

COMMENT ON STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR

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“One of the underlying features of the crisis was the build-up of excessive on and off balance sheet leverage in the banking system”. Failure to capture major on and off balance sheet risks, as well as derivatives related exposures, was a key destabilizing factor over the past two and half a year.”

Thus to highlight **what have been the incentives for banks to increase their leverage** and to develop in such scale their activity on derivatives markets, and to reduce or annihilate these incentives is of prime importance to strengthen the resilience of the banking sector and see how to improve the Basel II framework first and second pillar.

We will discuss this question in a first section, in a second section we will comment on **b) enhancing risk coverage**, and in a third section on **c) Supplementing the risk-based capital requirement with a leverage ratio**.

I BANKS' INCENTIVES FOR INCREASING LEVERAGE

Since 2004, banks have widely used traditional and synthetic securitisations in order to reduce their obligation in capital, thus enabling them to renew their lending capacity or to be able to benefit from new lending opportunities with highest margins. The choice of exposures and the securitisations structure are carefully done in order to optimize the final yield of the bank capital.

Although synthetic securitisations are technically burdensome and costly since the originating bank pays the excess spread through the CDS premium, they stay profitable because they allow to reduce very significantly the capital obligation by substituting a financial Risk Weight of 20% to the corporate Risk Weight of 100% thanks to credit swaps and this was the case even if the originating bank kept the equity tranches, as in most cases, and provided liquidity facility.

When the collateral was invested in a repurchase agreement with the bank, it also benefited from this short-term funding, and this partly accounts for the liquidity shortage of 2007.

In CGFS Paper n°34 "The role of valuation and leverage in procyclicality" the group recognizes as causes of the crisis:

- "The leverage and risk embedded in structured products increased making traditional measures of balance sheet leverage less meaningful
- Assets held in highly leverage off-balance sheet vehicles increased dramatically"

The main incentive for securitization is for banks to maximize their short-term profits with commissions and structuring fees with this originate and distribute model which was with a minimum regulatory capital mobilization and this has been amplified by accounting methods allowing:

"Upfront recognition of profits on structured products where some risks were retained lasting on the economic life of the transaction."¹

Of course an upfront recognition of profits generates boni of which role in the crisis is well known.

These incentives are still effective and if the calculation of a leverage ratio adding off balance-sheet exposures to total assets, it will not capture risks from derivatives, and the motives of main actors for building up short term profits whatever they will be are the same as before crisis.

This is why, in our opinion, the main economic role of banks which is the financing of real economy through intermediation should be favored in the regulatory capital requirement and we suggest that the MRC obligation would be calculated by main activities of the Bank, the lending activity should not be penalized as it is in the Basel II framework: "Banks increasingly chose to book credit exposure in the trading book due to lower capital charge".

¹ CGFS Paper n°34 "The role of valuation and leverage in procyclicality"

We suggest :

- 1) That the activity of the bank on derivatives should be measured and analyzed per se to bear a relevant basic MRC for genuine risks as well as for counterparty risk.
- 2) To review the treatment of lending activity and in particular the treatment of maturity ²and correlation in the formula, to favor financing of industry and diversification and a true analysis of the economics of lending by banks instead of reliance on external warranties or credit enhancements or derivatives. It should also be considered that the ALM and liquidity monitoring allow banks to manage transformation and interest risks and that they should not be induced to look for credit derivatives on markets but instead have a capital constitution and leverage ratio objectives on a medium term horizon.
- 3) To separate investments in bonds from lending activity since direct investments in corporate and governments bonds of the major part of the portfolio of the bank (investment plus trading) is to be preferred rather than investments in derivatives for liquidity and capital markets stability and efficiency. It is our opinion that the treatment of bonds in pillar one has led banks to replace them by CDO's and RMBS or to include them in the trading book thus opting for mark-to-market value, and especially for French banks.³
- 4) To promote a separate evaluation for CDS and CDO's or others ABS in order to capture their very specific risks and discourage systematic securitizations which are not useful from an economic point of view.⁴

² « The treatment of Credit Risk in the Basel Accord and Financial Stability » M-FLAMY International Journal of business 2006

³ See CGFS Paper n°34 "The role of valuation and leverage in procyclicality" Table 1

⁴ Where did the risk go ? How misapplied bond ratings cause MBS and CDO market disruptions" Joseph R. Mason & Joshua Rosner, May 2007.

