Session1: Progress of Financial Regulations across the Banking, Securities and Insurance Sectors

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Outline

I. Joint Forum report on “Review of the Differentiated Nature and Scope of Financial Regulation”

II. Basel Committee Consultative Proposal on Capital and Liquidity

III. Policy Tools to Address TBTF

IV. Issues for discussion

I. Joint Forum report on “Review of the Differentiated Nature and Scope of Financial Regulation”

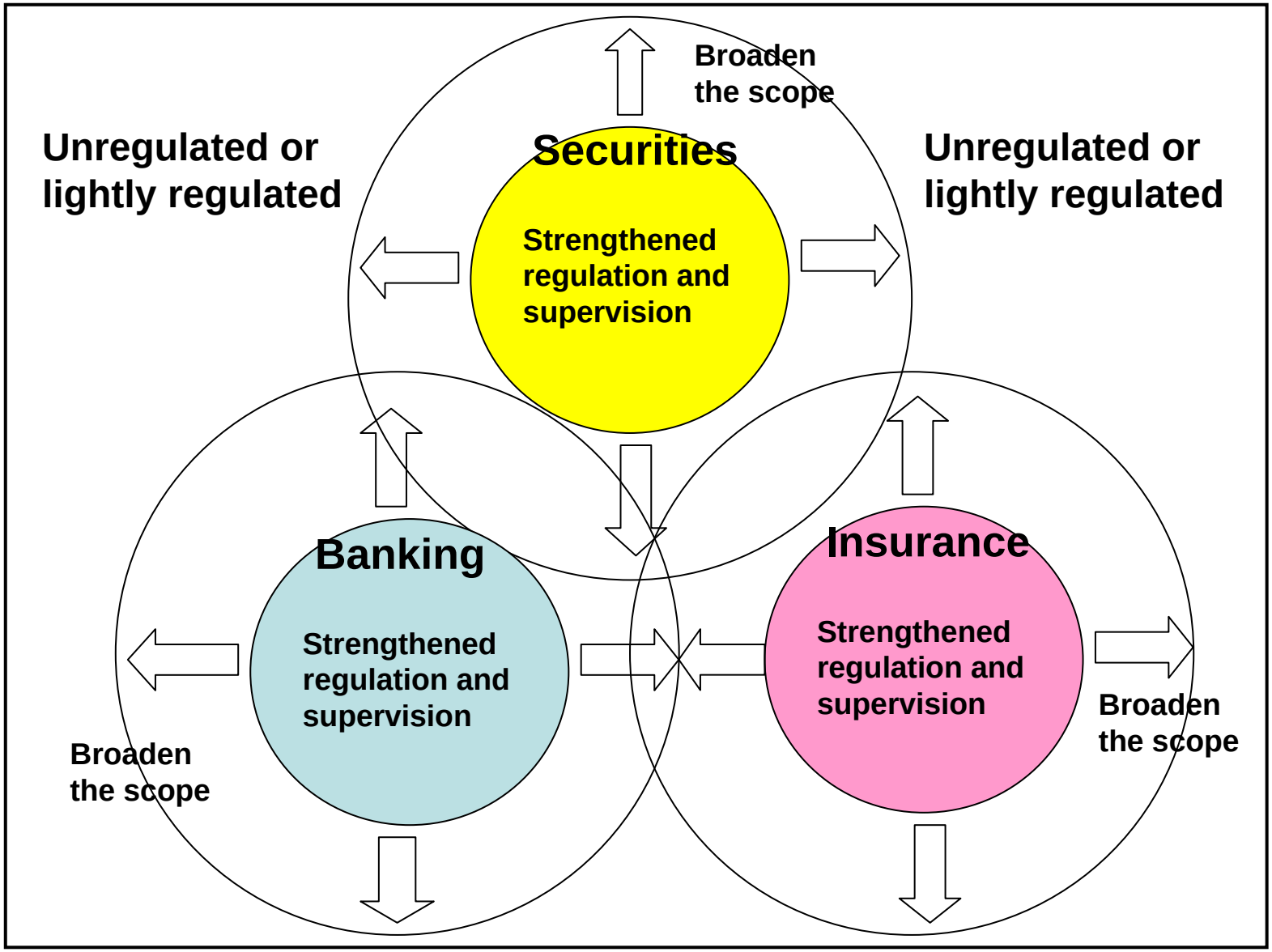
Mandate

- Joint Forum
  - Parent Committees: BCBS, IOSCO, IAIS
  - Cross-sectoral issues: banking, securities, insurance
- G20 report (March 2009)
  - Identify areas where <u>systemic risks may not be fully captured</u> in the current regulatory framework
  - Focus on currently <u>unregulated or lightly regulated entities</u>

