Industry Assessment of Proposed Banking System Regulatory Reforms

Financial Stability: Towards a Macroprudential Approach
HKIMR – BIS conference
Hong Kong SAR, 5-6 July 2010

Panel Discussion
Tuesday, 6 July 2010

Dr. K. Mark Lawrence
Managing Director, Mark Lawrence Group
Co-Chairman, Institute of International Finance Risk Management Working Group
Member, IIF Special Committee on Effective Regulation

mark@marklawrencegroup.com

Some key questions regarding the proposed "Basel III" reforms

- What should be the new minimum levels of total and Tier 1 capital that banks should be required to hold, i.e., how should the new framework be calibrated?
- Will these proposed changes to the Basel II framework, if implemented, result in a more stable & resilient global banking system? If not, what else is needed?
- What will be the cumulative impact on the global real economy of all of the proposed changes, taken together?
- How should the trade-off be made between the assumed benefits resulting from increased stability of the banking system, and the negative impact on global GDP growth that will flow from these changes?
- Will the G20 consensus behind these revisions to the global framework which was forged at the height of the financial crisis continue to hold, now that economic recovery is underway? How important is it to have a unified, global response, rather than a variety of national responses?
- How is the industry likely to respond to these regulatory changes, if they are implemented in their current form?

Summary Industry Response to Basel Committee's Dec. 2009 proposals

- Institute of International Finance (IIF) – global banking industry assoc. with ~390 member institutions, including significant Asian & emerging market membership
- IIF leadership meets regularly with Basel Committee & other regulatory bodies (FSB, Senior Supervisors Group, central bankers & regulators)
- IIF produced comprehensive response (~ 150 pages) to the Basel Committee's consultative papers on capital and liquidity reforms to Basel II; response contains both general & detailed, specific comments on the proposals
- *"IIF… endorses the goals and objectives of the proposals in the Consultative Documents and in particular the use of improved capital and liquidity requirements, as well as strengthened internal risk management, to achieve both more robust banks and a more resilient system"*
- *"At the same time, and with equal emphasis, the IIF underscores the importance of conducting a comprehensive analysis of the cumulative impact of all regulatory proposals currently being considered on employment and the economies in the major markets… while only preliminary data exists it can be said that, as written, the proposals will likely have severe economic consequences both for the financial industry and the economy at large that ought to be avoided…"*

Overarching themes from IIF response to Basel III proposals April 2010 (I)

- Achieving objectives of reform will require **substantial revisions** to the proposals

- **Cumulative Impact Assessment and Timing:** the design and calibration of the proposals needs to be based on assessment of their cumulative impact, with full consideration of the interdependencies among the proposed measures

  - Decisions on the timing of implementation need to be based on a careful assessment of economic conditions and the resilience of the global financial industry

  - Implementation should involve the careful phasing-in of specific requirements, with grandfathering where necessary

- **Capital Composition:** improving the composition of banks' capital is necessary. However, the proposed rigid definition of capital will have a significant impact on firms' lending

  - The currently proposed regime of exclusions and deductions is excessively conservative and would benefit from changes to achieve a more economically realistic result, while nevertheless ensuring that the overall quality of capital improves substantially throughout the system

Overarching themes from IIF response to Basel III proposals April 2010 (II)

