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Update on Regulatory Issues in Respect of the Credit Crisis

By Peter Follak

Financial Turmoil and Global Recession

Last year, we saw a credit event in the finance industry – the realisation of subprime mortgage risks – evolve into a liquidity event and then into a solvency event. Now we are heading towards global recession. Crisis resolution plans everywhere – but are we really going anywhere? If we don’t clearly distinguish between separate problems and their driving factors, we won’t be.

The shortening of banks' funding profiles, causing severe stress in interbank and other lending markets – i.e. the credit crisis – is continuing. The fallout of the credit crisis has triggered the unwinding of global imbalances which Fed Chairman Ben S.Bernanke in a recent speech puts this way: “In the simplest terms, these imbalances reflected a chronic lack of saving relative to investment in the United States and some other industrial countries, combined with an extraordinary increase in saving relative to investment in many emerging market nations.” These problems cannot be solved by regulating the finance industry. Nor can rescue and recovery actions for financial institutions in distress replace preventive prudential regulation. At the moment the focus is on cleaning up, whereas the regulatory stage has to be set carefully, avoiding hasty patchwork and over-reaction born out of day-to-day crisis management – although the regulators have to be established with powers of early intervention urgently in case of any legal loopholes. This is why, basically, we are still confronted with the same regulatory needs as last year and why progress can be only gradual. So don’t be surprised if we will be facing old acquaintances of our Committee’s Rio report. Just putting more capital into the system will not solve the regulatory problems – the focus has to be on avoiding wrong and providing for the right incentives for financial institutions. This was also the essence of the Committee’s discussion with M. Jacques de Larosière, Chairman of the High-Level Group on Financial Supervision in the EU, on 20th March.

Driving Factors and Possible Responses

1 Structure of Supervision and Supervisory Authorities

Though not actually having triggered the crisis, shortcomings in the instruments and in the structure of supervision and supervisory authorities, which might be obstacles to efficient crisis management, both on a national and on a cross-border level, have been brought to light.

Neither in the USA nor in the EU have final decisions been made. The US Treasury Department had published its so-called Blue Print for a Modernized Financial Regulatory Structure as early as March 2008.[1]It has not been outdated by the collapse of Lehman Bros., but in practice, the U.S. finance industry is by now dominated by institutions established with banking licenses. The High-Level Group Report on

[1] http://www.treas.gov/offices/domestic-finance/regulatory-blueprint; see also Government Accountability Office, Financial Regulation: a Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, http://www.gao.gov/new.items/d09314t.pdf.

Financial Supervision in the EU, chaired by Jacques de Larosière[2], is under discussion. It proposes the establishment of a European Systemic Risk Council (ESRC) including the ECB, CEBS[3], CEIOPS[4] and CESR[5], mandated with macro-economic information and a related risk warning system, and a European System of Financial Supervisors coordinating cross-border supervision, as well as strengthening the standard-setting mandates of the "level 3 committees" (CEBS, CEIOPS, CESR). The ultimate aim would be single European authorities each in the banking, insurance and securities fields setting the general standards, whereas day-to day supervision would be entrusted to the related national authorities. Cross-border cooperation is also addressed by the chapter "Supervisory Arrangements" of the EU package providing amendments to the European banking and securities firms directives.[6] A final outcome should be in view by the end of the 2nd quarter 2009 at the latest.

On a global level, it is likely that the IMF will be entrusted with operating a financial (in)stability early warning system, and the FSF (Financial Stability Forum) with promoting convergence of supervisory standards[7].

Apart from these global developments, several national legislators are already working on enhanced powers of early intervention for supervisors.

2 Liquidity

Liquidity, or rather unexpected shortage of liquidity in the financial system had proved to be a key factor in driving the turmoil.
So far, the focus has been on active crisis management which has prevented a potential worst-case scenario:

- central bank liquidity management
- government guarantees for bank funding, in particular interbank borrowing.

