



Response to the Basel Committee's request for comments on the consultative document: Countercyclical capital buffer proposal

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Response to the Basel Committee's request for comments on the consultative document:
Countercyclical capital buffer proposal

Dear Members of the Basel Committee on Banking Supervision:

As already noted in a previous response to a Basel Committee consultation (International framework for liquidity risk measurement, standards and monitoring, April 2010) we have been steadily devoting significant effort into understanding the development of best practice and evolving regulatory framework for risk management. It is our primary interest to ensure that our customers have at all times in place effective data and analytic tools allowing them to assess their risk exposures and support decision making.

In the same vein, we have aimed at contributing to the development of methodologies and practices for effective risk management as a responsibility. The documentation we have produced since 2007 on liquidity risk and capital management should be seen as a step in this direction. This includes:

- two White Papers on Liquidity Risk published in the early stages of the crisis; December 2007;
- two white papers on counterparty credit risk and credit value adjustment (CVA) in 2010;
- the response to a Basel Committee Consultative Paper: Proposed Enhancement to the Basel II Framework, April 2009;
- the response to a Financial Services Authority Consultative Paper, June 2009;
- the response to a Basel Committee Consultative Paper: International framework for liquidity risk measurement, standards and monitoring, April 2010;
- articles in our corporate magazine Th!nk.

Please see the Reference section at the end of this document for full details.

Following up in this spirit, we respectfully submit the following suggestions as a response to your request for comments to your consultative paper: Countercyclical capital buffer proposal, issued for comments in July 2010.

1. Introduction

The recent financial crisis highlighted the pro-cyclical amplification of financial shocks. The measures proposed in the consultative paper are designed to dampen excess cyclicity, promote forward looking provisioning, conserve capital for use in periods of stress, and protect the overall banking system from excessive credit growth. The Basel Committee on Banking Supervision (the “BCBS”) issued a consultative document regarding its proposal for a countercyclical capital buffer (the “Proposal”).

In this Proposal, BCBS stated that the four key objectives of introducing countercyclical buffers are:

- dampening any excess cyclicity of the minimum capital requirement;
- promoting more forward-looking provisions;
- conserving capital to build buffers at individual banks and the banking sector to be used in times of stress;
- achieving the broader macro prudential goal of protecting the banking sector from periods of excess credit growth.

In the Annex (published in July 2010), BCBS states that the capital conservation buffer should be available to absorb losses during a period of severe stress whilst the countercyclical buffer would extend the capital conservation range during periods of excess credit growth (or other appropriate national indicators).

Through a quantitative impact study, BCBS is considering ways to mitigate cyclicity, by adjusting for the compression of probability of default estimates in the internal ratings-based (“IRB”) approach during benign credit conditions through the use of downturn probability of default estimates.

The Proposal provides that a buffer would be “deployed when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses.” Accordingly, such countercyclical capital buffers are expected to be deployed in a given

jurisdiction only on an infrequent basis, “perhaps as infrequently as once every 10 to 20 years.” In general, national bank regulators would inform banks 12 months in advance of their judgment of any necessary “buffer add-on” in order to give banks time to build up the additional capital requirements, while reductions in a buffer would take effect immediately to help reduce the risk that the supply of credit would be constrained by regulatory capital requirements.

Under the Proposal, internationally active banks would look at the geographic location of their credit exposures and calculate their buffer add-on for each exposure on the basis of the buffer in effect in the jurisdiction in which the exposure is located. (In other words, an internationally active bank’s buffer would effectively be equal to a weighted average of the buffer add-ons applied in jurisdictions to which it has exposures.) Accordingly, internationally active banks “will likely find themselves carrying a small buffer on a more frequent basis, since credit cycles are not always highly correlated across the jurisdictions to which they have credit exposures.” The Proposal also notes that the BCBS is continuing to consider the home-host aspects of the Proposal.

To assist the relevant national banking regulators in each jurisdiction in making buffer decisions, the BCBS developed a methodology to serve as a common starting reference point. The methodology “transforms the aggregate private sector credit/GDP gap into a suggested buffer add-on,” with a zero guide add-on when credit/GDP is near or below its long-term trend and a positive guide add-on when credit/GDP exceeds its long term trend by an amount which suggests there could be excess credit growth. The BCBS noted, though, that national authorities are not expected to rely mechanistically on the credit/GDP guide, but rather are expected to apply judgment in the setting of the buffer in their jurisdiction after using the best information available to gauge the build-up of system-wide risk.

