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. There are two separate aspects of the crisis with separate driving factors, which have to be clearly distinguished:

- a liquidity and credit event in the finance industry, accelerated by enormous leverage in the financial sector;
- unwinding of global imbalances, triggered by the fallout of the financial crisis.

However, these imbalances have not been caused by the crisis. The downturn of the real economy is a separate problem and 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. Just putting more capital into the system can strengthen banks' balance sheets in respect of future write-offs during the downturn of the real economy. But it will not solve the regulatory problems – the focus has to be on avoiding wrong and providing for the right incentives for financial institutions.

Driving Factors and Possible Responses

1 Supervisory Style; Macro versus Micro Supervision

Supervisors worldwide are unanimous on the need for a systemic approach of banking regulation and supervision as a complement to assessing individual institutions.

2 Structure of Supervision and Supervisory Authorities

Cross-border supervision of banks is still based on the “Basel Concordat”, issued in 1975 and amended in 1983. The so-called “Turner Review” by the FSA (March 2009) is getting to the point “…the world has…not…even a powerful treaty-based organisation with authority in the area of bank regulation and supervision… International agreements on bank regulation, and encouragement to increased but voluntary coordination on supervision are achieved via multiple non treaty-based fora, e.g. the Financial Stability Forum, the Basel Committee on Banking Supervision, the Senior Supervisors Group.” The crisis has clearly brought to light the limits of such “soft law” regulation.

The collapse of Lehman Bros. has clearly demonstrated the urgent need for a clear base in public international law with the authority to issue regulation on large cross-border
institutions, comprising
- minimum harmonisation of regulation to achieve consistency and a level playing field;
- co-operation of supervisors including mandatory intervention in specified cases,
The outcome might be a regulatory framework beyond mere principles, but less detailed than the related European Directives. The early intervention framework should include moratoriums in respect of cross-border transactions of non-compliant institutions. A difficult question is how to avoid moral hazard incentives caused by bail-out expectations. Excluding national discretion on bail-outs, although discriminating compliant institutions, would not be realistic. However, in the case of bail-outs of large cross-border institutions which are subject to the above-mentioned regulatory minimum harmonisation, supervisory co-operation and burden-sharing should be mandatory, as well as application of stringent conditions on the institutions concerned. Due to the political implications, progress will be slow.

Regional organisations, in particular the EU, and monetary unions- could achieve a clear legal basis more easily. But neither in the EU nor in the USA have final decisions been made.
Based on the High-Level Group Report on Financial Supervision in the EU, chaired by Jacques de Larosière, the European Commission has set out an action plan. The draft directives to give effect to the new framework have been published on 23rd September, 2009. They encompass:
- a European Systemic Risk Council (ESCR), hosted by, but separated from the ECB
- 3 new EU supervisory agencies – the European Banking Authority (EBA), the European Security and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). They will issue mandatory technical standards and guidelines, whereas day-to-day supervision will basically remain with the national authorities. However, in certain cases the EU Agencies will have power of direct intervention.
Implementation will be very delicate, because basically, binding powers over national supervisors require amendments to the EU Treaty.

A fundamental re-structuring of the U.S. supervisory system is also under discussion.

3 Liquidity

Liquidity, or rather unexpected shortage of liquidity in the financial system had proved to be a key factor in driving the turmoil. Therefore, major efforts to strengthen global standards for liquidity risk management and supervision are crucial. They would require similar dimensions as Basel II, and priority for this project vis-à-vis to further perfection of Basel II might have to be taken into consideration. This will be part of a broader Basel Committee programme announced under the headline “Comprehensive response to the global banking crisis” in September 2009. The intention is “to introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.” Concrete proposals will be issued by year-and 2009, to be completed by the end of 2010.
4 Capital Adequacy

Although 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.

In the regulatory field, the first EU package – a Directive proposed in October 2008 - has been passed by the European Parliament on 6th May, 2009. It focuses on securitisation regulation, including a 5% tranche to be retained by originators in case of securitised credit risk, and enhanced disclosure, to come into force by year-end 2009. Further proposals have been outlined in July 2009, including
- through-the-cycle expected loss provisioning;
- specific incremental capital requirements for residential mortgages denominated in a foreign currency, as well as LTV restrictions for preferential treatment of mortgages under the Standard Approach;
- removal of national options and discretions in the CRD.

The Commission will publish related proposals for a directive in October 2009, as well as consultation on a balance-sheet based (i.e. not risk-based) general leverage ratio. A CEBS working group on the definition of core capital elements has been set up in June 2009.

The first Basel Committee package - enhancements to the Basel II framework - has been published in July 2009, including the capital regime for trading book positions, as well as enhanced requirements for the use of models. It will also provide for the management and disclosure of non-contractual commitments, implicit support, pipeline and warehousing risks with regard to securities positions. This package is part of the above-mentioned broader programme announced under the headline “Comprehensive response to the global banking crisis” in September 2009, with the aim to
- introduce a countercyclical capital buffer;
- address systemic risks;
- raise the quality of the Tier 1 capital base (common shares and retained earnings);
- introduce a general balance-sheet based leverage ratio.