Apart from direct government intervention by issuing guarantees, deposit insurance is a further instrument to enhance bank liquidity by supporting confidence in the system. The EU has already proposed a related Directive raising the minimum amounts to be guaranteed from € 20,000 to € 100,000[8], whereas US initiatives are pending in Congress.[9]

As far as prudential liquidity regulation and supervision is concerned, liquidity supervisory regimes are still nationally based even in the EU, due to the principle of "host" country responsibility based on the "Basel Concordat".[10] The Basel Committee has published new guidelines in September 2008[11] which have already been taken up by

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[2] De Larosière Report,
http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf
[3] Committee of European Banking Supervisors
[4] Committee of European Insurance and Occupational Pensions Supervisors
[5] Committee of European Securities Regulators
[6] Proposal for a Directive amending Directives 2006/48 EC and 2006/49 EC, 01.10.2008, COM (2008) 602 final, in particular Directive 2006/48 EC, Art. 4 para. 48 and 49, Art. 40 and 42.
[7] See De Larosière Report (FN 2), recommendations 25 pp.
[8] EU, COM (2008), 661, 15th Oct 2008, amending Directive 94/19 EC. The De Larosière Report (Recommendation 14) recommends harmonisation of deposit guarantee schemes in general.
[9] HR.703.
[10] Basle Concordat (Basel, BIS,1975; amended version May 1983); Supplement (April 1990).
[11] Basel Committee, Principles for Sound Liquidity Risk Management and Supervision, Sept. 2008.

the proposed EU Directive on the amendment of the banking and securities firms directive.[12]
Nevertheless, the regulation of maturity and liquidity mismatches should be included in international cooperation and convergence as closely as is the case with capital requirements.[13]Surprisingly, the EU has not taken up the overdue subject of harmonisation of liquidity requirements beyond the above-mentioned general principles. The Basel Committee seems to be tackling the problem by including the liquidity issues in its Basel II enhancement package[14] as a sub-topic of Pillar 2 – supervisory review of capital requirements. However, due its proven importance, the issue of liquidity management should be regulated separately from capital requirements.

Further, as government guarantees for funding instruments cannot be a permanent solution, stringent legislation on and regulation of covered bonds might be worth considering for a revival of these markets.

3 Capital Adequacy

Capital Adequacy was only a secondary, i.e. second round issue of the crisis, it plays a fundamental role in building up confidence between financial institutions. Such confidence is essential in order to kick-start interbank lending and repair the liquidity of the financial system. This is why it was, and still is, a main concern of day-to-day crisis management and direct support of the individual national banking systems.

In the regulatory field, the first EU package – a Directive proposed in October 2008[15] - will be decided on by end of April, 2009. It focuses on securitisation regulation and enhanced disclosure, to come into force by year-end 2009. In addition, the recognition of hybrid capital elements will be harmonised (although, this issue is not directly affected by the crisis). Further proposals to fight pro-cyclicality – i.e. a tendency of Basle II to tighten requirements and putting strain on the banking system during the downturn part of the economic cycle while loosening up in times of boom – are expected by summer 2009, e.g. dynamic provisioning and building up buffers during booms.
The Basel Committee package goes further, which is expected to be strongly supported by other initiatives, including the EU.[16] Proposed enhancements to the Basel II framework have been published for comment in January 2009[17], including the capital regime for trading book positions, as well as enhanced requirements for the use of models. The Basel Committee package will also provide for the management and disclosure of non-contractual commitments, implicit support and pipeline and warehousing risks with regard to securities positions:

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[12] See FN 6, in particular proponed amendments to Directive 2006/48 EC, Annex V..
[13] Group of Thirty, Financial Reform: A Framework for Financial Stability, 15th January 2009, www. Group30.org/pubs/recommendations.pdf, Core Recommendation 8.
[14] Basel Committee, Consultative package for comment, Proposed Enhancements to the Basel II Framework, 16th Jan 2009.
[15] FN 6. As far as requirements for securitisation are concernid, see in particular proponed amendment to Directive 2006/48 EC, Annex IX.
[16] See the De Larosière Report (FN 2), Recommendation 1.
[17] See FN 14.