There is general consensus on the need for stronger counter-cyclical capital buffers to be part of the Basel capital framework. This is clearly a powerful and necessary starting point. However, the challenge lies in the calibration of the parameters when trying to implement in practice this generally agreed objective.

We have identified in fact several design issues that we believe deserve further attention by the committee:

1. Which approach to follow in determining the counter-cyclical capital buffer : discretionary, rule based or mixed?
2. What are the most appropriate policy instruments to introduce counter-cyclical?
3. Is there a need for counter-cyclical liquidity measure?

4. What is the most appropriate accounting treatment of a counter-cyclical capital reserve?
5. How to provide disincentives for the (mis)use of financial innovation and tighten counter-cyclical rules for financial institutions that extensively use it?
6. How to avoid regulatory arbitrage associated with the introduction of countercyclical regulatory capital measure?
7. Does size and correlation matter during systemic crisis?
8. Is there a need for a holistic Balance Sheet Management approach?

2. Analysis of possible approaches in determining the counter-cyclical capital buffer

After a detailed analysis of possible alternative methodologies that can be used in determining the counter-cyclical capital buffer, three approaches seem to emerge so far:

- i. The discretionary approach
- ii. The rule based approach
- iii. A mixture of the two

With a discretionary system, bank regulators would need to judge appropriate level of required capital ratios in the light of analysis of the macroeconomic cycle and of macro-prudential concerns. It would depend crucially on the quality and independence of the judgments made. Using a formula-driven system, the required level of capital would vary according to some predetermined metric such as the growth of the balance sheet. The Turner and other (e.g., Geneva) Reports believe that there is merit in making the regime at least to a significant extent formula driven. This could be combined with regulatory discretion to add additional requirements on top of the formula-driven element if macro-prudential analysis suggested that this was appropriate. We believe this is the right approach to follow. We also believe that the methodology to be followed in practice to determine such add-on needs further investigation. The empirical evidence reported in the Proposal does not seem to provide conclusive evidence on how to precisely calibrate the parameters in the model.

A strict upper bound on the countercyclical capital buffer might be counter-productive. Historically, when Credit/GDP increased above a certain threshold this signaled a downturn. Hence, the regulators want to have a cap on the capital buffer. However, this cap should only be a guideline as it is possible that credit can grow much more in the future credit bubble before finally exploding.

Also in the build up phase banks are given 12-month advance notice to increase the buffer. This is required so that banks can gradually build up capital by issuing new capital instruments and reducing disbursements. However, during this period capital distributions should be limited to what has been previously announced. Otherwise, some banks may choose to distribute more capital before the mandated date, as they know distributions will be restricted in the near future, going against the spirit of the countercyclical buffer.

3. Recommendations on instruments to take into account countercyclicality

There are several options that have been analyzed in different consultative papers, research papers and international reports (see references at the end of this document) regarding instruments that can be used as counter cyclical buffer. We believe that the right way forward is to consider a combination of instruments. At a minimum we believe that the countercyclical buffer should consider an increase on capital requirements, as currently outlined in the July consultative paper. This buffer must be able to absorb losses on a “going concern” basis. Consequently this buffer must comprise the highest quality capital, most likely equity and retained earnings. We also believe that to avoid regulatory capital arbitrage, as we will describe in the subsequent sections, we recommend that further countercyclical measure will be added and in particular:

- a cap on leverage and
- a capital multiplier if significant currency or maturity mismatch is found

Bank should limit their risk taking by limiting their leverage beyond reasonable threshold in order to protect deposit holders and show a prudent funding strategy. We share the view of the U.S. Treasury comments in the September 2009 report on this. “Although it may be relatively easy for banks to arbitrage any free-standing risk-based capital requirement and relatively easy for firms to arbitrage any free-standing simple leverage constraint, it is much more difficult to arbitrage both frameworks at the same time”.

