in their on- and- off balance sheet activities and that corresponds to the bank’s environment and conditions.” Furthermore, “in those instances where supervisors determine that a bank’s internal control system is not adequate or effective for that bank’s specific risk profile, they should take appropriate action.” In accordance with Core Principle 17 of the Basel Core Principles for Effective Bank Supervision, *Internal controls and audit*, specific attention should be given to ensure the existence of: i) “clear arrangements for delegating authority and responsibility; (ii) separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities.”

Where clear delegation of authority, segregation of responsibilities are not in place, the most appropriate and obvious action might be to initiate a more deterrence based approach – rather than a negotiative based approach. However, reference must be made to factors highlighted under the first paragraph of this conclusive section.

Increased formalisation under principles based regulation would still allow for a consideration of

¹⁵¹ “The frequency of monitoring different activities of a bank should be determined by considering the risks involved and the frequency and nature of changes occurring in the operating environment.” See Framework for Internal Control Systems in Banking Organisations at page 20 <http://www.bis.org/publ/bcbs40.pdf>

¹⁵² See also Principle 10 of the Principles for the Assessment of Internal Control Systems; Framework for Internal Control Systems in Banking Organisations at page 20 <http://www.bis.org/publ/bcbs40.pdf>. “Monitoring the effectiveness of internal controls could be undertaken by personnel from several different areas, including the business function itself, financial control and internal audit. For that reason, it is important that senior management clarify which personnel are responsible for which monitoring functions.” Further, “monitoring should constitute part of the daily activities of the bank – whilst including separate periodic evaluations of the overall internal control process.”; *ibid*

the substance of transactions – whilst allowing for flexibility in terms of its application. With regards to its application, this implies its suitability as the appropriate mode of regulation - based on the level of accountability it could provide an organisation with and whether an organisation, because of its structure and culture, should consider applying it at all.

Measures Aimed at Mitigating Pro Cyclical Effects of the Capital Requirements Framework: Counter cyclical Capital Buffer Proposals¹⁵³

Introduction

In its consultative document on “Counter Cyclical Capital Buffer Proposal”¹⁵⁴ the Basel Committee highlights the principal aim of the proposal, namely “ the implementation of buffers of capital to achieve the broader macro prudential goal of protecting the banking sector from periods of excess aggregate credit growth which have been linked to the build up of system wide risk.”¹⁵⁵ A further benefit of the proposal which is attributed to the aim of protecting the banking sector from the credit cycle is its potential to assist in “leaning against the build-up phase” of the cycle in the first instance – this occurring (according to the Committee), through the capital buffer acting to raise the cost of credit – hence dampening and reducing its demand.¹⁵⁶

This paper aims to highlight reasons attributed to the importance of introducing counter cyclical capital buffers – the principal focus being the need to mitigate pro cyclical effects. In so doing it commences with an introduction on how such pro cyclical effects arise and why they need to be addressed. The paper also illustrates that even though it is increasingly acknowledged that capital, on its own, cannot address system wide risks (owing to the growing importance and significance of liquidity risk), that current measures aimed at mitigating pro cyclical effects focus primarily on capital. Hence the need to introduce counter cyclical buffer proposals which are also linked to the redress of liquidity risks, also constitutes an objective which the paper aims to address. Such need will be considered under the fourth section of this paper which considers recommendations made by the Financial Stability Forum and which specifically (and importantly) includes bank loan loss provisions. Thus whilst progress with measures aimed at ensuring that banking systems are equipped with buffers of capital (to protect them against future losses) is very much appreciated, greater focus on other measures aimed at addressing losses and unforeseen problems attributed to “maturity transformation of short-term deposits into long term loans”¹⁵⁷ (which exposes banks to such vulnerabilities as liquidity risks) are required.

One of the principles which were highlighted by the Basel Committee as constituting vital components of a “global financial stability framework” is namely, the principle that “All macroeconomic policies need to be counter cyclical, building up buffers in good times that can be

¹⁵³ See Basel Committee for Banking Supervision , Bank for International Settlements Publications <www.biz.org/publ/bcbs172/mariannweojo.pdf>

¹⁵⁴ See Basel Committee on Banking Supervision, „ Consultative Document: Counter Cyclical Capital Buffer Proposal“ July 2010 <http://www.bis.org/publ/bcbs172.pdf?noframes=1> at page 2. The Consultative Document interestingly highlights the fact that the Counter Cyclical Proposal is not a Pillar 2 approach – since “it does not relate to supervisor review of individual banks.” see *ibid* at page 12. Furthermore, the Consultative Document addresses the treatment of surplus when buffer returns to zero by indicating that “the Basel Committee’s working assumption is that the capital surplus created when the counter cyclical buffer is returned to zero, should be unfettered – that is, no restrictions should be imposed on distributions when the buffer is turned off.” See *ibid* at page 13

¹⁵⁵ Further, the Committee adds that since capital is more expensive than other forms of funding, the build up of defences (such as capital defences which are built up by banks during periods where “the risks of system-wide stress” are characterised by significant and marked levels of growth) may provide the additional benefit of helping to stabilise excessive credit growth levels during periods of economic and financial booms. See *ibid*.

¹⁵⁶ See *ibid* at page 3

¹⁵⁷ See Principles for Sound Liquidity Risk Management and Supervision September 2008 at page 1 (page 7 of 44) <<http://www.bis.org/publ/bcbs144.htm>>

run down in bad times. In particular, fiscal authorities need to reduce debt levels in good times in order to have the capacity to respond at times of stress.¹⁵⁸

Whilst it is contended that monetary policies should be aimed at the control of inflation, fiscal policies are considered to have the role of “counter cyclical demand management.”¹⁵⁹

A. Pro cyclicalit¹⁶⁰

Pro cyclicalit is a term used to denote “ the self-reinforcing mechanisms within the financial system and between the financial system and the real economy that can exacerbate boom and bust cycles, undermining financial and macroeconomic stability. These effects are most prominent in the downward phase. As strains develop, previously unseen risks materialise, deepening the retrenchment that is already under way.”¹⁶¹ Furthermore, it is not only contended that “the effects of pro cyclicalit are critical (but hidden) in the expansion phase, when the underlying risks build up, but that historical experience reveals that credit mistakes are made during the boom phase but are revealed only during the bust.”

An example of a “fundamental” source of pro cyclicalit as provided by the Committee of the European Banking Supervisors(CEBS),¹⁶² is attributed to “excessive risk-taking during periods of expansion, which results in the build up of vulnerabilities”.

