Successfully implementing major financial stability regulatory reforms: the risk weighting based controversy (Basel v Dodd Frank) and the role of national supervisors

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ABSTRACT

As well as a consideration of the role contributed by national supervisors in the successful implementation and enforcement of standards, recommendations and regulations, the significance of clear and unambiguous mandates in enhancing communication between micro prudential supervisors (usually national financial supervisors and central banks) and macro prudential bodies which are responsible for writing the laws that are enforced by micro prudential supervisors, will be highlighted in this paper. This will incorporate a discussion on the advantages and disadvantages inherent in clear, explicit mandates – such a discussion necessitating a distinction between financial stability and monetary policy objectives.

Furthermore, the role of credit ratings and their significance in influencing investor choices and judgments, will be considered as a means of highlighting how they contribute to the neglect of risks, exposures attributed to certain financial instruments, and ultimately, systemic risks which de stabilize the financial system.

Key Words: European Systemic Risk Board, financial stability, credit ratings, Dodd Frank Act, micro prudential supervision, risk weights, European Central Bank, counterparty risks, macro prudential arrangements, central banks, European Supervisory Authorities, monetary policy, risks
Successfully Implementing Major Financial Stability Regulatory Reforms: The Risk Weighting Based Controversy (Basel v Dodd Frank) and the Role of National Supervisors.¹

Marianne Ojo²

Introduction

“Micro prudential supervisors have a key role, because stable institutions are an essential and necessary condition for achieving financial stability – which is why the European Supervisory Authorities (ESAs) and national supervisors together with the central banks, are members of the ESRB and why the ESRB and the ESAs comprise the European System of Financial Supervisors.”³

Whilst financial stability could be defined as “a condition in which the financial system – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the impact of financial imbalances,”⁴ financial instability, it is contended, generally refers to two types of phenomenon which are considered to be closely linked, namely:⁵

- Large movements in asset prices
- Financial distress of institutions

In other words, financial stability objectives and cycles can usually be discerned and distinguished from those of monetary policy where significant changes in asset prices or financial distress occurs.

In highlighting the aims, objectives of this paper, as set out within the abstract, this paper will commence with a section on Financial stability and monetary policy objectives – a section which is aimed at highlighting why monetary policy objectives are less flexible and more rigid than financial stability objectives. Section two then proceeds to consider the synergetic relationship between monetary policy setting and prudential frameworks. The third section is committed to a consideration of the European Systemic Risk Board, its objectives, composition and non binding powers. Section four will then go on to highlight why „clear and explicit” objectives are required in order to achieve clarity about mandates. This will be followed by a section which elaborates on the Basel Committee's tasks and challenges in its efforts to facilitate financial stability. Section six will then consider what roles national supervisors can play in facilitating the Basel Committee's efforts to achieve financial stability objectives. This will then be followed by section seven – which highlights the importance of risks and risk based weightings in triggering financial instability – before a conclusion is derived.

¹ National supervisors impliedly comprise national financial supervisors and central banks. National supervisors are distinguished from micro prudential supervisors where reference is also made to the European Supervisory Authorities. Whilst national supervisors are also micro prudential supervisors, micro prudential supervisors could also comprise national financial supervisors, central banks and the European Supervisory Authorities.

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⁴ European Central Bank, see preface of Financial Stability Review June 2011 at page 9 < http://www.ecb.int/pub/pdf/other/financialstabilityreview201106en.pdf?id=628667d5a27d080f284591a4df18378>

⁵ See Speech by Andrew Crockett, “In Search of Anchors For Financial and Monetary Stability”, at the SUERF Colloquium in Vienna, 27-29 April 2000 < http://www.bis.org/speeches/sp000427.htm>
A. Financial Stability v Monetary Policy Objectives

Financial stability functions and objectives are generally considered to be less defined and more ambiguous than monetary policy objectives. There are several plausible explanations for this – and which justify whether monetary policies should be more rigid and less flexible. The question is presented as to whether “monetary policy should be directed at limiting the build up of financial imbalances. In particular, should monetary policy respond to perceived asset price misalignments which in the central bank’s view, threaten financial stability?”\(^6\) It is added, further, that the response to this (as well as such response being “the conventional view”), is that they should not (monetary policies should not respond to perceived asset price alignments which are considered to threaten financial stability).\(^7\)