4. Liquidity Risk regulation

As solvency and liquidity are complementary, these rules should be implemented jointly, which would imply requiring more capital in a counter-cyclical way for institutions with large maturity mismatches. However, as capital will never be enough to deal with serious liquidity problems, there is a clear case for having a counter-cyclical liquidity requirement as well.

There is increasing support in different reports and statements on the need for regulating liquidity, including introducing a counter-cyclical element into this regulation. We endorse this view. The recent crisis showed that the risk profile of banks and financial institutions critically depends on the way that they fund their assets e.g. Lehman Brothers in US and Northern Rock in the UK.

As the U.S. Treasury September 2009 Report argues, excessive funding of longer term assets with short term debt by a bank can contribute as much or more to its failure as insufficient capital. Furthermore, the Report states that liquidity is always and everywhere a highly pro-cyclical phenomenon. Indeed, because capital, even though high, may be insufficient to deal with liquidity problems in a crisis, sufficient independent liquidity requirements are also very important.

There seems to have been relatively less specific international discussion on the best method to ensure sufficient counter-cyclical measure for liquidity risk, than on the issue of solvency relating to capital and provisioning requirements. Regulation of liquidity needs to be complementary with regulation of solvency. Though arguing that the liquidity regime should be independent from the regulatory capital regime, the September 2009 U.S. Treasury Report correctly says that it is equally important to recognize that they are highly complementary. Indeed, this Report considers the merits of making regulatory capital requirements also a function of the liquidity risk of banking firms. Though clearly higher capital cannot be totally relied on to prevent a run by creditors, it may be consistent with macro prudential goals to require banks with larger structural funding mismatches, or those who rely on volatile short-term funding sources, to hold more capital. This would force the banks to internalize its higher liquidity risk as a cost, thus encouraging them to seek longer term funding. The Geneva Report and Warwick Report are going further by recommending that regulators increase the existing capital requirements by two multiples, one linked to the growth of credit, and the other to maturity mismatches. We agree on the idea of considering a multiplier, but we disagree on the size of this coefficient. In fact we believe more research and quantitative impact analysis is needed to appropriately calibrate this coefficient. The Geneva and Warwick reports suggest using at least two multipliers. The first multiple for capital adequacy

requirements would be a function of the growth of lending; regulators would meet with monetary policy officials (where they are separate) in a financial stability committee. This would produce a forecast of the growth of aggregate bank assets consistent with the central bank's target for inflation and long-term estimated growth. The forecast would have a reasonable band around it reflecting uncertainty. If a bank's assets grow less than the lower bound, it may put aside a lower multiple.

A second multiple on capital requirements would relate to the mismatch in the maturity of bank assets and liabilities. One significant lesson of the crisis is that the risk of an asset can be determined largely by the maturity of its funding. Northern Rock, as well as other banks might well have survived with the same assets and capital supporting it, if the maturity of its funding had been longer.

A liquidity multiple to capital adequacy requirements is added to discourage banks from a reliance on inappropriately risky sources of funding. Assets that cannot be posted at the central bank for liquidity are assumed to have minimum maturity of two years or more. If a pool of these assets was funded by a pool of two-year term deposits, there would be no liquidity risk and no liquidity charge. But if the pool of funding had a maturity of one month and so had to be rolled over every month, the liquidity multiple on the base capital charge would be near its maximum, say 1.2, so the minimum capital adequacy requirement would rise from 8 percent to 9.6 percent. Liquidity multiples would give banks an incentive to find longer-term funding, and where they cannot do so, to hold a liquidity buffer that could be drawn down in times of stress buying time for institutions to deal with a liquidity problem.

5. The accounting rule

The accounting treatment of a counter-cyclical capital reserve is hugely important. As regards to accounting disclosure rules, these should satisfy both the needs of investors and those of financial stability. An optimal approach may be to rely on a dual disclosure approach, where both current profits and losses are reported, and profits after deducting a non-distributable counter cyclical buffer that sets aside profits in good years for likely losses in the future.

It is important that building of counter-cyclical buffers as required by financial stability be matched by the integrity and transparency of financial statements. The accounting rules deemed to categorize the add-on of capital requirements due to countercyclical effect should be designed to allow provisions for latent loan losses to be build up during periods of credit growth, indeed possibly shifting to a system in which provisions are

made when credit is disbursed, not when it is incurred. There are reasons to believe that accounting standards setters will modify standards to include macro-prudential regulation.