Some of the recommendations put forward and highlighted as means of addressing pro cyclicalit include:¹⁶³

- A policy response founded on the build up and run down of capital buffers in a counter cyclical fashion over the business cycle. These safety margins must be built up in good times, when it is easier and cheaper to do so.¹⁶⁴ Such a build-up will restrain risk-taking during the expansion phase of the business cycle. During periods of recession, these buffers can be run down, allowing the system to absorb emerging strains more easily and dampening the feedback mechanisms.
- The importance of distinguishing between the regulatory minimum capital requirement and buffers operating above the minimum requirements. A breach of the regulatory minimum

¹⁵⁸ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 2 of 26 <<http://www.bis.org/speeches/sp100303.pdf>>

¹⁵⁹ *ibid* at page 6. Furthermore, it is added that consideration should be given to “the need to maintain fiscal buffers that allow a response to financial system stress - which implies that government debt should be maintained at reasonably low levels in good times so that additional debt can be taken on in times of stress without unsettling financial markets.” See *ibid* at page 7

¹⁶⁰ Pro cyclicalit is also the tendency for periods of financial/economic downturns or booms to be further exacerbated by certain economic policies. For further considerations on the possible consequences of according a high degree of prominence to certain economic objectives, see M Ojo, „Social Rights and Economic Objectives: The Importance of Competition at Supra National Level „ http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1651610

¹⁶¹ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 16 and 17 of 26 <<http://www.bis.org/speeches/sp100303.pdf>>

¹⁶² Furthermore, the CEBS defines pro cyclicalit 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

¹⁶³ H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 16 and 17 of 26

¹⁶⁴ *ibid*; also see Bank for International Settlements, “Addressing financial system procyclicalit: a possible framework”, *Note for the FSF Working Group on Market and Institutional Resilience*, April 2009.

brings with it severe consequences, which could result in a bank being shut down. The buffers are intended to be built up in good times so that they can absorb losses without the bank becoming insolvent.”

The Basel Committee has proposed building up these buffers through a combination of counter cyclical capital charges, forward-looking provisioning and capital conservation measures.¹⁶⁵ It is also recommended that other potential macro prudential instruments such as loan-to-value (LTV) ratios should be explored.

Jimenez and Saurina, Goodhart, Hofmann and Segoviano are amongst several other academics who have put forward proposals aimed at addressing pro cyclical problems.¹⁶⁶ The proposal put forward by Jimenez and Saurina “focuses on an additional flow of loan loss provisions – in addition to specific and general provisions.”¹⁶⁷ Such a design is aimed at addressing the “future increase in credit risk deriving from too lenient credit standards during periods of economic booms.”¹⁶⁸ As observed by the CEBS, whilst a similar proposal (to that of Jimenez and Saurina) was also put forward by Goodhart, Hofmann and Segoviano, some reservations on the potential and efficiency of the present applicable principle for policy intervention (that is, conserving buffers in the system during periods of economic booms – for the purposes of “controlled” utilisation of such buffers during periods of economic pressures), were expressed by Kashyap, Rajan and Stein.¹⁶⁹

The promotion of financial stability through more risk sensitive capital requirements, constitutes one of Basel II’s primary objectives.¹⁷⁰ However some problems identified with Basel II are attributed to pro cyclicity and to the fact that not all material credit risks in the trading book are adequately accounted for in the current capital requirements.¹⁷¹ 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”¹⁷² – hence

¹⁶⁵ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 16 of 26 <http://www.bis.org/speeches/sp100303.pdf> and also Basel Committee on Banking Supervision, *Strengthening the resilience of the banking sector – consultative document*, December 2009.

¹⁶⁶ For further information on this see Committee of European Banking Supervisors, “Position Paper on a Counter Cyclical Capital Buffer” July 2009 at page 34. “Studies which were included and reviewed in the Dynamic Operation Project (DOP) of the Basel Committee on Banking Supervision (BCBS) – which addressed the issue of the cyclicity of Pillar One capital requirements include those of Goodhart, Hofmann and Segoviano along with Kashyap and Stein. The DOP report examined several academic papers that implemented simulation approaches to estimate the magnitude of the cyclical variations of Basel II requirement over the business cycle.” See *ibid* at page 33.

¹⁶⁷ See *ibid* at page 33

¹⁶⁸ “Given that the provision is positive during periods of economic booms, and negative during periods of recessions, it is argued that such a provision should have a counter cyclical impact on banks’ lending policies.” *ibid*

¹⁶⁹ It is acknowledged that “time-varying capital requirements represent a potentially important improvement over the current time invariant approach in Basel II because they allow some of the rainy day funds to be spent when it rains – thereby reducing the pressure on banks to liquidate assets (as well as associated negative spill overs for the rest of the economy. However, time varying capital requirements are also acknowledged to be problematic from a cost perspective” See *ibid* at page 36; see also Jimenez and Saurina, “Credit Cycles, Credit Risk, and Prudential Regulation” (2006) *International Journal of Central Banking*, vol.2, no.2; Goodhart, Hofmann and Segoviano, “Bank Regulation and Macroeconomic Fluctuations” (2004) *Oxford Review of Economic Policy*, vol. 20, no. 4; Kashyap, Rajan and Stein, “Rethinking Capital Regulation”, Paper prepared for the Federal Reserve Bank of Kansas City symposium on “Maintaining stability in a Changing Financial System”, Jackson Hole, August 2008.

¹⁷⁰ 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

¹⁷¹ See *ibid* at page 23 of 47

¹⁷² See Annex on Proc cyclicity, 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

resulting in capital requirements which fluctuate over the cycle. Other identified¹⁷³ consequential effects include the fact that fluctuations in such capital requirements may result in credit institutions raising their capital during periods when it is costly¹⁷⁴ 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.”¹⁷⁵

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 Directive¹⁷⁶ 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.

The fact that “adjustments (for individual institutions’ contributions to systemic risk) would actually exacerbate pro cyclicality, has been highlighted.¹⁷⁷ A second and further consequence of using “certain market based measures of systemic risk to address the time dimension” is that, “the measures would provide the wrong signal: Systemic risk would look low when, in fact, it was actually high.”¹⁷⁸

Even though the implementation of higher levels of capital buffers could serve as a means for the management of systemic risks, liquidity requirements¹⁷⁹ 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.¹⁸⁰ 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 the following effects which are generated by higher capital and liquidity standards, namely:¹⁸¹

¹⁷³ 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

¹⁷⁴ Liquidity, a topic which will be addressed in the next section, 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

¹⁷⁵ See “Is Basel II Pro Cyclical? A Selected Review of the Literature” Financial Stability Review December 2009 at page 150

¹⁷⁶ 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

¹⁷⁷ See C Borio, “Implementing a Macro Prudential Framework : Blending Boldness and Realism” Bank for International Settlements Publications at page 8 <<http://www.bis.org/repofficepubl/hkimr201007.12c.pdf?noframes=1>>

¹⁷⁸ *ibid*

¹⁷⁹ “However, the analysis of the impact of liquidity standards is considered to present specific challenges. Under the Proposal put forward by the Basel Committee on Banking Supervision in December 2009, banks will be required to meet two new liquidity requirements – a short term requirement called the Liquidity Coverage Ratio (LCR) and a long term requirement called the Net Stable Funding Ratio (NSFR). The Proposal focuses mainly on the NSFR – which is considered to be the more relevant constraint to macro economic effects on a longer term basis.” 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>>

¹⁸⁰ See particularly R Cifuentes, G Ferrucci and HS Shin, “Liquidity Risk and Contagion” (2005) Journal of the European Economic Association Volume 3 at pages 556-566 <http://www.bri.org/bcbs/events/rtf04shin.pdf>

¹⁸¹ See Basel Committee on Banking Supervision, “An Assessment of the Long Term Economic Impact of Stronger

- 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 for the growing criticism of Basel II.

B. 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.”¹⁸²

In their report on “Addressing Pro cyclicalities 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.”¹⁸³ This has resulted in an “increasingly important role for liquidity provided by central banks in the funding of bank balance sheets.”¹⁸⁴ 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.”¹⁸⁵

As identified in the ECB’s Financial Stability Review, “the specific knowledge that banks possess about their borrowers make bank loans particularly illiquid.”¹⁸⁶ 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:¹⁸⁷ The “destruction” of such specific knowledge which banks have about their borrowers and the reduction of “the common pool of liquidity.”¹⁸⁸ 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.¹⁸⁹

“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.