Case study: AIG

- A global financial conglomerate with significant insurance operations in more than 130 countries
- Consolidated supervisor: Office of Thrift Supervision
- Problems stemmed from the holding company and its non-insurance subsidiary
  - AIG Financial Products in London (ca. 400 employees)
  - Unregulated financial products trading business, in particular CDSs to insure credit events on AAA tranches of ABS
  - Counterparties bought protection to reduce regulatory capital requirements
- Securities lending against cash collateral
  - Downgrade of AIG caused liquidity shortage

Concept


Broaden
the scope
Unregulated or
lightly regulated
Securities
Strengthened
regulation and
supervision
Unregulated or
lightly regulated
Banking
Strengthened
regulation and
supervision
Broaden
the scope
Insurance
Strengthened
regulation and
supervision
Broaden
the scope

Five Areas

- Key regulatory differences across sectors
- Financial groups
- Mortgage origination
- Hedge funds
- Credit risk transfer products
  - CDS and FG (financial guarantee) insurance

Key regulatory differences

- Opportunities for regulatory arbitrage
- Supervision on a group-wide basis
  - Banking: much focus on consolidated supervision
  - Insurance: only started requiring
  - Securities: do not require in the core principles
- Global uniform capital framework within sector
  - Banking: yes
  - Insurance and Securities: no

Recommendations 1-3

- R1: BCBS, IOSCO and IAIS to review and revise their core principles to ensure the principles appropriately take into account systemic risk and the overall stability of the financial system
- R2: International minimum capital adequacy framework should be in place in each sector
- R3: BCBS,IOSCO and IAIS to work together to develop common cross-sectoral standards to reduce opportunities for regulatory arbitrage

Financial groups

- Unregulated entities including SPEs in calculating group capital adequacy
  - They were used to lower capital requirements of regulated entities
- Intra-group transactions and exposures (ITEs) including those involving unregulated entities
  - They were the source of contagion as shown in the Lehman case
- Unregulated parent companies of regulated entities
  - Supervisors do not have the legal authority to exercise oversight and collect information, in particular parents in other jurisdiction

Recommendations 4-6

- R4: Ensure all financial groups are subject to supervision and regulation that captures the full spectrum of their activities and risks
- R5: 1999 JF principles on the *Supervision of Financial Conglomerates* should be reviewed
  - Including the calculation of capital adequacy on a group basis
- R6: Enhance the consistency of supervisory colleges across sectors

Mortgage origination

- Poor mortgage underwriting practices
  - UK: total mortgage to GDP 50% to over 80% in 1997-2007
  - Canada: Loans with over 80% LTV must have insurance
- Mortgage originators subject to differing supervision, regulation and enforcement regimes
  - Range from the smallest individual mortgage brokers to large international lenders
  - US: non-prime business mainly conducted by state licensed mortgage originator, not subject to stringent supervisory oversight

Recommendations 7-9

- R7: Ensure mortgage originators adopt minimum underwriting standards which should be published and accessible
  - Borrower's ability and willingness to repay
  - Appropriate LTV ratios based on sound appraisal
- R8: Ensure different types of mortgage providers are subject to consistent mortgage underwriting standards and consistent regulatory oversight and enforcement
- R9: National policymakers to establish public disclosure of mortgage underwriting practices. FSB to consider establishing a review process