Four reasons which have been put forward to bolster this response are as follows:\(^8\)

- Monetary policy should only respond to asset prices to the extent that they provide information about future inflation.
- Central bank’s efforts to avoid imbalances from building-up\(^9\) would be futile since by the time it is able to form firm judgment about its existence, it would be too late (“pricking a bubble in its latter stages would only aggravate the instability which it is intended to avert”).
- The response of asset prices to monetary policy is highly unpredictable as well as dependent on market sentiments.
- Who is able to predict with confidence that an asset price movement is a bubble and not merely a reflection of fundamental/basic asset values?”

B. Synergies between Monetary Policy Setting and Prudential Frameworks

Is it preferable to create an agency whose monetary policy functions are distinct and separate from those of its prudential and financial stability objectives? The following section is aimed at highlighting the synergetic relationships between monetary policy setting and prudential frameworks.

In order to counter the belief and argument that macro prudential frameworks could lead to conflicts between monetary and macro prudential actions, two reasons have been put forward to bolster the likelihood that macro prudential policy and monetary policy will be complementary and congruent to each other – rather than moving in opposite directions:\(^10\)

i) The fact that financial cycles associated with serious financial distress tend to be considerably longer than typical business cycles – which implies that most of the

\(^6\)ibid
\(^7\)ibid
\(^8\)ibid
\(^9\)It is argued that “Monetary policy makers will need to keep an eye on longer-term trends if they are to take into account the gradual build-up and unwinding of financial imbalances and their economic and inflationary effects.” See J Caruana, „Monetary Policy in a World with Macro Prudential Policy“ Bank for International Settlement Publications < http://www.bis.org/speeches/sp110610.htm>
\(^10\)ibid
time, monetary policy makers can treat macro prudential policy developments as a relatively slow moving background.\(^{11}\)

ii) The need to think in terms of a policy hierarchy – a good example being the potential set of responses to strong capital inflows. Capital inflows into emerging market economies can put strong upward pressure on domestic inflation, as well as on credit and asset price growth. In this situation, the top priority is to apply macroeconomic policies - including monetary, fiscal and exchange rate measures - to safeguard domestic financial stability." \(^{12}\)

The complementary and synergetic natures of functions relating to financial stability, as well as monetary policy setting functions, the need to couple such functions, is reflected by the following macro prudential oversight frameworks: \(^{13}\)

\(^{11}\) “It also means that the pursuit of price stability over horizons of just two years or so, is no longer fully appropriate.”

\(^{12}\) “The appropriate role of macro prudential policy is to curb excessive risk-taking by the domestic financial system. Such restraint might well help to cool aggregate demand and, as such, should be taken into account by monetary policy. But the use of macro prudential policy should not be used as an excuse to postpone or reduce the inevitable tightening of monetary policy.” See ibid

\(^{13}\) See European Central Bank, Financial Stability Review December 2010 at page 61
As illustrated by the diagram above, the central bank constitutes part of the embracing body as its expertise is required in the overall objectives of the respective macro prudential frameworks. Greater focus should be dedicated to the identification and diagnosis of risks rather than the preventative and remedial stages. Even where aggregate risks which exist at Euro wide level differ from those which exist at the micro prudential level, the identification of threatening risks at an early stage would eventually help mitigate or prevent the build-up of potentially threatening and dangerous risks at system level.