Capital and Liquidity Requirements” Bank for International Settlements Publications August 2010 at page 5
<<http://www.bis.org/publ/bcbs173.pdf?noframes=1>>

¹⁸² Principles for Sound Liquidity Risk Management and Supervision Sept 2008 at page 1
<<http://www.bis.org/publ/bcbs144.htm>>

¹⁸³ Report of the Financial Stability Forum on “Addressing Pro cyclicalities in the Financial System: Measuring and Funding Liquidity Risk” http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

¹⁸⁴ *ibid*

¹⁸⁵ „In order to counter the transfer of funding liquidity risk by systemically important financial institutions to the public sector“ ; *ibid*

¹⁸⁶ European Central Bank, “The Concept of Systemic Risk” Financial Stability Review December 2009
<http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?a3fef6891f874a3bd40cd00aef38c64f> at page 137

¹⁸⁷ *ibid*

¹⁸⁸ *ibid*

¹⁸⁹ *ibid*

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.¹⁹⁰

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.¹⁹¹

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”.¹⁹²

In responding to the apparent gaps which exist with Basel II – as revealed by the recent crises, proposals which are aimed at imposing penalties for the occurrence of maturity mismatches¹⁹³ have been put forward.¹⁹⁴ 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.”¹⁹⁵

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.¹⁹⁶ Such proposals are aimed at “giving banks the right incentives *ex ante* and at improving the resilience of the financial system to shocks *ex post*.”¹⁹⁷ Furthermore, the ECB’s Financial Stability Review also

¹⁹⁰ Principles for Sound Liquidity Risk Management and Supervision Sept 2008

<<http://www.bis.org/publ/bcbs144.htm>>

¹⁹¹ *ibid*

¹⁹² “The FSF proposes that the BCBS and CGFS develop a joint research effort to address funding and liquidity risk, starting in 2009. A key component of this research agenda is to define robust measures of funding and liquidity risk, which could assist assessments of liquidity risk by the private sector. Stress tests to gauge the probability and magnitude of a liquidity crisis in different market environments will be considered in this light.” For further information on this, see Report of the Financial Stability Forum on Addressing Pro cyclical in the Financial System: Measuring and Funding Liquidity Risk” http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

¹⁹³ 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.

¹⁹⁴ 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.”

¹⁹⁵ *Ibid* at 148

¹⁹⁶ Brunnermeier et al, Kashyap et al, and Perrotti and Suarez are all of the opinion that even though liquidity assistance to help banks cope with aggregate liquidity shocks is commendable, it would generate minimal benefits where such banks are not provided with the right incentives to reduce the probability of such shocks in the first place. For further information on this, see “Is Basel II Pro Cyclical? A Selected Review of the Literature” Financial Stability Review December 2009 at page 149

¹⁹⁷ *ibid*

highlights proposals which are aimed at supplementing Basel II regulation through the establishment of a mandatory liquidity insurance arrangement - whereby each bank has to pay the supervisor a liquidity charge.¹⁹⁸

Even though the Basel Committee states (in its Consultative Document) that its Counter Cyclical Capital Buffer Proposal is not a Pillar 2 approach “since it does not relate to the supervisor review of individual banks”¹⁹⁹, the Committee of European Banking Supervisors (CEBS) highlights the fact that “whilst forward looking systems of capital buffers for banks should be designed within the boundaries of the existing framework and that identified mechanisms could be employed alternatively under Pillar One, that its implementation under Pillar Two is still considered to be the most sensible option at the time.”²⁰⁰

The Committee of European Banking Supervisors classifies Pillar 2 capital buffers into two components – the first being aimed at “building sufficient additional resources (above regulatory minimum) whilst the second is aimed at “covering losses arising from extreme events.”²⁰¹ Whilst the CEBS is also of the opinion that rating agencies appear to prefer Pillar One solutions (which are considered to be more transparent and less prone to national discretions), it also draws attention to the fact that Pillar 2 would allow for quicker responses and may be used for testing tools (which will be subsequently improved and possibly implemented under Pillar One).²⁰²

C. Mitigating the Procyclical Effects of Basel II

Basel III

The more refined and consolidated Basel II framework - along with “macro prudential overlay” [the objective of this “macro prudential overlay” comprising i) the redress of stability over time (that is, to address pro cyclicity), and ii) the redress of stability at each point in time (system-wide approach)],²⁰³ is referred to as Basel III.²⁰⁴ Means through which “stability over time (pro cyclicity)” could be achieved include:²⁰⁵

- Through counter cyclical capital charges and forward looking provisioning
- Capital conservation rules for stronger capital buffers.”

According to a report,²⁰⁶ the two principal solutions which have been endorsed by the Turner Review and the DeLarosiére Report, and which are considered to have the potential to reduce pro

¹⁹⁸ ibid

¹⁹⁹ See Basel Committee on Banking Supervision, „ Consultative Document: Counter cyclical Capital Buffer Proposal“ July 2010 <http://www.bis.org/publ/bcbs172.pdf?noframes=1> at page 2.

²⁰⁰ Committee of European Banking Supervisors “Position Paper on a Counter Cyclical Capital Buffer” July 2009 at pages 1 and 2 <<http://www.c-eps.org/getdoc/715bc0f9-7af9-47d9-98a8-778a4d20a880/CEBS-position-paper-on-a-countercyclical-capital-b.aspx>>

²⁰¹ ibid at page 3

²⁰² ibid at page 4; On this basis, members of the CEBS conclude that “any counter cyclical adjustments should be calibrated to individual banks’ portfolios and based on risk sensitive concepts.” See ibid.

²⁰³ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 9 of 26 <<http://www.bis.org/speeches/sp100303.pdf>>

²⁰⁴ ibid

²⁰⁵ ibid; Means whereby stability at each point in time (system-wide approach) could be achieved include through “systemic capital surcharge for systemically important financial institutions; the identification of inter linkages and common exposures among all financial institutions; and the systemic oversight of OTC derivatives.” ibid.

²⁰⁶The Turner Review :Key Elements of the Turner Review (page 2 of 4) <<http://www.dlapiper.com>>

cyclical effects²⁰⁷ induced by the CRD and Basel II, include: 1) The requirement that banks “hold bigger reserves during good times - hence limiting credit and risk expansion in good times and storing up capital to be used during bad times” (2) “Increasing risk-weighting on a range of assets because this also restricts balance sheet expansion”.

Another proposal put forward as an optimal means of rectifying Basel II's pro cyclical effects – as illustrated through the “amplification of business cycle fluctuations”, involves the utilisation of a “business cycle multiplier of the Basel II capital requirements that is increasing in the rate of growth of the GDP”. Under such a scheme, it is argued, riskier “banks would face higher capital requirements without regulation exacerbating credit bubbles and crunches.”²⁰⁸

Other mechanisms provided under the CRD as means of mitigating pro cyclicalities within the capital requirements framework include:²⁰⁹

The use of downturn Loss Given Default (LGD) estimates, PD estimates being based on long data series, technical adjustments made to the risk weight function, stress testing requirements and Pillar 2 supervisory review process. It is acknowledged, however, that more measures may be required to mitigate the pro cyclical effects of the capital requirements framework. Options provided include those aimed at reducing its cyclical risk sensitivity, measures which enhance its risk capture, and the intentional introduction of counter-cyclical buffers (comprising capital and/or provisions).

