Executive summary

- At the centre of the Basel 3 reforms (first proposed in December 2009) is a need to create a more resilient banking system. The measures being contemplated are multiple and complex but, broadly, aim to: increase the quality of capital being held by banks; enhance the coverage of risks against which capital is held; address the issue of leverage; reduce procyclicality; address the interconnectedness of firms; and introduce an international liquidity framework.

- In the context of systemic risk, the Basel 3 measures of particular interest are the introduction of multiple regulatory buffers and contemplation of capital or liquidity surcharges for firms designated as SIFI.

- In our view a SIFI surcharge would represent just another regulatory buffer (albeit one that attempts to reflect how systemic risk crystallises in firms). Not unlike the Basel Committee, we consider capital instruments performing a similar function to a SIFI surcharge to include going and gone concern contingent capital.

- Any assessment of how systemic risk builds up in firms is better addressed by the enhanced supervision of firms: a closer working relationships between firms and regulators (that formalises and consolidates good supervisory practices that have evolved under what is known as Pillar 2 under the Basel 2 framework) and a supervisory mandate that enables supervisors to intervene and mitigate risks locally before they spread into the wider financial system.

The financial crisis has understandably led to an increased focus on firms’ capital and liquidity resources as well as their ability to identify early warning signs and cope with future stress. As a result, prudential regulation is being reviewed and reformed. While some countries have introduced local changes and we have seen amendments to the European Capital Requirement Directive (CRD), the changes being proposed to the Basel 2 Capital Accord (2005) are wide ranging and have been instigated by the G-20. AFME and its members, through the Global Financial Markets Association (GFMA), have made extensive contributions to the discussion about the changes needed to the current rules.

Basel 3 Reforms

In December 2009 the Basel Committee published a package of reforms (BCBS 164: Strengthening of the resilience of the banking system and BCBS 165: International framework for liquidity risk measurement, standards and monitoring). In parallel the European Commission issued its own consultation (Possible further changes to the capital requirements, otherwise known as CRD 4). In broad terms, the proposals aim to:

“The measures being contemplated by Basel 3 are complex and need to be considered in terms of their cumulative economic impact”
• improve the quality, consistency and transparency of the bank capital base;
• strengthen the risk coverage of the framework with new standards for counterparty credit risk exposures arising from derivatives, repos and securities;
• introduce a leverage ratio with the purpose of containing the build up of excessive leverage in the banking system and providing an extra layer of protection against model risk and measurement error;
• improve measures to address procyclicality; and
• introduce two minimum liquidity risk standards – a 30-day liquidity coverage ratio (LCR) and a 1-year Net Stable Funding Ratio (NSFR) – along with a set of common monitoring metrics and application standards to allow supervisors to analyse liquidity risk trends at a bank and system wide level.

Some of the measures being contemplated by Basel 3 are complex and need to be considered in terms of their cumulative economic impact and interaction with other measures. As a consequence, we are now seeing transitioning arrangements being put in place for both the leverage ratio and NSFR and the Committee may consider other areas where such arrangements are needed. The financial services industry also remains concerned about the calibration of the package and the numerous technical points to be resolved, but, nonetheless, it shares the objective of achieving a robust, proportionate and more risk sensitive capital requirements regime.

In the context of systemic risk, the Basel 3 measures of particular interest are the introduction of multiple regulatory buffers, the contemplation of a capital and/or liquidity surcharge for firms designated as SIFI and the potential role that contingent capital (which we presume to include both going and gone concern) could play in mitigating such surcharges.

We do not believe that there is a need for a capital or liquidity surcharge on SIFI. Indeed, as we explain in Chapter 1, there are major issues with proceeding to have special rules for institutions deemed to “systematically important”. It is our view that a SIFI surcharge represents just another regulatory buffer (albeit one that attempts to reflect how systemic risk crystallises in a firm). We suggest that capital instruments performing a similar function to a SIFI surcharge include contingent capital (which we presume to include both going and gone concern).

We also suggest that crystallisation of systemic risk within a firm is best addressed through the supervisory tools already available to the regulatory community, as we explain overleaf.

“Enhanced supervision will introduce a continuous dialogue between a firm and its supervisors”
Enhanced Supervision

Effective prudential regulation is not achieved merely through capital and liquidity requirements. Whilst the principle that firms govern and take responsibility for themselves must be preserved, it is accepted that supervisory activity over firms’ behaviour and resources has to become more effective to ensure that risks are better understood by regulators and that preventative measures taken as part of the Pillar 2 approach (in its broadest terms) are timely.