II ENHANCING RISK COVERAGE

§ 21& 114 Regulatory capital treatment for mark-to-market risk:

- 1) Mark-to-market losses due to CVA account for 2/3 of losses, actual defaults accounting for 1/3 only. These counterproductive accounting methods have initiated a spiral of asset value – liquidity and capital destruction ⁵, as it has been established by many analysis of the crisis propagation including conclusion of CGFS.

Since valuation methods for structured product, CDs and most of derivatives are not backed by time series data observed on efficient markets and validated, we propose to simply stop the mark-to-market or model value accounting for derivatives and to rely on historic value with the obligation to build up a provisions reflecting the best bank's evaluation of a counterpart default consequences when needed. Thus the propagation of a systemic risk through herding behavior between the few actors of these transactions would be lessened and the liquidity factor which has contributed to prices collapse on this improperly called market will not impact actors engaged in bilateral and sometime different or longer term transactions.

The drawbacks of this accounting method are such : incentive for risky market practices and to speculation, impressive erosion of major banks capital supported by shareholders and taxpayers_ that it must no more be maintained for only ideologic motives.

- 2) The concentration of CDS contracts on a small amount of participants, for structured products also and the fact that for derivatives major banks and financial institutions account for 80 % of issues, explains that the correlation on assets for financial firms is much higher than for corporate and as seen above, this is increased by the treatment of corporate bonds which induces banks to favor investing in derivatives .

A correlation factor higher of 25% is proposed but under stress test a higher correlation should be used(40% ?).Facing this concentration risk, an evaluation of losses linked to counter-party risk can be measured with stress tests or scenarii given by regulators and added to a minimum capital charge for derivatives , repo's and securities financing which is relevant and could simply be calculated as a proportion or underlying exposure for the bank.

3)Securitisations products cannot be treated as if they had the same risk exposure as a similarly rated corporate debt instrument ⁶but they imply a specific risk evaluation in order to capture their leverage effect and illiquidity, and even operational risk at settlement as explained by J.R.Mason.

⁵ Sylvie Mathérat « Fair Value and Financial Stability” Stability Financial Review October 2008

⁶ Where did the risk go ?How misapplied bond ratings cause MBS and CDO market disruptions” joseph R. Mason& Joshua Rosner, may 2007

4) In order to increase the incentives to use CCPs for derivatives, it is suggested that the risk-weight could be 0: as explained above we believe that concentration and systematic risk neither leverage will not disappear with more transparency and that this measure should simply be replaced by an obligation in capital higher for OTC transactions than for CCP's.

5) The § 125 proposes to recognize CDS hedges in measuring the CVA loss" to provide an incentive for banks to hedge the CVA risk". We believe that it is not relevant and dangerous to induce banks to use CDS and especially in that case where the bank does not hold any bond and is only exposed valuation risk and not to actual default risk. Each movement in price or rumor could lead to soaring CDS prices without actual economic foundation, which could destabilize the underlying bonds quotation.

§96 Similarly, considering the concentration of CDs market and its high volatility we also suggest that the spread of the bond of similar maturity of the counterparty and not the CDS spread would be directly use to calculate the IRC .

5) Addressing reliance on external credit ratings: the role of credit agencies in the crisis and their implication in securitizations have been fully described, as well as "*the second negative incentive is for rating agencies to produce good ratings for exposures instead of accurate and conservative assessments.*"

Considering this bias and that the models used by agencies to rate securitization tranches have not been satisfactory, we suggest that the weights in standard approach and FIRB method should be increased since the weights for AAA and AA- are of 20% and A+ to A6 50% which is still in favor of securitization instead of direct financing for corporates.

As for liquidity facilities we believe that they should be taken for 50% whatever their maturity, the risk resulting more from adverse economic or market conditions rather than from maturity.

III LEVERAGE RATIO

The objective is to *“Help contain the build-up of excessive leverage in the banking system and introduce additional safeguards against attempts to game the risk-based requirements”*

The integrating of off balance sheet items is the major difficulty to establish this ratio. The analysis of the bank's position on derivatives should help to measure it including the potential exposure, which is necessary to fully encompass risk taken on forward and options. Positions on CDS and other written credit protections should also be estimated at notional value (and eventually tested).

§225 We suggest that the cases where originator is obliged to take back assets on the balance sheet should be evaluated in a stress test only.

Considering the liquidity management of the bank we think that the size of the portfolio assuring the liquidity and the quality of assets for this liquidity are relevant, and should be observed for future standards.

The comparison between large banks and evolution if this ratio on few years will be useful to evaluate what should be a capital requirement on derivatives activity and on securities funding in order to avoid future crisis of this magnitude and to qualify the ALM and overall management of banks.