A counter cyclical capital charge, it is contended,²¹⁰ “would require financial institutions to hold more capital during buoyant periods whilst lowering the regulatory capital levels during periods of stress.” Other capital conservation measures include “actions aimed at limiting excessive dividend payments, share buy backs and compensation paid out by financial institutions. Through a retention of earnings during buoyant periods, a bank is able to conserve excess capital which can be used to absorb asset write offs during less buoyant periods and periods of financial stress.”²¹¹

The introduction of forward looking provisions has been supported by various sources and bodies.²¹² As well as illustrating how dynamic provisions can contribute towards mitigating pro

²⁰⁷Exacerbated strains on bank capital is the term used to denote pro cyclicalities ; see *ibid*

International Accounting Standards are also considered to have had a pro-cyclical impact. It is stated that “in particular moving to marking to market accounting, rather than the more traditional marking to maturity, exacerbated volatility in the accounts of banks – with valuation becoming practically impossible for some securities as the market in them disappeared.”; *ibid*

²⁰⁸R Repullo, J Saurina, and Carlos Trucharte, “How to Mitigate the Pro cyclical Effects of Capital Adequacy Rules” <<http://www.eurointelligence.com/article.581+M5ff0e4ba595.0.html>>

²⁰⁹See 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 http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf

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²¹⁰ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 17; The methodology of the proposed “Too-Connected-to-Fail Capital Charge” highlighted by Jorg Chan Lau in his paper, comprises three important features . “First, it builds upon an intuitive principle: the capital charge must be proportional to the incremental contribution to societal losses (or risk) due to the failure of the institution. Second, by relating the concept of incremental contribution to systemic risk to concepts such as Value-at-Risk and Expected Shortfall, the TCTF capital charge is aligned with the spirit of Basel II. This alignment will facilitate its adoption and implementation by supervisory agencies and systemic risk regulators. Third, the measurement of the incremental contribution can be accomplished using a simple toolkit of models such as CoRisk analysis, network analysis, and portfolio credit risk models.” See J Chan Lau, „Regulatory Capital Charges for Too-Connected-to-Fail Institutions: A Practical Proposal” http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1566443 and <http://www.imf.org/external/pubs/ft/wp/2010/wp1098.pdf> at page 21

²¹¹ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 17

²¹² Bodies such as ECOFIN. See particularly, M Burroni et al, “Dynamic Provisioning: Rationale, Functioning, and

cyclical effects, a preference for such provisions (in comparison to prudential reserves), has also been highlighted.²¹³ Burroni et al share the opinion that since provisions directly affect reported profits, they are more fully consistent with the idea of an expected loss model²¹⁴ (than is the case with prudential reserves).²¹⁵

The benefits of provisions, and particularly forward looking provisions, will be considered in greater detail under the concluding section of this paper.

D. Principles Governing the Operation of the Basel Committee’s Counter Cyclical Capital Buffer Proposal

In opting for the establishment of principles which would serve as guidance for the operation of its counter cyclical capital buffer proposal, the Basel Committee made provision for possible problems which could arise if a hard rules – based approach were to be adopted.²¹⁶ Such problems, in the Basel Committee’s opinion, include the requirement of a very high degree of confidence (“that the variables used to calculate the buffer requirement would **always** correctly perform as intended and would not send out false signals”).²¹⁷ Despite allowing for a certain degree of flexibility – through such a principles and judgemental based approach, the Committee acknowledges the importance of establishing a “clear set of principles” which would not only “promote sound decision making in the setting of the counter cyclical buffer”²¹⁸ but the need to restrict the scope of judgement allowed (through the establishment of such clear set of principles). Furthermore, it highlights the importance of “proper communication” (where exercising such judgemental based decisions) as constituting an integral aspect of the proposal.²¹⁹

Whilst the principles generally serve as guidance in the use of judgement within the framework, Principle One specifically provides that buffer decisions are to be guided by “the objectives to be achieved by the buffer – namely the protection of the banking system against potential future losses when excess credit growth is associated with an increase in system-wide risk.”²²⁰

Principle Five highlights the importance of alternative tools such as “loan-to-value limits, interest

Prudential Treatment” http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531323 and http://www.bancaditalia.it/pubblicazioni/econo/quest_ecofin_2/QF_57/QEF_57.pdf at page 6

²¹³ See *ibid* at page 23

²¹⁴ “Regulatory capital”, it is argued, “should address “unexpected losses”- such losses being defined as “losses that are large but infrequent” . On the other hand, “loan loss reserves should address “expected losses”. See L Laeven and G Majnoni, “ Loan Loss Provisioning and Economic Slowdown: Too Much Too Late?” (2003) *Journal of Financial Intermediation* Volume 12 at page 195

²¹⁵ M Burroni et al, “Dynamic Provisioning: Rationale, Functioning, and Prudential Treatment” http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531323 and http://www.bancaditalia.it/pubblicazioni/econo/quest_ecofin_2/QF_57/QEF_57.pdf at page 23

²¹⁶ See Basel Committee on Banking Supervision, „ Consultative Document: Counter cyclical Capital Buffer Proposal“ July 2010 <http://www.bis.org/publ/bcbs172.pdf?noframes=1> at page 7

²¹⁷ *ibid*

²¹⁸ *ibid*

²¹⁹ *ibid*

²²⁰ “The counter cyclical capital buffer is meant to provide the banking system with an additional buffer of capital to protect it against potential future losses, when excess credit growth in the financial system as a whole is associated with an increase in system-wide risk. The capital buffer can then be released when the credit cycle turns so that the released capital can be used to help absorb losses and reduce the risk of the supply of credit being constrained by regulatory capital requirements. A side benefit of operating the buffer in this fashion is that it may lean against the build-up of excess credit in the first place. As such, the buffer is not meant to be used as an instrument to manage economic cycles or asset prices. Where appropriate, those may be best addressed through fiscal, monetary and other public policy actions. It is important that buffer decisions be taken after an assessment of as much of the relevant prevailing macroeconomic, financial and supervisory information as possible, bearing in mind that the operation of the buffer may have implications for the conduct of monetary and fiscal policies. “ see *ibid*

rate qualification tests or sectoral capital buffers which may be deployed in situations where excess credit growth is concentrated in specific sectors but aggregate credit growth is judged not to be excessive or accompanied by increased system-wide risk. “

Such principles governing the operation of the Basel Committee’s Counter Cyclical Capital Buffer Proposal can be contrasted with the CEBS’ view which (in line with EFC and G20 decisions), underlies the need for counter cyclical approaches that are based on automatic rules. The need for rules which would serve as a form of “automatic stabilisers” is attributed to the following factors:²²¹

- The importance of ensuring that deterrents exist to “overcome industry or political resistance to increase buffers during periods of economic booms and to provide a level playing field”
- The need for transparency and “clearly announced ex-ante in order to ensure that market participants are aware that banks build up buffers during periods of economic booms and run them down during recessive periods.
- CEBS’ acknowledgment that discretion is already envisaged under Pillar Two – hence the need for the existence of some rules

E. Financial Stability Forum Recommendations Aimed at Mitigating Pro cyclicality

In its report²²² on “Addressing Pro cyclicality in the Financial System”, the Financial Stability Forum’s recommendations to mitigate mechanisms that amplify pro cyclicality was extended to three areas:²²³

i) bank capital framework, ii) bank loan loss provisions as well as iii) leverage and valuation issues.