- Enhancements to Pillar 1 (prescription of ratios):
  - increase of capital requirements for liquidity credit lines extended to vehicle companies issuing asset backed commercial papers (so-called ABCP conduits) by eliminating discretion between maturities;
  - banks would have to obtain comprehensive information about the underlying exposure characteristics of their externally rated securitisation positions if they wish to make use of the preferential securitisation framework of Basel II;
  - a new class "Resecuritisation Exposures" within the securitisation framework, i.e. specific (higher) capital requirements if one underlying exposure was a securitisation exposure (re-packaged or multi-layer exposures);
  - restrictions in respect of ratings resulting from "self guarantees".
- Enhancements to Pillar 2 (supervisory review):
  - firm-wide governance and risk management;
  - capturing risks of off-balance sheet exposures and securitisation activities, in particular firm-wide risk concentrations, including both contractual risks and potential impacts of non-contractual commitments, implicit support and reputation risk;
  - observation of the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision (see above, Chapter 2);
  - observation of the Basel Committee's Supervisory Guidance for Assessing Banks' Financial Instruments Fair Value Practices (see below, Chapter
  - observation of the Basel Committee's Principles for Sound Stress Testing Practices and Supervision (see also below, Chapter 6).
  - implementation of internal incentives to manage risk and returns over the long-term (reinforcement of compensation schemes).
- Enhancements to Pillar 3 (disclosure) which should help market participants to better understand a bank's overall risk profile and restore confidence:
  - securitisation exposures in the trading book;
  - sponsorship of off-balance vehicles;
  - internal assessment approach for securitisation and other ABCP liquidity facilities;
  - resecuritisation exposures related to multi-layer securitisation (re-packaged securitisation exposures);
  - valuation principles with regard to securitisation exposures;
  - pipeline and warehousing risks with regard to securitisation exposures.
- Treatment of trading books:
  - The vast majority of losses during the crisis has been on retained trading exposures. Therefore, and as the Basel II focus had been on banking books, the Basel Committee, in cooperation with the IOSCO, wishes to raise capital charges on the trading book in general, and to extend the scope of its existing guidelines for "incremental default risk" to include other event risks such as migration risk and concentration risk. The related proposal[18] should become effective at yearend 2010 .
- Use of models (see also below, Chapter 6):
  - The focus on individual credit evaluation – the core of Basel II – relies heavily on models and appropriate model validation. In view of severe shortcomings during the crisis, the Basel Committee has proposed Principles for

[18] Basel Committee Consultation Paper Revisions to the Basel II Market Risk Framework and Guidelines for Computing Capital for Incremental Risk in the Trading Book, 16th Jan 2009.

Sound Stress standards	Testing Practices and Supervision,[19] in addition to model validation within the market risk framework.[20]

The extension of the enhanced Basel II framework to the insurance industry via "Solvency II" which might be adopted by the EU by end of May 2009, should be welcomed.

4 The Non-Regulated Financial Sector

The crisis has clearly demonstrated that the existence of an undisclosed and unregulated, thinly capitalised shadow banking system, involved in large-scale liquidity and maturity transformation, can directly affect the liquidity and, through second round effects, the solvency of the entire financial system. In the aftermath of the Lehman crisis at the latest, reform initiatives worldwide are postulating that "all systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight."[21] According to unanimous consent, disclosure requirements will not be enough. Nevertheless, final details have not been discussed, and implementation will not be easy, because many of the related institutions operate off-shore. The alternatives seem to be direct supervision of the shadow banking system, or indirect inclusion by regulating the relationships of "shadow institutions" with licensed financial institutions, and regulation by activity or by charter. Most current proposals seem to tend towards activity-based regulation, e.g. oversight of CDS and OTC markets.[22] On the contrary, restricting certain types of activities to, instead of reserving them for, licensed institutions would not solve the problem, because this would not replace supervision of such activities[23].

5 The Role of the Rating Agencies

A draft EU Directive states that "it is commonly agreed that credit rating agencies contributed significantly to recent market turmoil by underestimating the credit risk of structured credit products."[24] In the USA, the Credit Agency Reform Act of 2006 has been in force since 27th June 2007, and has been enhanced by an amendment to the Exchange Act in February 2009.[25] The EU reaction is overdue; a related Directive proposal of 12th November 2008 should be decided in due course. [26]In any case, both the USA and the EU will benefit from a licensing system and from model disclosure and integrity requirements.

6 The Use of Risk Models

The finance industry has become increasingly reliant on risk models – as a basis of Agency ratings and valuation under accounting practices and capital requirements. This

[19] Issued for comment on 6th Jan 2009.
[20] See related Basel Committee Consultation Paper (FN 18), item 9.
[21] Group of Thirty (FN 13), Core Recommendation no. 1; see also the De Larosière Report (FN 2), Recommendation 7.
[22] See Group of Thirty (FN 13), Recommendation 15.
[23] However, such restrictions are recommended by the Group of Thirty (FN 13), for example in respect of proprietary positions (Recommendation 1).
[24] Proposal for a Regulation of the European Parliament and the Council on Credit Rating Agencies, 12th Nov. 2008, COM (2008) 704 final, p.2.
[25] Exchange Act Release No. 34 – 59342 (Feb 2 2009), pp. 16 – 31.
[26] See FN 24.

process has been particularly supported by supervisors in designing the Basel II Advanced Approach. The crisis has clearly evidenced weaknesses of model-based approaches in general and specific model elements in particular, and supervisors have expressed “concern about firms' ability to capture credit risk in these value at risk models”.[27] Related practices have been analysed by the Basle Committee with the following results ”Since individual risk components are typically estimated without much regard to the interactions between risks..., the aggregation methodologies used may underestimate overall risks even if “no diversification” assumptions are used.”[28] “...a model may embody assumptions about relationships between variables or their behaviour that may not hold in all circumstances (e.g. under periods of stress)...The main concern in this area of economic capital continues to centre on the accuracy and stability of correlation estimates, particularly during times of stress. The estimates provided by current models still depend heavily on explicit or implicit model assumptions.” [29]As a minimum solution, the Basel Committee has proposed Principles for Sound Stress Testing Practices and Supervision [30] which should be generally applied in risk management practices.