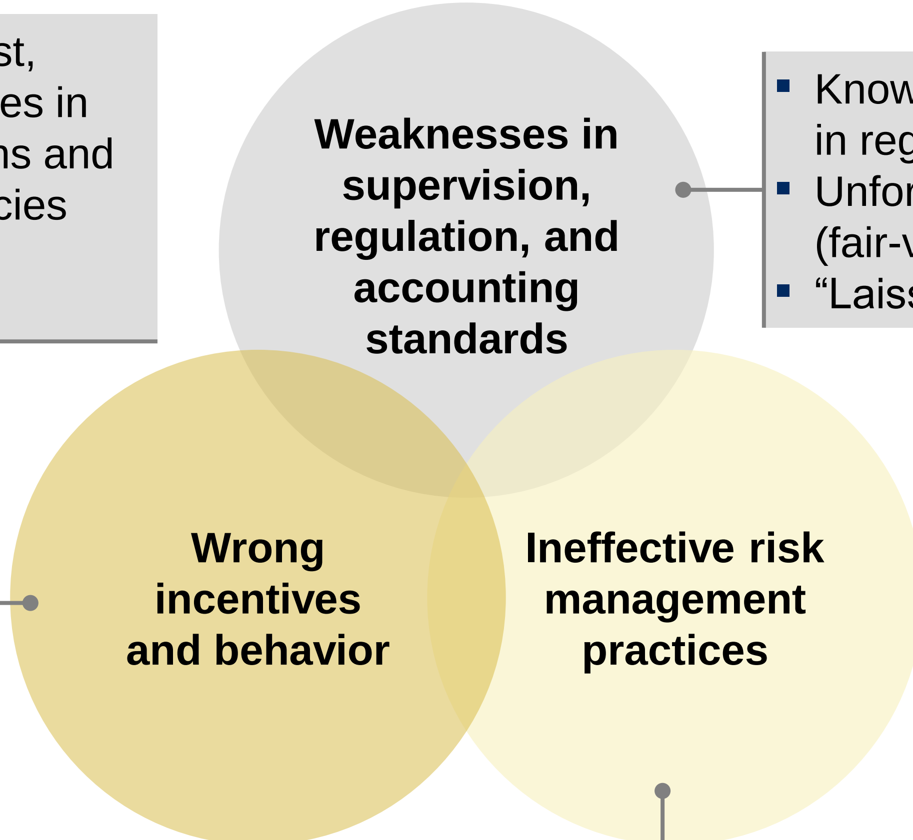
- **Leverage ratio**: The IIF supports preventing excessive growth of leverage in the system. However:
  - the currently proposed gross leverage ratio (disregarding all risk mitigation) would result in an overstated and misleading view of banks' economic risks, leading to disproportionate constraints on lending
  - It would substantially disadvantage lower-risk banks and banking systems, creating perverse incentives for banks to increase the risk levels in their portfolios, in order to produce higher returns
  - These disadvantages would be compounded if the leverage ratio is established as a fixed, mandatory tool in "Pillar I"
  - It is crucial that the leverage ratio be applied exclusively under "Pillar 2", to avoid fundamental contradictions with the adjusted Basel framework
  - On that basis, a carefully designed leverage ratio could be used by supervisors as a supplementary metric among several tools in order to detect anomalies and to prevent excessive leverage at individual firms
  - Current divergence of accounting standards creates a need for substantial regulatory adjustments in any leverage ratio

Overarching themes from IIF response to Basel III proposals April 2010 (III)

- **Counter-cyclical Measures:** a combination of effective risk management, forward-looking provisioning and capital tools is needed to address procyclicality
  - Proposal threatens significant overshooting - buffers will likely add on rigid additional capital, which is unlikely to be available for use in case of stress
  - Actual availability of capital buffers for use during times of stress needs to be ensured
- **New Liquidity Framework:** IIF supports strengthening liquidity management, in particular the need for robust short-term survival ratios. However:
  - "Net Stable Funding Ratio'" (NSFR) turns what should be a risk-based assessment of each bank's exposures and funding into a rigid formula based on arbitrary assumptions
  - As proposed, NSFR will severely constrain maturity transformation; it should be modified and moved to "Pillar 2"
  - Proposed narrow definition of liquid assets focused on sovereign debt fails to recognize that not all markets have sufficient supply of government debt, and would distort markets for bank and corporate paper

Firms' conduct was based on multiple structural flaws in regulation, risk management, and incentives

- Conflicts of interest, moral hazard issues in financial institutions and credit rating agencies
- Weak risk culture
- Lack of diligence



- Known arbitrage opportunities in regulation (Basel I)
- Unforeseen impact of policies (fair-value accounting)
- "Laissez-faire" policy

- Insufficient or ineffective methodology, capability, processes in financial institutions
- Shortcomings vs. "good practice" in financial institutions and credit rating agencies

The Global Financial Crisis had many important causes, including risk management failures, weak culture and poorly aligned incentives

SELECTION

Weaknesses in supervision, regulation and accounting standards

Capital adequacy
- Capital incentives in Basel I to shift risky assets off balance sheet
- Capital requirements too low for trading risks and securitization