A summary of the recommendations relating to capital, as provided in the Report of the Financial Stability Forum is as follows:²²⁴

That the Basel Committee on Banking Supervision (BCBS) should strengthen the regulatory capital framework so that the quality and level of capital in the banking system increase during strong economic conditions and can be drawn down during periods of economic and financial stress;

That the BCBS should revise the market risk framework of Basel II to reduce the reliance on cyclical VAR-based capital estimates;

The BCBS should supplement the risk-based capital requirement with a simple, non-risk based measure to help contain the build-up of leverage in the banking system and put a floor under the Basel II framework;

Supervisors should use the Basel Committee's enhanced stress testing practices as a critical part of

²²¹ Committee of European Banking Supervisors, “Position Paper on a Counter Cyclical Capital Buffer” July 2009 at pages 3 and 4 <<http://www.c-ebs.org/getdoc/715bc0f9-7af9-47d9-98a8-778a4d20a880/CEBS-position-paper-on-a->

²²² “Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System” http://www.financialstabilityboard.org/publications/r_0904a.pdf

²²³ 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 page 46 of 47

²²⁴ See “Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System” at pages 2 and 3 http://www.financialstabilityboard.org/publications/r_0904a.pdf

the Pillar 2 supervisory review process to validate the adequacy of banks' capital buffers above the minimum regulatory capital requirement;

That the BCBS should monitor the impact of the Basel II framework and make appropriate adjustments to dampen excessive cyclicality of the minimum capital requirements;

That the BCBS carry out regular assessments of the risk coverage of the capital framework in relation to financial developments and banks' evolving risk profiles and make timely enhancements.

6) Conclusion

In its attempt to adopt "a building block approach" which would organise the work on pro cyclicity – the aim of this approach being "the alignment of development of tools to address pro cyclicity according to a specific set of objectives", four identified objectives set out by the Basel Committee in its December 2009 Consultative Document "Strengthening the Resilience of the Banking Sector", are as follows:²²⁵

- To dampen any excess cyclicality of the minimum capital requirement;
- To promote more forward looking provisions;
- To conserve capital to build buffers at individual banks and the banking sector that can be used during periods of stress; and
- To achieve the broader macro prudential goal of protecting the banking sector from periods of excess credit growth."

In accordance with the CEBS' observations, counter cyclical mechanisms should be i) bank specific, (ii) based on risk sensitive concepts - should also be compatible with the incentive structure presented by Basel II (as well as Basel III), and (iii) should not be excessively burdensome in terms of data needs and computational efforts.²²⁶

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 provisions – as well as provisions which are aimed at addressing losses and unforeseen problems attributed to "maturity transformation of short-term deposits into long term loans", would be greatly welcomed.

Hannoun highlights the advantages which a forward looking provisioning model offers over that of an "incurred loss" provisioning model. In his opinion, a forward looking provisioning model encourages banks to set aside provisions in a forward looking fashion based on expected losses – as opposed to the more backward looking provisions based on incurred losses.²²⁷ Furthermore, he adds that "a forward looking approach not only captures actual losses more transparently, but is also less pro cyclical than the incurred loss provisioning model which is presently being used."²²⁸

Further, the Committee of European Banking Supervisors (CEBS) has acknowledged that tools

²²⁵ See Basel Committee on Banking Supervision, „ Consultative Document: Counter cyclical Capital Buffer Proposal“ July 2010 <http://www.bis.org/publ/bcbs172.pdf?noframes=1> at page 1

²²⁶ Bank specificity would ensure that counter cyclical tools are "tailored to the peculiarities of each bank's portfolios", risk sensitive based concepts would mitigate "perverse incentives – as well as opportunities for arbitrage". See Committee of European Banking Supervisors, "Position Paper on a Counter Cyclical Capital Buffer" July 2009 at page 4

²²⁷ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 17

²²⁸ *ibid*

which could be implemented as measures for mitigating cyclicalities, 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.²²⁹

The proposed 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).”²³⁰ 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.

²²⁹ Committee of European Banking Supervisors, “Position Paper on a Counter Cyclical Capital Buffer” July 2009 at page 2 <http://www.c-eps.org/getdoc/715bc0f9-7af9-47d9-98a8-778a4d20a880/CEBS-position-paper-on-a-countercyclical-capital-b.aspx>

²³⁰ 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>>

Measures Aimed at Enhancing the Loss Absorbency of Regulatory Capital at the Point of Non Viability²³¹

Introduction

Capital is very significant in its role since it serves to absorb risks and protect deposits. Given the imposition of an adequately stipulated minimum ratio, it could also facilitate the process of equalising competition between banks (rather than impeding their ability to compete).

The Basel Committee's recent consultative document on the "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" sets out a proposal aimed at "enhancing the entry criteria of regulatory capital to ensure that all regulatory capital instruments issued by banks are capable of absorbing losses in the event that a bank is unable to support itself in the private market."²³²

Of particular interest are the Committee's observations regarding the consequences of rescuing several distressed banks during the recent Financial Crisis, through the injection of funds (by the public sector) in the form of common equity and other forms of Tier One Capital. Two associated consequences are as follows:²³³

Its effect of supporting not only depositors but also the investors in regulatory capital instruments – which consequently resulted in the inability of Tier Two capital instruments (mainly subordinated debt), and in some cases, non-common Tier One instruments, to absorb losses incurred by certain large internationally active banks that would have failed - had the public sector not provided support.

As a means of ensuring that instruments are accorded with the status of "regulatory capital" and also dealt with accordingly, a pre condition was stipulated by the Committee – such pre condition being that "such instruments are capable of bearing a loss."²³⁴

As well as the affirmation of its opinion that "a public sector injection of capital (needed to avoid the failure of a bank) should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred if the public sector had not chosen to rescue the bank", the Basel Committee clearly indicated in the Consultative Document that all regulatory capital

²³¹ See Basel Committee for Banking Supervision, Bank for International Settlements Publications <http://www.biz.org/publ/bcbs174/mariannejojo.pdf>

²³² See Basel Committee on Banking Supervision, Consultative Document "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" August 2010 at page 1 (page 7 of 20) < www.bis.org/publ/bcbs174.htm.>

²³³ See *ibid*

²³⁴ Of particular interest is the third option which was provided by the Committee as a means of ensuring this outcome (of ensuring that such instruments are capable of bearing a loss). This option is namely, the requirement that "all regulatory capital instruments include a mechanism in their terms and conditions that would ensure that they would accept a loss at the point of non viability." See *ibid*.

instruments must be capable of absorbing a loss at least in gone concern situations.²³⁵ This requirement was prompted by the Basel Committee's observations from the recent Financial Crisis – which revealed that many regulatory capital instruments do not always absorb losses in gone concern situations. In this respect it remarked that:²³⁶

“The numerous public sector injections of capital during the crisis, and other forms of public sector support have had the indirect consequence of ensuring that in many instances, capital instruments issued by banks that have been bailed out, have not taken any losses at all.”