The issuing of warnings to the relevant actors and the recommendation of appropriate actions, a specific objective of the ESRB, is considered to be “closely linked to the scope of warnings and Recommendations”. It is also highlighted that even though it is not possible to specify in advance

<table>
<thead>
<tr>
<th>Comparison of UK, US and EU micro-prudential oversight frameworks</th>
</tr>
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<tbody>
<tr>
<td><strong>Overarching body</strong></td>
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<tr>
<td><strong>Scope</strong></td>
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<td><strong>Overall objective</strong></td>
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<td><strong>Role of central banks</strong></td>
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<td><strong>Crisis management</strong></td>
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an appropriate scope for potential warnings and recommendations, it is still possible to identify those who might be responsible for taking appropriate policy or supervisory action.\textsuperscript{14}

In certain jurisdictions the micro prudential supervisor may also be responsible for executing monetary policy setting functions as well as macro prudential decisions (for example, the central bank). Where the central bank has policy responsibility for BOTH monetary and financial stability, the ranking of certain objectives is considered to be desirable. \textbf{Which objectives should be more highly ranked than others?} Monetary or financial stability objectives? Need for independence and accountability where both distinct functions (monetary policy setting functions as well as macro prudential decisions) are exercised by the central bank. Could be argued that prompt urgent actions which need to be taken in order to restore stability back to the financial system should take priority over monetary objectives – the duration for which such objectives should take pre-eminence being also subject to the required length or duration of time to restore the financial system back to normality. In such circumstances, where real serious threats are likely to endanger the financial system, monetary policy objectives would need to be flexible to the extent that they permit such changes in priority – through the incorporation of clauses which allow for such alteration or amendments to be executed.

Several arguments which justify the central bank’s responsibility in executing macro prudential decisions – one of which includes its ability to obtain information which is required for its functions and responsibilities. Three basic ways through which the central bank can obtain such information include:\textsuperscript{15}

- If the central bank is the micro supervisor, it may have direct, first-hand access on an ongoing basis, through an onsite power (for the supplementation of the right to call for reports).
- The central bank may be able to obtain bank-specific information – as well as undertake due diligence inspections when prompted by concerns, using its own or specialized contract staff – even where it is not responsible for supervision.\textsuperscript{16}
- The central bank may obtain its information from other agencies such as a micro prudential supervisor. Such information sharing may be a legal obligation, the subject of a memorandum of understanding, or simply considered good practice.

C. The European Systemic Risk Board (ESRB)

I. Establishment and Objectives

Whilst the US Financial Stability Oversight Council was established by the US Dodd Frank Act, the European Systemic Risk Board (ESRB) was established on the basis of Article 95 of the EC Treaty

\textsuperscript{14} “At the EU level, for example, this would include the new European Supervisory Authorities, which will be responsible for, among other things, developing technical standards, ensuring compliance among national supervisors with appropriate community law and eventually direct supervision of some EU wide institutions, notably Credit rating Agencies”.


\textsuperscript{16} “The central bank may be legally empowered to obtain such information or it may succeed because its actual or potential counterparties agree to provide it.”
as “a body without legal personality.”¹⁷

The objective of the ESRB is considered to be three fold:¹⁸

- Developing a European macro prudential perspective to address the problem of fragmented individual risk analysis at national level
- Enhancing the effectiveness of early warning mechanisms by improving the interaction between micro and macro prudential analysis
- Allowing for risk assessments to be translated into action by the relevant authorities.

II. Non Binding Powers of the ESRB

Article 5 of the Regulations¹⁹ states that the ESRB “will not have any binding powers to impose measures on Member States or national authorities.” Instead, Commission proposals describe the ESRB as a “reputational body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority.”

By virtue of Article 95 of the EC Treaty, mandate is also given to the ESRB to request for information from national supervisors where such information has not been provided.

Owing to the non-legally binding effects of the ESRB’s recommendations, its authority (or the ability of other authorities to comply with its instructions or mandate) may be questioned. However, its recommendations cannot simply be ignored. Addressees of recommendations must state whether they agree with its recommendations or not.”²⁰

- The inability of the ESRB to issue binding recommendations has led some to describe it as a “toothless talking shop” which will duplicate activities already undertaken by other national and international institutions.²¹

III. Structure of the ESRB

The ESRB is comprised of: i) a General Board ii) a Steering Committee and iii) a Secretariat

The General Board serves as the decision making body of the ESRB and its membership consists

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¹⁷ “The legal basis on which the ESRB has been established endows it with a mandate which covers the entire financial sector without exceptions.” See International Association of Risk and Compliance Professionals (IARCP), “The European Systemic Risk Board “ <http://european-systemic-risk-board.com>