Specific US issues
- Poor underwriting standards in the US (in particular, by non-regulated institutions)
- Inadequate supervisory structure

"Laissez faire" policy
- No catch-up of regulations with complex business

Supervision
- Insufficiently robust monitoring & understanding of banks' risk management practices & weaknesses

Fair-value accounting
- Pro-cyclical effects not fully understood/underestimated
- Weaknesses in stress situations

Interpretation of regulations
- Aggressive interpretations, e.g.
  - 364-day liquidity lines
  - Consolidation of SPVs

Ineffective risk management practices

Liquidity management
- Insufficient liquidity management practices
- Failed in stress situations
- Inadequate contingency plans

Risk measurement
- "Domino effects" of risks underestimated
- Lack of integrated view on risks
- Insufficient data history

Stress testing
- Models failed credit cycle test
- Scenarios not extreme enough
- Not forward-looking

Valuation
- Insufficient internal valuation models
- Passive reliance on external valuations

Operational risk
- Reputational risks underestimated
- Weak operational controls

Governance
- Accountabilities not clearly defined
- Banks' risk profiles not sufficiently understood by management & boards

Wrong incentives and behavior

Credit Rating Agencies
- Lack of transparency and accountability
- Conflicts of interest
- Lack of diligence
- Weaknesses in methodologies

Management oversight
- Business not aligned with "risk appetite" & risk management competence
- Insufficient timing and quality of information flow
- Too much reliance on quantitative models
- Risk concerns pushed aside
- Lack of courage to act against market expectations

Incentive structure
- Bonus schemes with excessive short-term incentives encourage risk
- "High greed culture", in particular, for originators

Market expectations
- Market expectations on profit beyond economic reality

Early warning systems
- Partially inadequate, largely failed management response

Transparency
- True risk of complex transactions not transparent
- Excessive reliance on Credit Rating Agencies, insufficient own credit due diligence
- Weak incentives for originator/investor to generate transparency/monitor

SOURCE: Financial Stability Forum, Institute of International Finance (IIF), Senior Supervisors' Group, U.S. Treasury

"Senior Supervisors Group" provided the first official diagnosis of the failures in March 2008 …

I. SSG Background

The Senior Supervisors Group

- Formed in 2007 in response to market events
- Comprises 9 supervisory agencies from 7 countries
- Supports the priorities of the Financial Stability Board
- Is not a policy-setting body

… and then published a deeper analysis of the risk management and governance failures on 21 October 2009

Senior Supervisors Group

- Observations on Risk Management During the Recent Market Turbulence
- Risk Management Lessons from the Global Banking Crisis of 2008

Principal conclusions from second (Oct. 2009) SSG report confirm & detail systemic governance failures in the 20 largest north Atlantic firms (I)

Overarching Observation (1/2)

- **Weaknesses in governance, incentives, and infrastructure undermined the effectiveness of risk controls and contributed to last year's systemic vulnerability**
  - The unwillingness or inability of boards of directors and senior managers to articulate, measure, and adhere to a level of risk acceptable to the firm
  - Arrangements that favored risk takers at the expense of independent risk managers and control personnel,
  - Compensation plans that conflicted with the control objectives of the firm, and
  - An inadequate and often fragmented infrastructure that hindered effective risk identification and measurement

Principal conclusions from second (Oct. 2009) SSG report confirm & detail systemic governance failures in the 20 largest north Atlantic firms (II)

Overarching Observation (2/2)

Boards didn't understand the risks that were being taken by the management

- **Disparity between the risks that their firms took and those that their boards of directors perceived the firms to be taking**
  – Insufficient evidence of active board involvement in setting the risk appetite for firms in a way that recognizes the implications of that risk taking
- **Rarely did supervisors see firms share with their boards and senior management**
  – Robust measures of risk exposures (and related limits)
  – The level of capital that the firm would need to maintain after sustaining a loss of the magnitude of the risk measure, and
  – The actions that management could take to restore capital after sustaining such a lossy

Effective boundaries for risk-taking not set in advance

SSG (Oct. 2009): Lots of critical improvement still needed, much work to do – needed improvements will take several years