Concrete proposals will be issued by year-and 2009, to be completed by the end of 2010.

In summary, there has been a resurfacing of problems which had been addressed and criticised during the Basel II consultative process, but have not been finally resolved.

5 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.

A EU Draft Directive on so-called “Alternative Investment Funds” will apply the principles of homecountry control and the European Passport to a widely defined range of funds other than UCIT funds, such as hedge funds and private equity funds. It would include licensing, minimum capital, disclosure and regulatory reporting requirements. Proposed U.S. drafts are aiming at extending financial group consolidation, based on a
wide definition of control, and, separately, at hedge funds.

However, the core topic still requires an in-depth analysis of aims, scope and scale of supervision and regulation.

6 The Role of the Rating Agencies

The Basel II regime has created (wrong) incentives to rely on ratings, as well as statutes in a couple of jurisdictions forcing investment institutions to restrict investments to agency-rated AAA instruments. 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. In the EU a related Directive proposal of 12th November 2008 should be issued in due course. The Basel Committee's first package seeks to ensure that banks perform their own due diligence and do not simply rely on rating agency credit ratings. Failure to meet these criteria would result in related capital deductions.

7 The Use of Risk Models

The UK FSA distinguishes 4 categories of problems:
- short observation periods
- statistically non-normal distribution
- systemic versus idiosyncratic risk
- non-independence of future events (uncertainty).
As a minimum solution, the Basel Committee has proposed Principles for Sound Stress Testing Practices and Supervision which should be generally applied in risk management practices.

8 GAAP Valuation and Disclosure

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 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 has been implemented by the US FASB in April 2009. The IASB and the US FASB intend to achieve an agreement on a future common standard in fall 2009. A related draft is expected to be published in October, 2009. The FASB is still in favour of fair value as a regular basis, including credit exposures and liabilities. The IASB intends to measure financial instruments at amortised costs, if they have characteristics of a basic loan and are managed on a yield basis. The latest Basel Committee High Level Guiding Principles issued end of August 2009 are closer to the IASB, allowing for re-classifications according to an institution's business model. This view is shared by the US regulatory agencies.

9 Further Topics

Regarding harmonisation of the legal framework for cross-border liquidation and bankruptcy of financial institutions, in particular in respect of complex group structures, the Basel Committee has recently published a consultative document “Report
and Recommendations of the Cross-border Bank Resolution Group”. This is an extremely broad field, although not exactly in the regulatory area – as the Governor of the Bank of England, Mervin King has put it: global banking institutions are global in life but national in death.

10 Credit Crisis and Islamic Banking

Banks applying the principles of Islamic banking have so far performed relatively well. They cannot escape the deterioration of the global economy and falling asset prices. However, they were not much affected by the first round core crisis of the financial industry, because they are much less exposed to the systemic drivers of the liquidity squeeze:

- They have minimal direct exposure to the credit fallout of toxic securities – for obvious reasons. Regularly, these instruments are interest (riba) based and structured on interest cash flows and hence not shariah-compliant.
- Due to the closer link of Islamic finance instruments (murabaha and ijara-based sukuk) to the real economy, there is less leverage in the system. In general, Islamic banks have a strong commitment to asset-based transactions, which insulates them from specific internal risks of the financial system.
- The liquidity base of shariah-compliant trust account deposits is less volatile than the wholesale, in particular inter-bank, capital markets.
- Derivatives are only shariah-compliant for hedging purposes, i.e. risk mitigation instead of building up of open risk positions. Hence, proprietary trading can normally not endanger the capital base of Islamic banks.
- The concept of risk sharing (rather than selling off origination risks) supports an interest in the proper management of credit risk.
- Islamic bonds (sukuk) are strictly based on cash flows of the real economy (in particular ijara).
- Sharia compliance is based on the principles of gharar (contractual certainty) and maysir (i.e. profit or loss shall not be left to chance).

Nevertheless, the crisis has also revealed a few weaknesses which deserve some attention:

- Short-term liquidity management in the money market can be a problem, in particular funding through the overnight interbank market. The basis of shariah-compliant repo transactions (in particular sukuk) needs more critical mass. Perhaps governments and central banks of Islamic monetary unions could support the money market for Islamic banking by issuing suitable instruments.
- A further problem arises for Islamic banks seeking access to liquidity provided by non-Islamic central banks. On one hand, the repo-eligibility criteria of “traditional” central banks are based on interest-related instruments and would require some amendments. On the other hand, as mentioned above, the market of shariah-compliant tradeable instruments needs more critical mass.
- Whether or not the “profit equalisation reserves” of Islamic banks need more support in the direction of deposit guarantees, is uncertain. There is an implicit guarantee by Islamic regulators (which is explicit in certain states).

Under traditional supervisory standards, the Islamic regulators have done their homework by applying the international standards, supported by the Islamic Financial Services Board (IFSB).