¹⁸ See House of Commons Select Committees, “The Committee’s Opinion on Proposals for European Financial Supervision” <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmeuleg/5-i/5i04.htm>


²⁰ “Given its wide scope and the sensitivity of its missions, the ESRB is not to be conceived as a body with legal personality and binding powers but rather as a body drawing its legitimacy from its reputation for independent judgments, high quality analysis and sharpness in its conclusions.” See International Association of Risk and Compliance Professionals (IARCP), “The European Systemic Risk Board “ <http://european-systemic-risk-board.com>

²¹ See House of Commons Select Committees, “The Committee’s Opinion on Proposals for European Financial Supervision” <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmeuleg/5-i/5i04.htm>
Governors of the 27 national central banks  
- The President and the Vice President of the European Central bank  
- A Member of the European Commission  
- The Chairpersons of the three European Supervisory Authorities

Given the complex structure of the European Systemic Risk Board, explicit and clear mandate will be required in order to facilitate effective execution of its functions as well as avoid a duplication of functions. Certain levels of authority will need to be assigned with tasks relating to the detection, monitoring, prevention, mitigation, remedial and management functions relating to risk.

Micro prudential supervisors will have a crucial role to play in reporting risks which could constitute serious threats to the stability of their financial systems as well as at macro prudential/EU wide level. In this respect, the micro supervisory role assumed by the European System of Financial Supervisors (which comprises a collaboration between the new European Supervisory Authorities and national financial supervisors) will be fundamental. The micro prudential supervisory element of the ESRB should, to a greater extent, be involved in the early detection of risks which could constitute significant threats of systemic risks at micro – as well as macro level. For this purpose, greater focus had previously been attached to micro supervision.

D. Distinction Between Macro Supervisory Level arrangements and Micro supervisors and the Need for “Clear and Unambiguous” Mandate

Micro prudential supervisors generally enforce rules whilst macro prudential coordinating bodies could establish rules which the micro prudential supervisor implements. As a result, there is need for clear unambiguous mandate and consistency in the application of standards, recommendations and regulations.

However, “even where another agency has the power to determine micro prudential instruments and even though macro prudential standard setters write laws which are being enforced by national supervisors, such supervisors still operate with autonomy and accountability”. Such need for autonomy and accountability, as well as ensuring consistent application of decisions regarding the composition of regulatory capital (as well as consistency in the application of other standards) across jurisdictions, also provides greater justification for “clear and unambiguous” mandate.

Consequences of failing to implement Basel III in a manner which is consistent across the globe, include those resulting in “a competitive race to the bottom as well as increase risks to the global financial system.” It is proposed that the Basel Committee’s Standards Implementation Group (SIG) takes action through initiatives such as its peer review process, through which teams of experts are able to assess the extent to which countries have implemented Basel Committee standards.

22 ibid  
23 However, some micro prudential supervisors are endowed with the authority to issues rules and regulations. See Bank for International Settlements, “Central Bank Governance and Financial Stability” A Report by a Study Group May 2011 <http:www.bis.org/publ/othp14.pdf> at page 56  
24 See ibid at page 60  
26 See ibid
The stipulation of objectives in a “clear and explicit” manner, is considered to be “a powerful way of achieving clarity about the mandate. The articulation of a financial stability strategy within a clearly specified mandate being one such possibility of achieving clarity about the mandate – for example, by embedding the highest level objectives in statute, and then amplifying and interpreting the evolving understanding of what they imply for policy through high level strategy statements.”

Financial stability functions and objectives, it is argued, are often considered to be less defined and more ambiguous than monetary policy objectives. Hence financial stability functions and objectives could be considered to be in greater need of more defined, clearer, and more explicit mandates. Reasons attributed to the need for explicit mandates with explicit objectives in order to facilitate effective execution of the financial stability function are as follows:

- It helps those in the private sector that are subject to policy to be able to predict the likely direction of official actions under different scenarios
- Policy actions to constrain risk taking activities which threaten financial stability

However, even though advantages exist in stipulating clear mandates, certain disadvantages also emanate from the stipulation of mandates in a “clear and explicit” way which does not provide for flexibility in relation to an area such as financial stability – an area which, to a large extent, involves contingency issues and uncertainty.