Owing to huge liquidity problems, it was just recently announced that the ailing mortgage lender (Hypo Real Estate) is to be granted € 40 billion to the already € 102 billion in state guarantees. This (most recent) grant will also facilitate the launch of a “bad bank” whereby its toxic assets can be disposed of (aim being to strengthen the remaining core bank).²³⁷

The case of Hypo Real Estate (HRE)²³⁸ is considered within this respect, not because it is regarded as having not absorbed any losses (at all), but rather, because it is questionable whether the resulting burden imposed on taxpayers (arising from government funding), could have been mitigated to a greater extent. Even though rescue aid was granted by the Commission to Hypo Real Estate on the 2nd of October 2008 and further measures were also communicated by the German authorities on the 26th October 2009 (measures which included SOFFin guarantees of 8 and 10 billion Euros for HRE),²³⁹ HRE was eventually nationalised.²⁴⁰

²³⁵ The Basel Committee added that “if gone concern were to be defined as insolvency and liquidation, then all regulatory capital instruments would be loss absorbent on a gone concern basis and such loss absorbency would be achieved through the subordination of the capital instruments – with the result that any repayment in liquidation would only be received if all depositors and higher ranked creditors are first repaid in full.” It however defined „gone concern“ to include „situations in which the public sector provides support to distressed banks that would otherwise have failed. ibid at page 3

²³⁶ ibid at page 3

²³⁷ See Frankfurter Allgemeine Zeitung, “40 Milliarden Euro mehr Staatsgarantien”(Hypo Real Estate: 40 billion Euros Worth of More Government Guarantees) 11th September 2010 <<http://www.faz.net/s/RubD16E1F55D21144C4AE3F9DDF52B6E1D9/Doc~EB16F2C756D694B4CA07FA5F7EF8E7535~ATpl~Ecommon~Scontent.html>> See also Bild, “Staats-Garantien für Hypo Real Estate: Wieso kriegt die Pleite-Bank noch einmal Milliarden?” 11th September 2010 <<http://www.bild.de/BILD/politik/wirtschaft/2010/09/11/hypo-real-estate-wieso-kriegt/die-pleite-bank-ploetzlich-noch-einmal-milliarden.html>>

²³⁸ See European Commission, “State Aid no NN 44/2008 – Germany Rescue aid for Hypo Real Estate” http://ec.europa.eu/competition/state_aid/register/ii/doc/NN-44-2008-WLWL-en-02.10.2008.pdf

²³⁹ See European Commission “European Commission State aid no N 694/2009 – Germany Emergency Guarantees for Hypo Real Estate” paragraph 3

²⁴⁰ “In January 2009, the German government had promulgated necessary measures aimed at facilitating the adoption of legislation which would enable it acquire a majority stake holding in Hypo.”<<http://www.reuters.com/article/idUSTRE5381WB20090409>> “The squeeze out of minority shareholders – this being approved by a court in Munich in October 2009, paved the way for the German government's rescue fund SOFFin to get 100% of the real estate lender.” See Reuters; “Hypo Real Estate is Nationalised with Squeeze Out” <<http://www.reuters.com/article/idUSLD67573320091013>>

B. How Can the Desire to Facilitate Gone Concern Loss Absorbency of All Regulatory Capital Instruments (Including cases where there is public sector support) be Achieved?

“Conversion/Write offs”

Whereby debt instruments are transferred into “higher quality and common equity capital with better loss absorption characteristics – with the result that the institution’s ability to withstand further losses is consolidated.”²⁴¹

Debt regarded as bank capital should be converted to stock or written off in a crisis – hence compelling bond investors to bear some of the cost of future bail outs.²⁴² All regulatory capital instruments sold by banks should be capable of absorbing losses if the company is unable to fund itself – before taxpayers’ cash is plundered into rescuing a lender, so-called contingent capital should be converted into equity or written off.²⁴³

Controlled Winding Down Procedures

In the case which involved Bradford and Bingley, the UK authorities decided to pursue a wind down procedure whereby the retail deposit book was to be sold while an orderly wind down of the remainder of the business was to be undertaken for the purposes of maximising recoveries – as well as minimising the burden on tax payers.²⁴⁴

Reasons for undertaking the route of a controlled winding down process – as opposed to uncontrolled insolvency were also highlighted. An orderly winding down process would not only “maximise the value of the remaining assets and minimise the amount of necessary state aid”, but would also facilitate the repayment of the working capital facility as well as statutory debt. Furthermore, the reasons for the choice of a controlled winding down process necessitated a consideration of the legislation in force when the decision to wind down Bradford and Bingley (and thereafter, Rumpco) was taken – and such reasons include:²⁴⁵

An absence of a “strictly defined time-frame” for large and complex liquidations such as that of Bradford and Bingley (B & B). The fact that B & B would not have obtained the working capital facility which was required in order to pay Rumpco creditors – had B & B chosen the route of

²⁴¹ See Basel Committee on Banking Supervision, Consultative Document “Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability” August 2010 at page 13 (page 19 of 20) <<http://www.bis.org/publ/bcbs174.pdf?noframes=1>>

²⁴² “Basel Committee Says Bank Bond Investors Should Help Fund Future Bailouts” <<http://www.bloomberg.com/news/2010-08-19/basel-committee-says-bank-bond-investors-should-help-bear-cost-of-bailouts.html>>

²⁴³ *ibid*

²⁴⁴ See European Commission, “State Aid N194/2009 – United Kingdom : Liquidation Aid to Bradford and Bingley Plc” at paragraph 4 page 2

²⁴⁵ *ibid* at paragraphs 13 and 14

uncontrolled insolvency. An uncontrolled insolvency procedure would also have resulted in a liquidation shortfall with respect to debt owed to creditors. An uncontrolled insolvency procedure would have endangered the prospects of the recovery of full value of statutory debt. Rumpco's uncontrolled insolvency would have undermined financial stability – as well as market confidence.

C. Definition of Different Classes of Capital – should there be a re-definition of what constitutes regulatory capital – since it has been proposed that all regulatory instruments should be convertible/capable of absorbing losses?

Capital is considered to comprise of elements of Tier One, Two and Three capital. Tier One Capital comprises common equity – which has the following attributes: ²⁴⁶

- It is considered to be the highest quality component of capital
- It is subordinated to all other elements of funding – absorbing losses as and when they occur, having full flexibility of dividend payments
- No maturity date
- It is the primary form of funding which helps to ensure that banks remain solvent.

The distinction between definitions of Tier One and Tier Two capital are highlighted by the Committee as corresponding to capital which absorbs losses on a going concern basis and capital which absorbs losses on a gone concern basis respectively.²⁴⁷

Proposed key changes, whilst aimed at “significantly improving the quality and consistency of the common equity of Tier One capital”, as well as simplifying Tier Two Capital (to the extent that there would be only one set of entry criteria – and the removal of sub categories pertaining to Tier Two) also include the recommendation that Tier Three capital be abolished “to ensure that market risks are met with the same quality of capital as credit and operational risks.”²⁴⁸

As a result, the proposed harmonised structure of capital will consist of Tier One Capital (going concern capital) with further components comprising common equity and additional going concern capital and; Tier Two Capital (gone concern capital).²⁴⁹

In proposing a new definition of capital, the Basel Committee on Banking Supervision, in its Consultative Document,²⁵⁰ elaborated on “certain overarching objectives” which had contributed towards its formulation of the proposed new definition of capital and these are as follows:

- a) Tier One Capital must help a bank to remain a going concern
- b) Regulatory adjustments must be applied to the appropriate component of capital

²⁴⁶ Basel Committee on Banking Supervision, Consultative Document “Strengthening the Resilience of the Banking Sector” December 2009 at page 14

²⁴⁷ *ibid*

²⁴⁸ *ibid* at page 14-16

²⁴⁹ *ibid* at page 17

²⁵⁰ Basel Committee on Banking Supervision, Consultative Document “Strengthening the Resilience of the Banking Sector” December 2009 at pages 14 and 15 <<http://www.bis.org/publ/bcbs164.pdf>>