The Turner Report has suggested an approach which would imply that existing accounting rules would be used to determine profits and losses, reflecting fair value mark-to-market approaches for the trading book and known information on actual loan servicing and incurred loss on the lending book. This would be complemented by the creation of a non-distributable Economic Cycle Reserve that would set aside profits in good years to anticipate losses likely in the future. This Economic Cycle Reserve would also appear on the profit and loss account, allowing profits and earnings per share to be estimated before and after the reserve. Thus, two measures of profitability could be reported: the —traditional accounting one and another calculated after counter-cyclical reserves.

This approach will help all stakeholders (investors, shareholders, rating agencies, regulators) better understand the risk appetite of the financial institutions, thus adding disclosures to the overall business strategy pursued.

6. Financial innovation

Financial innovations increase during booms, when new and untested instruments that are difficult to value are introduced. This exacerbates pro-cyclicality, as such new, often opaque, and complex instruments, hide and under-price risk. Regulators should introduce appropriate model risk capital charge if such instruments are traded, or at least tighten counter-cyclical rules for financial institutions that extensively use them.

When new and complex products are originated and then distributed it is non-trivial to understand the interplay between risk classes, regulatory and accounting treatments and how, ultimately this “cocktail” will influence and drive the setting up of the overall business strategy. The evolution of the Collateralized Debt Obligation (CDO) market during the credit crunch is a good example of the matter. Only through a holistic view of the balance sheet is it possible to disentangle and understand if the resulting “new” bank portfolio is aligned with the overall risk appetite of the bank.

December 2009 proposals have provided substantial incentive for banks to move towards standardized OTC contracts and clear them through central counterparties (CCPs). Capital charge for complex, exotic derivatives that do not get cleared through CCPs will result in a large capital charge, which has to be balanced with potential profits from any new derivative before introducing new, complex instruments in the market.

Also stressed Expected Positive Exposure (EPE) requirement to take into account wrong-way risk and potential CVA charges related to new instruments will provide sufficient disincentive for banks to introduce new structured instruments in the absence of true economic value.

7. Regulatory arbitrage and international coordination of regulatory policies

The standards proposed in the consultative document witness an effort from the Basel Committee to achieve a higher degree of harmonization among supervisory regimes for countercyclical capital buffer requirements. We strongly endorse this effort. We believe that as much effort as possible should be put into the convergence of local supervisory regimes of capital and liquidity risk supervision. If local regimes display significant differentiation in such core dimensions as:

- I. discretionary or rule based approach for the definition of the add-on capital conservation buffer requirements;
- II. different stage of development of financial systems,
- III. capital and liquidity risk regulation
- IV. calibration of adjustment due to bank size and correlation;
- V. accounting treatment of capital requirements for countercyclical effect

Then, as a matter of fact, differentiation of regulations has at least two notable implications:

- It generates an uneven playing field that may affect cross-border competition. In extreme cases, very tough local regulations could create a pressure for supervisory arbitrage.
- From a more qualitative perspective, but even more importantly in a sense, the differentiation in supervisory styles is a sign of lack of agreement among supervisors about best practice of capital and liquidity risk management and tools for systemic risk mitigation.

A thorough debate occurred as a consequence of the crisis and has led to a much higher degree of agreement in the community of regulators and analysts regarding best practice for countercyclical capital buffer requirements, and more uniform requirements for supervision are a natural consequence of this.

In this context, we note that reporting for liquidity risk remains entirely left to local supervisors and there are still substantial differences between reporting requirements across local jurisdictions involving very significant elements of reporting as noted above.

To avoid regulatory arbitrage, the comprehensiveness of counter-cyclical regulation is an important issue, both nationally and internationally. The best approach seems equivalent comprehensive counter-cyclical regulation for all institutions, instruments, and markets. This would include also all non-banking financial institutions, such as hedge funds, private equity, insurance companies etc (the so-called —shadow banking system), as well as all instruments within banks —by consolidating all activities onto the balance sheet. It should also include counter-cyclical margin and collateral requirements on all securities and derivatives instruments.