We recommend a holistic approach, which we describe as “enhanced supervision”, as the way to ensure that emerging risks can be identified early and satisfactorily addressed. The framework we propose (which is explained in detail in Annex 1 to this paper) must:

• be capable of making the link between the activities and risks of the individual firm and the risks to the wider financial system;
• be grounded in a deep understanding of the supervised firms’ business models, and the risks inherent therein;
• be sufficiently flexible and risk-based, to ensure that capital and supervisory resources are targeted appropriately;
• be sufficiently responsive, continuous and consistently applied so that emerging risks are identified and tackled at an early stage;
• ensure that supervisors have the appropriate powers and resources; and
• include appropriate safeguards on supervisory action to avoid diminishing returns of poorly targeted supervisory requests, unjustified supervisory action, or, equally problematic, supervisory inaction.

Enhanced supervision will be best judged by reference to five targeted outcomes:

1. Supervisory expectations are transparent and benchmarked to reflect a firm’s peers and the markets in which it operates.
2. Assessment of governance and culture forms an integral part of establishing the risk profile of any firm.
3. Clear linkage is demonstrated between qualitative and quantitative approaches to supervision.
4. Timely and targeted supervisory interventions avoid a “one size fits all” approach.
5. Market confidence increases as a consequence of enhanced supervisory oversight.

Collectively, these outcomes should result in confidence in the prudential soundness of the firm. In turn, this should promote mutual trust, prevent arbitrary regulatory actions and counter the assumption that a surcharge applied across a SIFI class, above the revised general Basel standards, is the only (or even a superior) supervisory response to a risk emerging within a firm.

The recent crisis has already brought about considerable changes to supervisory practice, including more intensive supervision in many countries. There has also been a significant and targeted increase in the level of capital and liquid funds held by firms, coupled with better risk management and contingency planning (including work on the introduction of formal recovery and resolution planning).

The need for better and more effective oversight and supervision is also being addressed by the G-20. The Toronto Communiqué highlighted that new and stronger rules need to be complemented with more effective supervision and oversight.

The G-20 has asked the Financial Stability Board, in consultation with the International Monetary Fund, to develop recommendations to strengthen oversight and supervision, specifically relating to the mandate, capacity and resourcing of supervisors and the specific powers, including early intervention, which should be adopted proactively to identify and address risks.

To some extent, enhanced supervision represents the formalisation and consolidation of good supervisory practices that have evolved over time, and reflects what is known as Pillar 2 (in its broadest sense) under the Basel 2 framework, and been given impetus by the recent crisis. Inevitably, enhanced supervision will introduce further changes in the style of supervision,
with a more continuous dialogue between a firm and its supervisors and less reliance on “big bang” reviews occurring periodically. Furthermore, the internal processes within the regulator should be transparent and flexible enough to accommodate that breadth of dialogue.

Enhanced supervision also requires that supervisors be provided with a mandate to act and have the skills and resources to undertake this form of supervision. Although a challenge for regulators to meet, it is essential that supervisory teams have the necessary mix of skills and aptitudes not only to understand firms’ businesses and identify risks therein but also to challenge firms appropriately. There must also be safeguards on supervisory action. These are discussed in detail in Annex 1.

It follows from this, and from the arguments against the formal classification of firms as being “systemically important” set out in chapter 1, that imposing general capital surcharges on firms considered to pose a systemic risk – as has been suggested – would be a mistake. The key arguments against surcharges are that they are less able to be adapted to emerging risks and do not help to ensure that the right amount of capital is held in the right places in the financial system as a whole. Moreover, before any further quantitative measures are imposed, due consideration needs to be given to the impact of the changes being introduced via the Basel 3 reforms and the calibration of the package.

We believe that the combination of better risk management and contingency planning in firms along with enhanced supervision as described above would mitigate the risk of future crises much more effectively and proactively than the blanket application of capital, above the revised general Basel standards, which merely provides false comfort – because it is insensitive to changes in risk brought about by market developments – and systemic risk may be better addressed through enhanced supervision building on the current Pillar 2.

**Further reading:**

G-20 Pittsburgh Summit statement, September 2009
http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf

G-20 Toronto Summit declaration, June 2010
http://www.g20.org/Documents/g20_declaration_en.pdf

Joint industry response position paper to the Basel Committee’s December 2009 Package:

Joint industry response position paper to the Commission’s February 2010 proposal:


**Significant regulatory initiatives:**

Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee, 17 December 2009
http://www.bis.org/press/p091217.htm

18 June 2010 Press Release - Adjustments to the Basel II market risk framework announced by the Basel Committee
www.bis.org/press/p100618.htm

www.bis.org/press/p100716.htm

26 July 2010 Press Release - The Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package
www.bis.org/press/p100726.htm

Annex to 26 July 2010 Press Release – Broad agreement on main elements of the design of Basel 3 as announced by The Group of Governors and Heads of Supervision
www.bis.org/press/p100726/annex.pdf

Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010
http://www.bis.org/press/p100912.htm