- c) Regulatory capital must be simple and harmonised across jurisdictions
- d) The components of regulatory capital must be clearly disclosed

The proposed new definition of capital offers several advantages – one of which is namely, the facilitation of harmonisation – since the regulatory definition of capital varies according to the jurisdiction and its governing law.²⁵¹

D. Problems and Benefits Identified with Basel Committee’s Loss Absorbency Proposal

Some problems identified with the Basel Committee’s proposal - that all regulatory instruments should be capable of absorbing losses include the following:

- the need for a liquid market (which is considered not to exist at present)
- A possible rise in the banks’ cost of capital (since investors are likely to demand compensation for the increased risk being borne – for which they will not be repaid.²⁵² Lower levels of investment
- Increased uncertainty and further elevated levels of instability as a result of lower levels of investment

Even though the above-mentioned issues have been raised, the Basel Committee is clearly justified in its affirmation that “a public sector injection of capital (needed to avoid the failure of a bank) should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred if the public sector had not chosen to rescue the bank.”

Furthermore, most of these concerns are not entirely well-grounded since investment (in any case – and regardless of the recommendation that all regulatory capital instruments issued by banks are capable of absorbing losses on a going and gone concern basis) will always involve an element of risk. Banks should not be made to pay more money to investors for regulatory capital (if and when investors demand compensation for increased risk for which they will not be repaid) since investors get paid to take risks and should expect risks with investments. Perhaps some form of reward or loyalty payments could be tied in to the investments – such rewards being redeemed²⁵³ by investors only in the event that the bank or firm operates on a gone concern basis. Other schemes which serve to ensure that minimum safeguards are place to compensate investors, to insure investor protection - as well as encourage small investors to invest in securities, include the Investor Compensation Schemes Directive (the ICD) ²⁵⁴ and Deposit Guarantee Schemes Directive.²⁵⁵ The ICD (which has

²⁵¹ The regulatory definition of capital is considered to be “inevitably embedded in company law”. See European Banking Federation, Comments on Consultative Documents issued by Basel Committee on Banking Supervision “Strengthening the Resilience of the Banking Sector” and “International Framework for Liquidity Risk Measurement, Standards and Monitoring” at page 13

²⁵² “Basel Committee Says Bank Bond Investors Should Help Fund Future Bailouts”

<<http://www.bloomberg.com/news/2010-08-19/basel-committee-says-bank-bond-investors-should-help-bear-cost-of-bailouts.html>>

²⁵³ The European Banking Federation (EBF) made a proposal that instruments should not qualify (or be included) as Tier 2 capital if there would be incentives to redeem. European Banking Federation, Comments on consultative documents issued by Basel Committee on Banking Supervision “Strengthening the Resilience of the Banking Sector” and “International Framework for Liquidity Risk Measurement, Standards and Monitoring” at page 13

²⁵⁴ The Directive 97/9/EC on Investor Compensation Schemes, known as the Investment Compensation Scheme Directive (the ICD), was adopted in 1997 as a supplement for the Investment Services Directive (Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141,11.6.1993, p. 27–46).

²⁵⁵ Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes [amended by Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 and Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-

been replaced by the Markets in Financial Instruments Directive – MiFID), “provides for clients receiving investment services from investment firms (including credit institutions) to be compensated in specific circumstances where the firm is unable to return money or financial instruments that it holds on the client’s behalf.”²⁵⁶

It is acknowledged that the Committee’s recommendations should signal to investors that higher risks are to be anticipated. Furthermore, bond holders (and not tax payers) should now expect to be the first resort (in terms of funding and new equity) where it is evident that an institution is likely to operate on a gone concern basis. This could result in slightly lower levels of investment – however, it could also produce the beneficial result of discouraging investment by those investors who take excessive risks – hence reducing moral hazard. A balance should be struck between introducing appropriate incentives (aimed at sustaining healthy levels of investment) which would encourage non reckless investors to invest and the need to discourage excessive levels of risk taking.

Based on the Basel Committee’s efforts to improve the disclosure requirements of the components of regulatory capital, greater transparency should be facilitated – such transparency contributing to less uncertainty and assisting investors in deciding whether or not to invest in certain products. Bank depositors have greater need of protection since more rules (range of conduct rules)²⁵⁷ exist within the investment sector - which serve the purpose of assisting investors in arriving at their investment decisions. In so far as the Basel Committee is able to achieve efforts aimed at mitigating substantial elements of uncertainty which may exist – with respect to the implementation of new regulations, such efforts should eliminate the fears attributed to consequences of uncertainty – namely, greater volatility in the bank bond market.

Benefits of the Basel Committee’s Proposals

Discouraging excessive risk taking (since investors will not be encouraged to buy securities under the assumption that they will avoid losses in the event of a bank failure)

It would reduce the need for government bailouts owing to the requirement that contingent capital be converted (to equity or written off) to fund rescues rather than taxpayers solely bearing the cost. Hence bond investors of a bank will serve as the first resort during the impending collapse of a bank.

guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance)]

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML>

²⁵⁶ See Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes at page 2 <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0371:FIN:EN:PDF>>

²⁵⁷ As well as serving as an “additional layer of protection in collaboration with conduct of business rules, prudential regulation and operational safeguards, the Investor Compensation Schemes Directive (ICD) is also aimed at “protecting investors against the risk of losses in the event of an investment firm’s inability to repay money or return assets held on their behalf.” See DG Internal Market and Services, EVALUATION OF THE INVESTMENT COMPENSATION SCHEME DIRECTIVE DG INTERNAL MARKET AND SERVICES EXECUTIVE REPORT AND RECOMMENDATIONS at page 2

http://ec.europa.eu/dgs/internal_market/docs/evaluation/inv-comp-schem-directive_en.pdf

E. Measures Identified by the AFME as Means of Rescuing Failing Banks Without Taxpayer Financing.

In its paper “The Systemic Safety Net: Pulling Failing Firms Back From the Edge”, the Association for Financial Markets in Europe (AFME) shed some light on two mechanisms which are considered to be instrumental in the achievement of the goal of managing a failing financial institution – as well as the re capitalisation of such an institution (without the need for capital support from governments and tax payers).²⁵⁸ These mechanisms are:²⁵⁹

- 1) The Bail In Mechanism : Whose implementation commences when a firm reaches a pre-defined trigger – which would re-capitalise a firm as a going concern (through the conversion of selected levels of unsecured debt to common equity). Since no shareholder or creditor consultation is considered to be necessary, a swift implementation of its operation is expected.
- 2) Contingent Capital: Whose implementation has been undertaken historically by the insurance sector and which serves as a provision for one-time losses. It is issued in the form of notes which are convertible into equity as soon as a pre-defined trigger is attained by the issuer. Since it requires no regulatory involvement, transparency is enhanced – such transparency serving as a potential means in helping to prevent localised problems from triggering into a full blown systemic crisis.”

One difference between both mechanisms can be attributed to the frequency of their applicability. Whilst contingent capital serves as a provision for one-time losses which are unexpected, the bail in mechanism operates according to an expected pre-determined threshold level.