E. Basel Committee’s Tasks and Challenges in its Efforts to Facilitate Financial Stability.

Basel III macro prudential measures aimed at facilitating financial stability will, to a significant extent, realize their desired results where consistently applied across jurisdictions. Furthermore, enhanced transparency in relation to Basel internal credit models will help facilitate market discipline. In its efforts to implement and achieve Basel requirements, national supervisors will play crucial roles in the translation of Basel Committee’s standards and requirements into national legislation. Three important actors are involved in the link between macro prudential power players - namely; standard setters, central banks and national supervisors.

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28 See ibid at pages 30 and 31; It is further added that such arrangements need to ensure the compatibility of financial stability operations with monetary policy responsibilities; see ibid
29 “Maintain financial stability is less easily interpreted than maintain price stability since price stability can be numerically approximated in terms of a generally agreed index – whereas financial stability cannot. Furthermore, financial stability objectives are often expressed in directional, rather than absolute terms: for example, “to promote” or “to support” or “to endeavour to achieve”. No metric exists to understand how much promoting, supporting or endeavouring is intended.” See Bank for International Settlements, “Central Bank Governance and Financial Stability” A Report by a Study Group May 2011 <http:www.bis.org/publ/othp14.pdf> at page 28
30 See ibid at page 29
31 “Given the current state of knowledge about what constitutes financial stability, and its main drivers, attempting to direct policy actions by way of explicit objectives, may create practical difficulties. Three reasons being:
- It would be unfortunate if explicit objectives excluded policy options which turn out to be favorable
- A clear objective statement directing the policy to ensure financial stability, without indicating the limits to which the authorities are prepared to insure private agents against tail risk events, may induce greater risk taking than available policy instruments are able to cope with.
- The unpredictability of financial crises

For these reasons, it is important to have flexible legislation which is adaptable to potential changes” see ibid at page 30
In ensuring consistent application of decisions regarding the composition of regulatory capital as well as consistent application of other regulatory standards across jurisdictions, other national supervisors such as financial supervisors will also play a crucial role in the Basel Committee’s efforts and initiatives to achieve this objective since they constitute a vital link between standard setters and central banks.

F. Roles of National Supervisors

1) National supervisors are required to evaluate whether the risk weights are considered to be too low based on the default experience for certain types of exposures in their jurisdiction – and as a result, may require that banks increase the risk weights as desired.  

2) National supervisors are responsible for determining whether an external credit assessment institution (ECAI) meets the criteria listed - such assessments of ECAIs being subjected to recognition on a limited basis. With the “mapping process”, national supervisory authorities are also required to assign the ratings of the recognized rating agencies to the risk weight categories (rating grades) in the Standardised Approach.  

3) National supervisors are expected to implement directives with limited scope where a deviation from the standard through differential application of their regulatory and supervisory authority occur.

The success and effectiveness of macro prudential bodies such as the European Systemic Risk Board (ESRB) depends on successful implementation and enforcement by micro prudential supervisors of standards, rules and regulations written at macro prudential level. Furthermore, certain “conditions for success” for such macro prudential bodies include:

- “Accessibility by central banks to relevant data and information for risk assessment and monitoring of vulnerabilities in the EU financial system. The ESRC will require a reliance on efficient and effective institutional mechanisms which ensure adequate information sharing with micro prudential supervisors and the European authorities.

- The need for effective translation of risk warnings into concrete recommendations on macro prudential policies which require follow up actions by competent authorities – this requiring adequate mechanisms for monitoring and enforcement.

- The need for swift and comprehensive coordination between the ESRC, the IMF and the FSB.”