Critical Areas of Needed Improvement

- **10 critical areas for continued improvement**
  - Board and Senior Management Oversight
  - Articulating Risk Appetite
  - Compensation Practices
  - Risk Information Technology Infrastructure
  - Risk Aggregation & Concentration Identification
  - Stress Testing
  - Credit & Counterparty Risk Management
  - Valuation Practices
  - Operations & Market Infrastructure
  - Liquidity Risk Management

The IIF Committee on Market Best Practices recommended 6 areas for industry action in its July 2008 final report; IIF Steering Committee on Implementation reported on industry progress December 2009

- The global industry response to the credit and liquidity crisis was formulated through the Committee on Market Best Practices (CMBP) of the Washington-based Institute of International Finance (IIF)
- The Committee (consisting of representatives from over 65 IIF member institutions, including rating agencies and investors) engaged 6 Working Groups to address key areas of focus
- Its July 2008 report contains Principles of Conduct and >100 specific recommendations in 6 main areas for industry action

Areas for industry action

1. Risk Management
2. Compensation Policies
3. Liquidity Risk, Conduits and Securitization
4. Valuation
5. Credit Underwriting, Ratings and Investor Due Diligence in Securitization Markets
6. Transparency and Disclosure

***Industry* follow-up and implementation in progress**

SOURCE: Final Report of IIF Committee on Market Best Practices, July 2008

13

IIF agrees that substantial further strengthening is required (Dec 2009)

Key findings of the IIF Steering Committee on Implementation (SCI) report

- Financial institutions have invested considerable resources in necessary improvements; significant changes are underway
- Strengthening risk management is currently a top priority - risk functions being reconfigured and upgraded for a more integrated approach to risk management. Specific areas of improvement include:
  - Governance and transparency;
  - Stress testing;
  - Liquidity risk management;
  - Risk measurement; and
  - Risk-aligned compensation policies
- Institutional culture is changing - perceptible shift in orientation from "sales-driven" to more "risk-focused."
- Firms are formalizing valuation reporting frameworks, with increased involvement of senior management — including the CFO and CRO functions— in valuation and reporting processes
- Key Impediments to Change:
  - Degree of cultural change required in firms;
  - Dependency on few senior personnel; and
  - IT/technology changes and dealing with legacy systems that are harder to change
- Essential to build systems which are sufficiently robust to ensure that changes made are real and enduring
- Greater IT investment required in risk management and risk-monitoring systems
- Reforms need to be institutionalized through governance changes

SOURCE: "Reforms in the Financial Services Industry: Strengthening Practices for a More Stable System" (SCI Report), December 2009 www.iif.com

Conclusions

- Failures of bank governance and risk measurement & management, and of bank supervision, were at least as important as causes of the crisis as any failure of regulatory design
- Accordingly, the extent to which the currently proposed major regulatory reforms can, by themselves, be effective in strengthening the resilience of the banking system is unclear
- At a minimum, significant strengthening of risk management and governance in firms, and of microprudential supervision, will also be required for the proposed regulatory reforms to be effective in preventing and mitigating future crises
- Achieving these outcomes should be of the highest possible priority and receive increased focus from the industry and supervisors, going forward. This will take some time
- Clarification of the objectives and responsibilities for macroprudential supervision and financial stability is also needed; together with improvements to cross-border resolution regimes. These will also take time
- Consequently, in light of their very substantial cumulative impact, prioritisation and careful phasing in of regulatory reforms is desirable, in addition to some key needed changes
- The industry and the Basel Committee are broadly aligned on the path of reform; imminent key decisions about calibration and timing should be made in light of the foregoing
- Additional, measured national policy responses may be appropriate. Such policy responses might reasonably include additional constraints on banks' business models or specific risk-taking activities in certain jurisdictions where deemed necessary (e.g., Volcker)

Industry Assessment of Proposed Banking System Regulatory Reforms

Financial Stability: Towards a Macroprudential Approach
HKIMR – BIS conference
Hong Kong SAR, 5-6 July 2010

Panel Discussion
Tuesday, 6 July 2010

Dr. K. Mark Lawrence
Managing Director, Mark Lawrence Group
Co-Chairman, Institute of International Finance Risk Management Working Group
Member, IIF Special Committee on Effective Regulation

mark@marklawrencegroup.com