According to the AFME, either of these options would serve as a better alternative than liquidation.²⁶⁰

²⁵⁸ Association for Financial Markets in Europe, “AFME Outlines Ways To Rescue Failing Banks Without Tax Payer Financing” <http://www.afme.eu/AFME/Home/sifi%20pr.pdf> at page 1 of 2

²⁵⁹ *ibid*

²⁶⁰ Furthermore, the AFME adds that with each option, the bank’s shareholders would bear the loss through devaluation or dilution of their equity and that (more critically), neither option requires capital support from tax payers or a pre capitalised fund for providing liquidity. See *ibid*.

F. Basel Committee's Measures Aimed At Improving the Quality of Tier One Capital

Category of Tier 1	Calculation	Notes
Common equity ("core Tier 1")	Common equity	<ul style="list-style-type: none"> ● Predominant form must be common shares plus retained earnings and other comprehensive income ● No debt-like instruments included in core Tier1 ● No "financial innovation" permitted ● Net of deductions (goodwill, deferred tax assets, minority interest, investments in own shares, etc) ● Deductions are internationally harmonised
	- Goodwill (deduction)	
	= Tangible common equity	
	- Other deductions	
	= Common equity net of deductions	
Additional going-concern capital ¹	+ Preference shares Preferred stock	<ul style="list-style-type: none"> ● Instruments must meet strict entry criteria (eg subordinated, no maturity date, fully discretionary non-cumulative dividends, no incentive to redeem) ● Only limited debt-like features permitted (preferred dividends) ● Grandfathering of capital instruments under consideration (including government rescue package instruments) ● Elimination of the use of innovative hybrid debt instruments
	+ Other non-dated, loss-absorbing instruments (only limited debt-like features permitted)	
	= Tier 1 capital (going-concern capital) ¹	<ul style="list-style-type: none"> ● Enhanced disclosure of all elements of Tier 1 capital, including all regulatory adjustments, main features, explanation of ratios
	Contingent convertible bonds (contingent capital)	<ul style="list-style-type: none"> ● Under review: some debt in banks' capital structure converts to equity when a predefined threshold is reached

Source: "Improving the Quality of Tier One Capital"²⁶¹

„The enhanced Basel II framework (which includes reforms aimed at increasing the quantity of capital – as well as improving the quality of capital),and the macroprudential overlay are (together) referred to as Basel III. „²⁶²

²⁶¹ See H Hannoun, „Towards a Global Financial Stability Framework“ Bank for International Settlements Publications, page 11 of 26 <<http://www.bis.org/speeches/sp100303.pdf>>see also page 9 of 26;ibid. „With hindsight, it is acknowledged that the global banking system entered the crisis with an insufficient level of capital and not enough high-quality capital. Recall that regulated financial institutions are required to hold Tier 1 and Tier 2 capital equal to 8% of risk-weighted assets, with Tier 1 capital representing at least half this amount. Unfortunately the definition of what constituted capital included instruments or accounting items that could not absorb losses on a going-concern basis. Market participants knew this, and increasingly focused on the levels of tangible common equity in banks' capital structures (after deduction of intangible assets such as goodwill). The levels of core Tier 1 equity proved to be too low.“ See page 10 of 26;ibid.

²⁶²Ibid at page 9 of 26

Conclusion

According to Laeven and Majnoni,²⁶³ regulatory capital, “should cope with the occurrence of unexpected losses – that is, losses that are large but infrequent and further, loan loss reserves should, instead, cope with expected losses.” In reconciling the different views held about bank capital requirements, they propose a partitioning of regulatory capital which is based not only on terms relating to priority (as is the case for Tier One and Tier Two Capital), but also (and foremost) on risk management considerations.²⁶⁴ The management of “Too Big to Fail Firms” should be sent appropriate signals – signals which would highlight the fact that the importance of such firms (to systemic stability) does not provide justification for the management of such firms to act recklessly. Intensive restructuring, to the extent that the entire management of such a firm is replaced (with new management) serves as an example of such a warning. This would also facilitate the reduction of moral hazard and excessive levels of risk taking.

Distinguishing between Expected and Unexpected Losses: Regulatory Capital and Unexpected Losses v Loan Loss Reserves and Expected Losses

Should Tier One Capital alone cover potential losses – particularly in view of the Basel Committee’s recent recommendation which is aimed at ensuring that all regulatory instruments absorb losses? Which component should (have) or be endowed with greater capacity to absorb expected or unexpected losses?²⁶⁵

With respect to the current debate on loss loan provisioning, the European Banking Federation (EBF), the EBF is supportive of the provisioning based on Expected Loss model and recommended a provisioning model based on the EL concept, which “captures the economic reality of the lending activities of financial institutions in line with the six principles of the Bank for International Settlements” in order to achieve sound Expected Loss provisioning approach.²⁶⁶

Two principal reasons have been put forward by the European Banking Federation to justify their proposal of a sufficient level of non-predominant Tier One when limits to the capital components are determined.²⁶⁷ These are attributed to “the quality of non-core instruments which will increase

²⁶³ See L Laeven and G Majnoni, „Loan Loss Provisioning and Economic Slowdowns: Too Much, Too Late? at page 6

²⁶⁴ *ibid*

²⁶⁵ The preference for total regulatory capital – owing to its effectiveness in capturing potential losses, was highlighted by the Federcasse – in reference to the proposal of a consideration of only Tier One capital to cover buffers. See Federazione Italiana delle Banche di Credito Cooperativo Casse Rurali ed Artigiane,(Federcasse) Comments on consultative documents issued by Basel Committee on Banking Supervision “Strengthening the Resilience of the Banking Sector” and “International Framework for Liquidity Risk Measurement, Standards and Monitoring” <http://www.bis.org/publ/bcbs165/ifoccb.pdf> at page 10

²⁶⁶ European Banking Federation, Comments on consultative documents issued by Basel Committee on Banking Supervision “Strengthening the Resilience of the Banking Sector” and “International Framework for Liquidity Risk Measurement, Standards and Monitoring” at page 6

http://www.finansraadet.dk/media/208544/ebf_hoeringssvar_international_framework_for_liquidity_risk_measurement_standards_and_monitoring_150410.pdf

²⁶⁷ European Banking Federation, Comments on consultative documents issued by Basel Committee on Banking Supervision “Strengthening the Resilience of the Banking Sector” and “International Framework for Liquidity Risk Measurement, Standards and Monitoring” at page 13

http://www.finansraadet.dk/media/208544/ebf_hoeringssvar_international_framework_for_liquidity_risk_measurement_standards_and_monitoring_150410.pdf

significantly compared to today's instruments; and the fact that institutions will need to increase their global own funds level to comply with the new rules. ²⁶⁸

Should the minimum capital ratio of 8% be revised?

For reasons associated with the desire to enhance the competitive ability of banks, an increase in the present capital ratio is not favoured.

Tier Two capital should be able to cover losses absorbed at the point of non viability – however, restrictions should be imposed on such potential – in contrast to the case with Tier One capital. There should be less restrictions on the classes of debt like instruments which can be included under Tier One capital.

Furthermore, those shares which are to be redeemed (as incentives) in the event of the firm operating as a gone concern (and which should also absorb losses – hence resulting in a reduction of their values when and if they are redeemed) should be included as Tier One capital. As illustrated, Basel III reforms reflect efforts being made within this field – particularly with respect to contingent convertible bonds (which are currently being reviewed).

²⁶⁸ Other benefits attributed to the non-core Tier 1 instruments include its large investor base and the very useful currency diversification. For this reason, a request was put (by the European Banking Federation) to the Committee to set Core Tier 1 at a reasonable level - close to 51%.;ibid

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