33 See paragraph 90; ibid

34 “The criteria for recognizing rating agencies, the usability of external ratings and the mapping process being described under paragraphs 91 to 108 of the ”International Convergence of Capital Measurement and Capital Standards : A Revised Framework Updated November 2005”. In the case of rating agencies seeking recognition in several EU member states, a joint assessment process is carried out among the EU member states concerned. The decision on the recognition of the rating agencies still lies with the relevant national supervisory authority.” See Deutsche Bundesbank, „Basel II: Standardised Approach for Credit Risk: External Rating“ < http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_basel_kreditrisiko.en.php

G. Importance of Risks and Risk Based Weightings in Triggering Financial Instability.

According to the ECB’s Financial Stability Review,36 the most significant risks faced by Euro area insurers are: Financial market/investment risks,37 risks for the profitability of guaranteed life insurance products that yields on AAA rated government bonds remain at low levels,38 risks of market driven and unexpected rise in long term interest rates resulting in investment losses, credit and equity investment risks, risks associated with moderate recovery in economic activity, contagion risks from banking activities via links to banks and other financial institutions, and risks of losses from a catastrophic event which exceeds projected losses.

Credit rating agencies39, the under estimation of risks attributed to certain assets, the opacity of internal risk models and credit ratings contributed to a significant extent in the triggering of financial instability which ultimately lead to the break out of the recent Financial Crisis. Where such important actors such as credit rating agencies are relied upon by market participants in providing sensitive information relating to asset values, the provision of inaccurate information will inevitably result in the destabilization of the financial system. Where ratings provided reflect over rated values which have induced investors to invest in worthless assets or the provision of loans to borrowers whose ratings were considered acceptable, resulting in low quality bank loans (and subsequently huge losses to such investors or institutions), the ability of such institutions to meet their obligations as they fall due without incurring unacceptable losses will be crucial – that is, the level of liquid assets retained by such institutions will be vital.

Counterparty risks constituted a fundamental component of the risks which resulted in the triggering of the recent Financial Crisis – such risks also being attributed to complex structured products and securities which were inaccurately rated and considered to have been “risk free” and which later turned out not to be. They also account for a significant proportion of the risks attributed to Over-the-Counter (OTC) derivatives markets. As part of efforts aimed at mitigating counterparty credit risks, a consensus was reached by G20 leaders that all standardized derivatives should be cleared through central counterparties latest by the end of 2010. Non-centrally cleared contracts are to be subjected to higher capital requirements to reflect their risk levels and more consolidated bilateral counterparty risk management requirements.40

Where the Basel Committee’s attempts to improve investors’ understanding of risk profiles of banks is countered by inaccurate information provided by credit rating agencies, such efforts and initiatives to allow market participants to exercise discipline, are likely to prove futile.

36 See June 2011 Report at page s 112 -117 < http://www.ecb.int/pub/pdf/other/financialstabilityreview201106en.pdf?628667d5a27d080f284591a4dfd18378>
37 “At the end of 2010 large euro area insurers continued to exhibit high exposure to government and corporate bonds, although there were some differences in investment strategies across institutions.” See ibid at page 112
38 “While lower levels of AAA-rated government bond yields have bolstered the valuation of insurers’ available-for-sale fixed income investments, they continue to pose challenges”; see ibid
39 Despite the increasing levels of US government bond yields, spreads on AAA-rated corporate bonds remained broadly unchanged over the review period. See ECB Financial Stability Review June 2011 at page 34.
A major hurdle still persists in the successful implementation and harmonisation of two major financial regulatory reforms: The Basel III framework and the Dodd Frank Wall Street Reform and Consumer Protection Act.

Consequences emanating as a result of the introduction of the Dodd Frank Act are not only based on the findings of Congress, but also “because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators.”

Credit risk models under Basel Accords were respectively criticized for facilitating capital arbitrage (Basel 1) and for being extremely risk sensitive (Basel II). However, as discussed under a previous paper, harmonization through common and general application of standards, principles, rules and norms are essential in the goal to mitigate regulatory arbitrage practices. Would the implementation of the Dodd Frank Act exacerbate regulatory arbitrage practices or is it an attempt to avoid the problems attributed to deficiencies of Basel requirements whereby the reliability Basel credit ratings as a means of determining risk weights have been questioned?