Hedge funds

- IOSCO 2009 report "*Hedge Fund Oversight*"
  - Operators (managers/advisors) subject to mandatory registration
  - Appropriate ongoing regulatory requirements
  - Operators/prime brokers provide information to regulators
  - Encourage development of industry good practices
  - Regulators cooperate and share information
- JF: four areas of concern
  - Internal organisation, risk management and measurement
  - Reporting requirements and international supervisory cooperation
  - Minimum initial and ongoing capital requirements
  - Procyclicality and leverage-related risks

Recommendations 10-12

- R10: Introduce and/or strengthen appropriate and proportionate minimum risk management regulatory standards for operators
  - Including liquidity risk management and stress tests
- R11: Impose reporting requirements on operators to identify sources of systemic risk and to enable cross-sectoral monitoring of systemically important hedge funds
- R12: Impose minimum initial and ongoing capital requirements on systemically important hedge fund operators

Credit risk transfer products

- CDS and financial guarantee (FG) insurance
- Issues that posed cross-sectoral systemic risk
  - Inadequate risk governance (in particular CDS)
  - Inadequate risk management practices
  - Insufficient use of collateral
  - Lack of transparency
  - Vulnerable market infrastructure
- Unregulated entities such as SPEs are major participants in CDS market
- FG insurers operate internationally with their regulation varies considerably across jurisdictions

Recommendations 13-17

- R13: Encourage or require greater transparency for both CDS and FG insurance
- R14: Supervisors to foster information-sharing and regulatory cooperation regarding CDS market information and the potential systemic risk raised by stress and scenario testing of FG insurers
- R15: Review prudential requirements for CDS and FG insurers
  - Establish minimum capital, reserving and liquidity requirements for FG insurers
- R16: Promote current efforts to strengthen market infrastructure, such as CCPs for CDS market
- R17: Clarify the position of FG insurance in insurance regulation

II. Basel Committee Consultative Proposal on Capital and Liquidity

Consultative proposal at a glance

Improving quality of capital

- Common Equity
- Eligibility criteria
- Regulatory minima

$$\text{Capital ratio} = \frac{\text{Capital}}{\text{RWA}}$$

Addressing liquidity-driven systemic risk

- Liquidity Coverage Ratio
- Net Stable Funding Ratio

Strengthened risk coverage

- Securitization products
- Market risk
- Counterparty credit risk

supplementary

Containing build-up of leverage

$$\text{Leverage ratio} = \frac{\text{Capital base}}{\text{Exposure}}$$

Mitigating procyclicality

- Reducing cyclicality of minimum required capital
- Forward-looking provisioning
- Limits on capital outflow
- Countercyclical capital buffer

To be completed by end-2010

- Review the comments received and finalise the regulatory reform on capital, leverage and liquidity
- Set the level of minimum capital requirements
  - Common Equity, Tier 1 and Total (Tier 1+Tier 2)
  - Review the results of Quantitative Impact Study (QIS)
  - Top-down calibration
- Finalise concrete proposal on:
  - Countercyclical buffer (variable/fixed)
  - Limits on capital outflow
  - Forward-looking provisioning
  - Policy tools to address TBTF (Too-Big-To-Fail)
- Implementation
  - Phase-in
  - Grandfathering

Key dates

- 16 April: Deadline for comments on consultative proposal
- 30 April: Submission of QIS data by banks
- 26-27 June: G20 Leaders' Summit (in Toronto)
- (summer) BCBS and other fora to finalise the reform package
- October: G20 Finance Ministers and Central Bank Governors
- 11-12 November: G20 Leader's Summit (in Seoul)

Countercyclical buffer

- Effective framework for capital buffer to be built up in good times that could be used in bad times
  - Built-up of capital buffer through Pillar 2 process (dialogue between banks and supervisors) proved ineffective
- Variable and/or fixed buffer
- Variable against credit (business) cycle through macro indicator such as total credit (total borrowings by non-financial entities) to GDP ratio
- Limits on capital outflow applied if the actual level of capital is below the target level (regulatory minimum + capital buffer)

Implementation

- A new set of standards will be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by the end of 2012
- Appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition

III. Policy Tools to Address TBTF

Key issues at a glance

Troubled financial institution

Deny TBTF
(=Any institution will be allowed to fail)

Accept TBTF
(=Systemic risk exception)

scope of "Living Will"