Having different capital buffers in different jurisdictions will contribute to differences in cost of capital. This might encourage regulatory arbitrage where multi-national companies will borrow from the cheapest jurisdiction having the lower counter cyclical buffer to finance activity in other jurisdictions. This sort of regulatory arbitrage is probably best addressed through Pillar 2.

8. Size and correlation matters: defining the risk appetite of a single jurisdiction.

The emphasis that the U.S. Treasury and other Reports place on higher capital requirements for systemically important institutions draws on the research at the BIS and elsewhere, which shows that large banks, and those more exposed to system-wide shocks, contribute more than proportionally to systemic risks. Both the size of individual banks, and of the total banking —or even financial system— are important, as in crisis situations they may need to be bailed out.

Moreover, standard liquidity ratios are uniform irrespective of the dimensions of the banks to which they apply. On the Capital side, the BCBS provide an adjustment for financial institutions with over 100 billions in total assets by considering 1.25 scalar on correlation. We believe the scalar adjustments need to be more granular, at least four (small, medium, big and very big), such that different dimension are properly taken into consideration. However, even if two banks show equal ratios, the potential systemic

impact can be totally different depending on the absolute amounts of their exposures. In this view, a uniform measure can prove unnecessarily strict for smaller banks, while not providing the desired degree of protection against systemic effects for larger banks. We therefore suggest that the individual bank's dimension be taken into account in the definition of the standard counter cyclical capital and liquidity requirement.

In addition to size, bank business models should also be taken into account. For example a bank largely financing exposures through deposits should have a smaller countercyclical buffer relative to a bank that is completely dependent on wholesale funding.

To an important extent, therefore, the total amount of acceptable systemic risk is determined by how much the public sector can afford to spend, without creating an undue burden on the economy. Therefore not only the size matters of a single financial institutions but really what is relevant from a systemic risk standpoint is its relative size within the banking sector. By making capital requirements of individual banks a function not only of their own size, but of the size of the total banking balance sheet relative to the government's capacity to raise taxes and cut spending it is possible to provide a sort of "cap" to the total amount of "risk appetite" of single Country. The emphasis in the BIS analysis is not however particularly on size of institutions, though this is important, but on the degree of correlation among institutions' balance sheets. However, as correlations tend to change so much during crisis periods, it seems quite arbitrary to try to determine ex-ante which institutions are potentially contributing more than other to systemic risky.

9. Holistic View of the Balance Sheet

Supervision and business strategy is a multidimensional discipline: increasingly complex balance sheets, opaque structured products embedding unclear leverage and optionalities all make it difficult to gain an overall, timely, transparent, and objective view of the interplay among risk types. It is therefore not always clear what exact business strategy is being pursued at a legal entity or even a holding group level.

In the late seventies the primary profit centre was in fact the legal entity. With the upcoming sophistication of the trading and structured finance activities, in the last 25-30 years we moved from an understandable corporate business strategy to one of a silos based departmental driven P&L. The real problem has become the resulting overall bank portfolio balance sheet at legal entity level is now is very difficult to understand. As

a result communicating the business strategy pursued to the interested internal and external stakeholders and how this is aligned with the overall risk appetite of the financial institutions, has been, and still looks to be, a challenge. This means that bankers need to use new and “fit for purpose” tools and methodologies that are able to identify the real risk drivers, their interplay, and their role played within different legal jurisdictions, accounting, and regulatory treatment. The limitations of the current regulatory, organizational and business silos mindset is probably the biggest and toughest lesson learned from the crisis. We strongly suggest that regulators endorse and gradually introduce in the spirit and in the letter of the upcoming legislation this holistic view of the balance sheet where the interplay of liquidity risk and economic capital is more precisely described. Consequently, we recommend that the impact on the bank and the financial system as a whole is estimated once the stress tests are simultaneously and coherently (same time horizon and severity) being executed across all risk types. We, in fact, think that the need to simultaneously look at the whole legal entity at balance sheet level (and at its dynamic evolution under stress conditions) from a risk, economic, regulatory, and accounting perspective is not a sophistication but a necessity.

We thank the Committee for its diligent review of our concerns and comments. We would welcome queries or requests for further detail on any of the topics raised, or related issues.

Yours Sincerely,

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