An area which has attracted much attention recently is the potential for differences in the calculation of risk-weighted assets across banks – both currently and prospectively under Basel III standards – with particular reference to a focus by market participants on differences in measured risk exposure. Many analysts have observed and highlighted the fact that large US banks generally have markedly higher average risk weights, ratios of risk-weighted assets to total assets, and ratios of common equity to total assets (adjusted for differences in accounting), than some of their foreign competitors. Furthermore, it is added that “these large disparities cannot be easily explained through differences in risk profiles, which are largely similar within the business lines of competing banks.”

Reasons for the inability to fully account for such large disparities are attributed to the opacity of bank balance sheets – as well as their internal risk models.

In accordance with Basel II (International Convergence of Capital Measurement and Capital Standards), “banks can use the credit assessments (ratings) of external rating agencies when determining the risk weights in the Standardised Approach (including securitization positions) as
long as the rating agencies are recognized by the respective national banking supervisors.”

The Basel Committee proposed “to permit banks a choice between two broad methodologies for calculating their capital requirements for credit risk.” One option being:

- To measure credit risk in a standardized manner, supported by external credit assessments

The other being:

- Subjected to the explicit approval of the bank’s supervisor, which would allow banks to use their internal ratings systems for credit risk.”

As well as the design of a framework which was never really implemented, unduly sensitive credit risk models and the tendency to generate pro-cyclical effects, a principal problem attributed to Basel II is considered to be “the entire concept of risk weighting” – particularly the idea that certain assets are riskier than others and the requirement that banks should retain more capital against risky assets.

It is also predicted that Basel III will generate problems related to risk weights since the risk weights for Basel II were not amended.

Revisions to the 1988 Basel Capital Accord for risk weighting banking book exposures – as a result of the implementation of Basel II

In determining the risk weights under the Standardised Approach, “banks may use assessments by external credit assessment institutions recognized as eligible for capital purposes by national supervisors in accordance with the criteria stated under paragraphs 90 and 91.”

1. At the EU level, the Basel recommendations for recognizing external rating agencies and the usability of external ratings have been implemented in Articles 81 to 83 of the Banking Directive (2006/48/EC). Further, on the 20 January 2006, the CEBS published its Guidelines on the recognition of External Credit Assessment Institutions (ECAs) in order to achieve a maximum level of consistency in the interpretation of the Directive with this respect.”See Deutsche Bundesbank, „Basel II: Standardised Approach for Credit Risk: External Rating” <http://www.bundesbank.de/bankenauflschaft/bankenauflschaft_basel_kreditrisiko.en.php>


3. Ibid

4. Two core problems, which in Salmon’s opinion, are linked to this idea are:

- The fact that the idea is backward looking: it assumes that securities which have been risky in the past are the same as securities which will be risky in the future

- The consequence of Basel II reform – which was to discourage banks from lending to risky enterprises – as well as encouraging the build up of apparently risk-free assets. This latter problem is also considered by Salmon to be the primary contributor to “the structured finance craze” whereby securitization was employed as a means of “manufacturing” apparently risk free assets out of risky pools. The crippling of banks such as Citigroup and Bank of America, it is contended, was not a result of direct exposure to sub prime loans, but exposure to triple A rated debt backed by pools of such loans – debt which turned out not to be risk-free at all.” See F Salmon, “The Biggest Weakness of Basel III”<http://blogs.reuters.com/felix-salmon/2010/09/15/the-biggest-weakness-of-basel-iii/>

classes are identified:\(^{51}\)

- Claims on sovereigns and their central banks \(^{52}\)

Individual claims on sovereigns and their central banks as provided by the Basel Committee:\(^{53}\)

<table>
<thead>
<tr>
<th>Credit Assessment</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to B-</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>

- Claims on non central government public sector entities (PSEs)

- Claims on multilateral development banks (MDBs)\(^{54}\)

- Claims on banks: Of which there are two options. National supervisors are to apply one option to all banks in their jurisdictions. Under the first option, all banks incorporated in a given country are to be assigned “a risk weight one category less favorable than that assigned to claims on the sovereign of that country.” \(^{55}\) The second option bases the risk weighting on the external credit assessment of the bank itself with claims on unrated banks being risk-weighted at 50%. \(^{56}\)