Split business lines/ reduce the size

Reduce resolution costs

- Enhance resolution scheme
- Improve market infrastructure
- Contingent capital

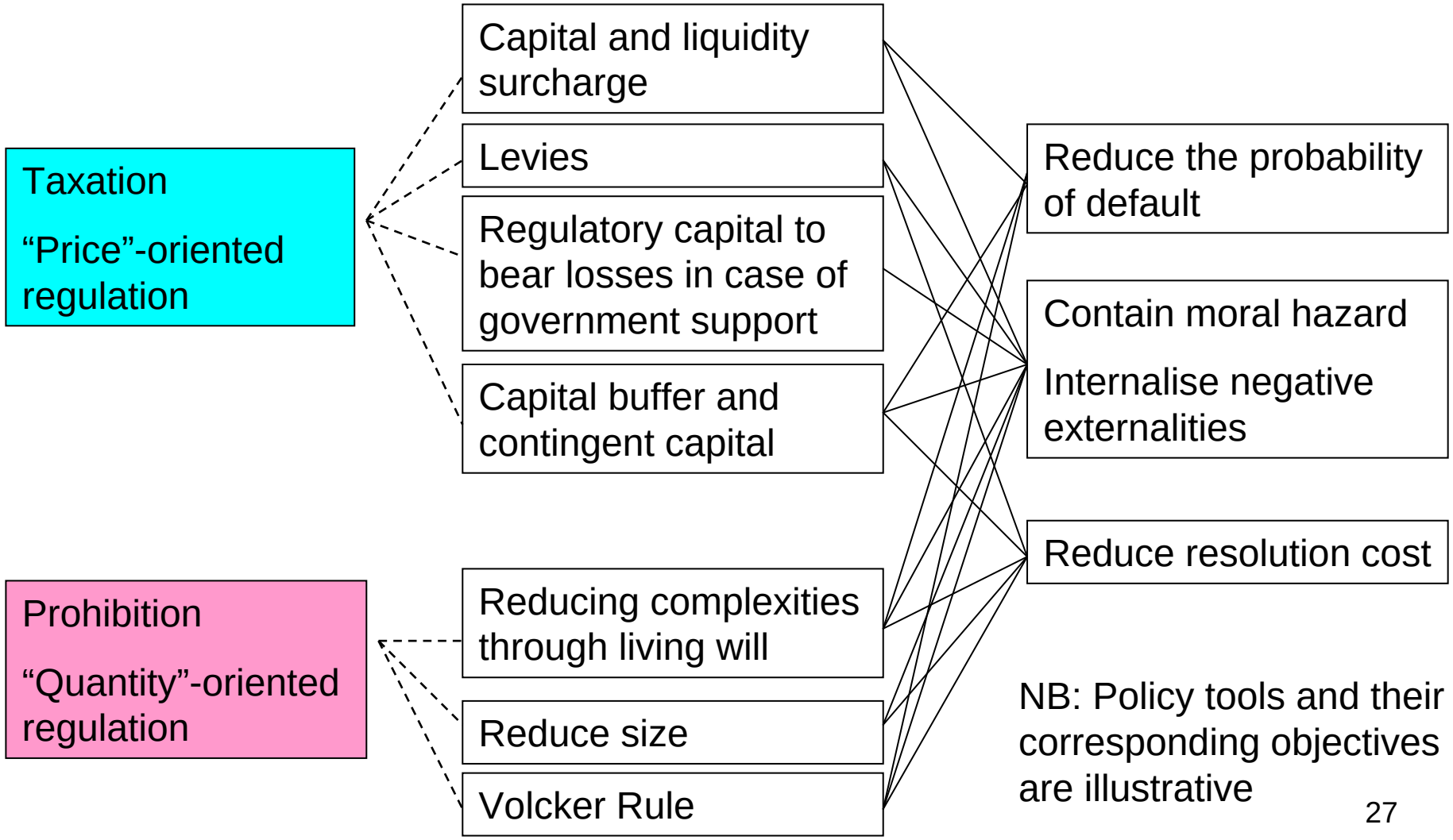
Contain moral hazard/ minimise rescue costs

- Capital and liquidity surcharge
- Recoup rescue costs (levies)
- Contingent capital to impose capital to absorb losses
- Ex post sanction on stakeholders?