7 GAAP Valuation and Disclosure

One driver of the crisis and source of transmission from individual credit events to a general liquidity crunch was the need to write down performing but illiquid securities under the mark-to-market valuation requirement of IAS 39. Related write downs had to go through profit and loss accounts and balance sheets affecting the capital base of the firms concerned.[31]The consequence was a further shift from a liquidity event to a solvency event.
Strictly marking to market is certainly an appropriate requirement for trading books. For performing assets on the banking book valuation at par value might be more appropriate as long as the intention is to hold them to maturity – be they securitised or not. The EU has already amended IAS 39 and IFRS 7 by a Directive[32] which allows for re-classifications of assets which are no longer held for selling. Such assets can be reported as loans and receivables at cost or amortised costs. A similar US proposal is pending in Congress [33].

8 Correlation Risks and Large Exposures

Traditionally, supervisors have captured correlation risks by regulating large exposures to borrower units: in the EU, integrated in the Banking Directive[34], separately in the U.S.[35]However, investment in structured securities involves the problem of hidden clusters of the underlying borrowers and risks. Obviously, supervisors are trying to

[27]Basel Committee , The Joint Forum, Credit Risk Transfer, Developments from 2005 to 2007, April 2008, p.25.
[28]Basel Committee Consultative Document “Range of Practices and Issues in Economic Capital Modelling”, August 2008, p.2.
[29]Basel Committee, FN 27, pp. 2 and 3.
[30]see FN 19
[31]Wellink Nout, BIS Review 21/2008, p. 4.
[32]1004/2008 EU
[33]re. SFAS 157 – distinguishing between active and inactive markets= marking to market (level 1) , mark-to matrix (level 2) and mark-to-model (level 3).
[34]Directive 2006/48 EG, adapted to Basel II respectively the CRD.
[35]OCC Regulation on Lending Limits, 60 FR 8532.

capture such hidden correlation through requirements applied to the respective risk models used by banks.[36]

On the contrary, an initiative included in the EU package[37]- a haircut for unsecured interbank lending to ¼ of own capital and further tightening of interbank lending in order to prevent domino effects – could be counter-productive, though mitigated by generous grandfathering provisions. One of the driving factors of the crisis was a general drain on interbank lending caused by mistrust in respect of hidden risks which might erode the solvency of counterparties. However, such hidden risks were suspected in exposures to the shadow banking system and in holdings of structured securities but not in straightforward lending between regulated banks. This has been justified by the actual realisation of risks and losses. Under this view, an additional haircut on interbank lending in times of a general liquidity drain can only be counter-productive.

9 Underwriting Standards

The trigger of the crisis had been “extremely weak subprime origination standards” through origination for distribution,[38]accumulated and accelerated by rapid and global transmission of risk through the use of securitisation.[39]Due to easy risk transfer, originators had little incentive to monitor the quality of underlying assets. The supervisors responded with amendments to the U.S. “Regulation Z” on mortgage lending practices[40]. The proposed EU package[41] requires regular underwriting standards to be applied in the case of risk transfer to third parties or collateralised risk mitigation.

10 Further Topics

Due to its purpose as a highlight on recent developments, this update has been restricted to some few items. Nevertheless, the following topics should at least be mentioned in brief:

- transparency and standardisation of markets outside regulated exchanges, e.g. setting up clearing structures for credit default swaps (CDS)[42];
- harmonisation of the legal framework for cross-border bankruptcy of financial institutions, in particular in respect of complex group structures – an extremely broad field, although not exactly in the regulatory field.

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[36]See above, Chapters 3 and 6..

[37] See FN 6, proposed amendments to Directive 2006/48 EC, Art. 110, 111, 113..

[38]Basel Committee (FN 27), p. 14.

[39]Wellink (FN 31), p.1.

[40] See Fed Press Release 0f 14th July 2008, www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm

[41] See FN 6, amendments to Directive 2006/48 EG, Annex V No. 3.

[42] See De Larosière Report (FN 2), Recommendation 7.