- Claims on securities firms: Claims on securities firms may be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to those under the framework (which was prevailing at the time). Otherwise such claims would follow the rules for claims on corporations. \(^{57}\)

- Claims on corporate

- Claims included in the regulatory retail portfolios

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\(^{51}\) “Classes which are not considered under these headings are to retain the previous current treatment – with the exception of exposures related to securitization.” See Basel Committee on Banking Supervision, “International Convergence of Capital Measurement and Capital Standards: A Revised Framework Updated November 2005” at pages 15-23 <http://www.bis.org/publ/bcbs118.pdf>

\(^{52}\) See ibid at paragraph 53; This also embraces claims on the Bank for International Settlements, the IMF, the ECB and the European Community: for further discussion in relation to this, see paragraph 56.


\(^{54}\) See ibid at paragraph 59

\(^{55}\) However, for claims on banks in countries with sovereigns rated BB+ to B- and on banks in unrated countries, the risk weight is to be capped at 100%. See paragraph 61; ibid

\(^{56}\) See paragraph 62; ibid

\(^{57}\) See paragraph 65; ibid
- Claims secured by residential property (Risk weighted at 35%)
- Claims secured by commercial real estate
- Past due loans
- Higher risk categories: The following claims (according to paragraph 79) being risk weighted at 150% or higher: Claims on sovereigns, PSEs, banks, and securities firms rated below B-; and claims on corporations rated below BB- (and other classes)
- Other assets
- Off balance sheet items

The Dodd Frank Act not only prohibits US regulators from relying on external credit ratings in any regulation – thus „making the implementation of Basel reforms relating to securitization and resecuritizations impossible,“ it:

Places US banks at a possible „competitive disadvantage under Basel III,“ as well as; Imposes additional cost burdens and problematic implementation issues (in matters relating to consistency, comparability and reliability of risk weighting measurements) for foreign financial firms.

„The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on 21 July 2010. The Act requires all financial companies that have total consolidated assets over $10 billion and that are regulated by specified federal financial regulators (namely the federal banking regulators, the Securities and Exchange Commission and the Commodity Futures Trading Commission) to conduct an annual stress test. The federal financial regulators are required to issue rules implementing the annual stress-test requirement. Each agency’s rules must, for entities regulated by it, define the term “stress test”, establish methodologies for conducting the stress test that include at least three sets of conditions (baseline, adverse and severely adverse), and establish the form and content of a report regarding the stress test which must be submitted to the Federal Reserve Board and to the entity’s primary federal financial regulator.”

59 See Speech by Stefan Walter, Secretary General of the Basel Committee on Banking Supervision at the Risk Europe Pre Conference Summit, Brussels 4 April 2011.
H. CONCLUSION

In order to maximize the potential to derive optimal results from the synergies between financial stability and monetary policy objectives, the synergetic relationships between monetary policy setting and prudential frameworks need to be understood. The role played by national supervisors, particularly central banks which are responsible for monetary policy setting functions as well as macro prudential issues has been emphasized in this respect. The benefits attributed to micro prudential supervisors such as central banks, their expertise and ability to gather crucial, timely and accurate information has also been highlighted. Other supervisors who also constitute the micro prudential supervisory function will also play a crucial role in the Basel Committee’s efforts and initiatives to achieve the objective of facilitating and sustaining financial stability since they constitute a vital link between standard setters and central banks.

Even though advantages exist in stipulating clear mandates, certain disadvantages also emanate from the stipulation of mandates in a “clear and explicit” way which does not provide for flexibility in relation to an area such as financial stability – an area which, to a large extent, involves contingency issues and uncertainty.

Whilst the Basel Committee’s determination of risk weights (and indeed the entire risk weighting process) and the reliability of credit ratings as means of determining risk weights have been questioned, and could be attributed to the Dodd Frank Act’s prohibition of US regulators from relying on external credit ratings in any regulation – thus „making the implementation of Basel reforms relating to securitization and resecuritizations impossible”, such a move might make it even more difficult to achieve consistency and harmonization – factors which are considered necessary to facilitate the Basel Committee’s initiatives in attaining and sustaining financial stability objectives.
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