Policy objectives

- Reduce the probability of default
  - Stringent regulation and supervision
  - Contain excessive risk-taking (Volcker Rule)
  - Contingent capital to recover the capital level early
- Reduce resolution cost
  - Harmonise resolution framework across jurisdictions
  - Reduce complexities through living will
  - Coordinated crisis management
- Contain moral hazard/internalise negative externalities
  - Let regulatory capital including sub-debt to absorb losses
  - Capital and liquidity surcharge
  - Recoup rescue costs through levies
  - Insurance such as pools of capital and liquidity

Policy tools



NB: Policy tools and their corresponding objectives are illustrative

IV. Issues for discussion

Fill the gaps

- Gaps between banking and other sectors
  - Strengthened capital framework both in quality and quantity is intensely discussed for banks, but no globally agreed framework for other sectors, non-regulated entities and financial groups as a whole
  - Still a room for regulatory arbitrage and shadow banking?
- Gaps across jurisdictions on the role of banks
  - Roles of banks, services they provide, and the importance of the banking sector in the economy vary across jurisdictions
- Gaps between funding and market liquidity
  - By securing liquid assets and reducing maturity mismatch, maintaining funding liquidity is addressed in the banking sector, but not actively discussed in other sectors
  - Systemic risk could arise from the evaporation of market liquidity, but no common “toolkit” is yet developed to tackle it

Secure consistency

- Consistency in containing risk taking of banks
  - Leverage ratio is intended to contain the build-up of leverage, thereby avoiding excessive risk taking, but it could induce banks to shift their asset portfolio from safer assets to risky ones to maximise their expected utility (Kamada et al (2010))
- Consistency in different capital constraints
  - Risk-based Basel II would be supplemented by non risk-based leverage ratio. Net Stable Funding Ratio (NSFR), addressing vulnerability in funding liquidity by reducing maturity mismatch, could be another capital constraint. Banks have to find their asset portfolios that meet all these constraints, which does not always prove to be optimal
- Consistency in holding risk-free assets
  - Liquidity Coverage Ratio (LCR) requires banks to hold more risk-free assets, which could be penalised by leverage ratio.

- Risk-based capital ratio (Basel II)

$$= \frac{capital}{RWA} = \frac{E}{R(A)}$$

RWA: risk weighted assets

- Non risk-based capital ratio (leverage ratio)

$$= \frac{capital}{asset} = \frac{E}{A} \geq \alpha$$

- Net Stable Funding Ratio (NSFR)

ASF: available stable funding
RSF: required stable funding

$$= \frac{ASF}{RSF} = \frac{E + g(L)}{f(A)} \geq 1 \qquad \therefore E \geq f(A) - g(L)$$

- If we want both leverage ratio and NSFR binding,

$$\frac{E}{A} = \frac{E}{f(A) - g(L)} \times \frac{f(A) - g(L)}{L + E} \geq \alpha$$

NSFR

- In case banks bear losses (*E* decreases), they would reduce *f(A)-g(L)* to meet NSFR. At the same time they would reduce liability (*L*) and consequently asset (*A*) to meet leverage ratio.

Macro perspective

- Financial system as a whole
  - Strengthened micro-prudential regulation has been proposed, but we do not know fully yet:
    - What factors drive the financial system to crisis
    - Which financial functions should be protected at the time of crisis
    - How to reduce interconnectedness in the system to avoid contagion
    - Whether we can remove regulatory arbitrage and shadow banking
    - How to secure market liquidity in times of stress (even though central banks could address funding liquidity shortage) and how counterparty risk could be assessed (and change in times of stress)
    - What the role and optimal design of safety-nets should be and whether it is politically agreeable (in particular whether the injection of public money is justified)
    - How competitive the financial sector would be under stringent regulation
- Impact on macro economy
  - How strengthened micro-prudential regulation would impact the real economy in the long run and how it should be implemented
    - Cost-benefit analysis to evaluate the former