After the crisis:
the regulatory landscape

John Thirlwell

C-5 FII conference, 16 November 2011

- International initiatives
  - Financial Stability Board
  - Basel III
- US: Dodd-Frank
- EU:
  - Stress tests
  - Transaction tax
- UK: Independent Banking Commission
- Living wills
- The crisis and after

Financial Stability Board (G20)

- Capital (loss absorbency) – Basel III
- G-SIFIs (too big to fail)
  - capital
  - resolution
- Shadow banking
- OTC derivatives
- Credit rating agencies
- Compensation

Basel III

%	**1/1/2013**	**2015**	**2018**
Equity	3.5	4.5	7.0
Other tier 1	1.0	1.5	1.5
Tier 2	3.5	2.0	2.0
Total	8.0	8.0	10.5
Cap deductions	0	40	100
Leverage ratio	Observed	Disclosed	In force
Liquidity coverage ratio	Observed	In force	In force
Net stable funding ratio	Observed	Observed	In force

Basel III (2)

- Conservation buffer: + 2.5% Tier 1 equity by 1.1.19 (included in 7%)
- Counter-cyclicality buffer: + 0 - 2.5%
- Capital deductions: minority interests, goodwill & intangibles, unrealised losses, deferred tax, investment in own shares etc
- Leverage ratio: Gross borrowings / Tier 1 = max x 33
- Cash
  - Liquidity ratio: 30 days net outflow
  - Net stable funding ratio: controls over short-term funding, i.e. < 30 days

Basel III +

- UK Independent Banking Commission:
  - UK SIBs primary loss-absorbing capacity (equity, contingent capital, bail-in bonds etc) of 17%-20%
  - UK large retail SIBs (RWA = >3% of UK GDP) min equity of 10%;
- China:
  - SIBs: Basel III + 3.5% by end 2013
  - Non-SIBs: Basel III + 2.5% by end 2016

Global - SIB criteria

1. Cross-jurisdictional claims and liabilities
2. Size (Total exposures)
3. Interconnectedness (Intra-financial assets and liabilities; wholesale funding ratio)
4. Substitutability (assets under custody, payments, debt and equity underwriting)
5. Complexity (OTC derivatives, trading book v available for sale values, level 3 assets)

- Each of the above weighted at 20%
- Supervisory judgement

G-SIB proposals

- Likely to be 28 G-SIBs (+ 1 supervisory judgement) (out of 73 surveyed in January 2011)
- Capital (to be implemented 2016 – 19)

  Scores allocated to 5 buckets:
  - bucket 1 + 1% Tier 1 common equity,
  - bucket 4 + 2.5% (most)
  - bucket 5 + 3.5% (empty)

- Recovery and resolution regimes (for G-SI*FI*s): recommendations to G20 Cannes, Nov 2011

Financial Stability Board (G20)

- Capital (loss absorbency) – Basel III
- G-SIFIs (too big to fail)
  - capital
  - resolution
- Shadow banking
- OTC derivatives
- Credit rating agencies
- Compensation

Shadow banking - definition
FSB *Scoping the issues* (April 2011):

- Entities and activities outside the regulated banking system that perform bank-like functions

- Volumes:

2007	$50tn (11 major economies)
2008	$47tn
2010	$60tn (FSB est, incl eurozone)

Loan origination	Commercial banks Mortgage finance companies Consumer finance cos
Loan warehousing	ABCP conduits SPVs
Securitisation	SIVs SPVs structured by securities companies
Distribution / W/sale funding	Money market funds Hedge funds Commercial banks

Shadow banking

- Regulation of banks’ interactions with shadow banking entities
- Regulatory reform of money market funds
- Regulation of other shadow banking entities
- Regulation of securitisation
- Regulation of activities related to securities lending and repos
- Policy recommendations by July 2012

US non-bank SIFIs
(Dodd-Frank)

- Definition: Global assets >$50bn (US assets for non-US) + one of, for example:
  - CDS outstanding >$30bn
  - Loans and bonds > $20bn
  - Short term debt / assets ratio < 10%
- After assessment, become Fed regulated (Bear Stearns, Lehman, Countrywide would have been caught by the new rules)

Financial Stability Board (G20)

- Capital (loss absorbency) – Basel III
- G-SIFIs (too big to fail)
  - capital
  - resolution
- Shadow banking
- OTC derivatives
- Credit rating agencies
- Compensation

OTC derivatives market

- By 31/12/12 all standardised OTC derivative contracts will be
  - traded on exchanges or electronic trading platforms where appropriate and cleared through central counterparties
  - reported to trade repositories
- All non-centrally cleared OTC contracts will be subject to higher capital requirements
- FSB report October 2011 says few members have legislation or framework to meet deadline (smaller markets waiting for US and EU)

Financial Stability Board (G20)

- Capital (loss absorbancy) – Basel III
- G-SIFIs (too big to fail)
  - capital
  - resolution
- Shadow banking
- OTC derivatives
- Credit rating agencies
- Compensation

- International initiatives
  - Financial Stability Board
  - Basel III
- US: Dodd-Frank
- EU:
  - Stress tests
  - Transaction tax
- UK: Independent Banking Commission
- Living wills
- The crisis and after

Dodd-Frank

- Financial Stability Council
- Agency oversight to include:
  - Non-bank financials (consumers) - CFPB
  - Hedge funds managing >$100m – registered by SEC
  - Financial advisers holding >$100m – federal regulation >$100m
- Orderly Liquidation Authority
  - Living wills
- Securitisation reform (5% retention)
- Derivatives regulation
- Investor protection
- Credit rating agencies
- Volcker rule

- International initiatives
  - Financial Stability Board
  - Basel III
- US: Dodd-Frank
- EU:
  - Stress tests
  - Transaction tax
- UK: Independent Banking Commission
- Living wills
- The crisis and after

EU

- Stress test 2011: 9 ‘failures’ out of 91 tested, 16 in ‘danger zone’; test based on 5% core Tier 1
- Taxes
  – Financial transactions tax
  – Bank levies

- International initiatives
  - Financial Stability Board
  - Basel III
- US: Dodd-Frank
- EU:
  - Stress tests
  - Transaction tax
- UK: Independent Banking Commission
- Living wills
- The crisis and after

UK:
Independent Banking Commission

- Capital requirements
- UK retail banking ring-fenced
- Depositor preference
- Increase competition in retail banking

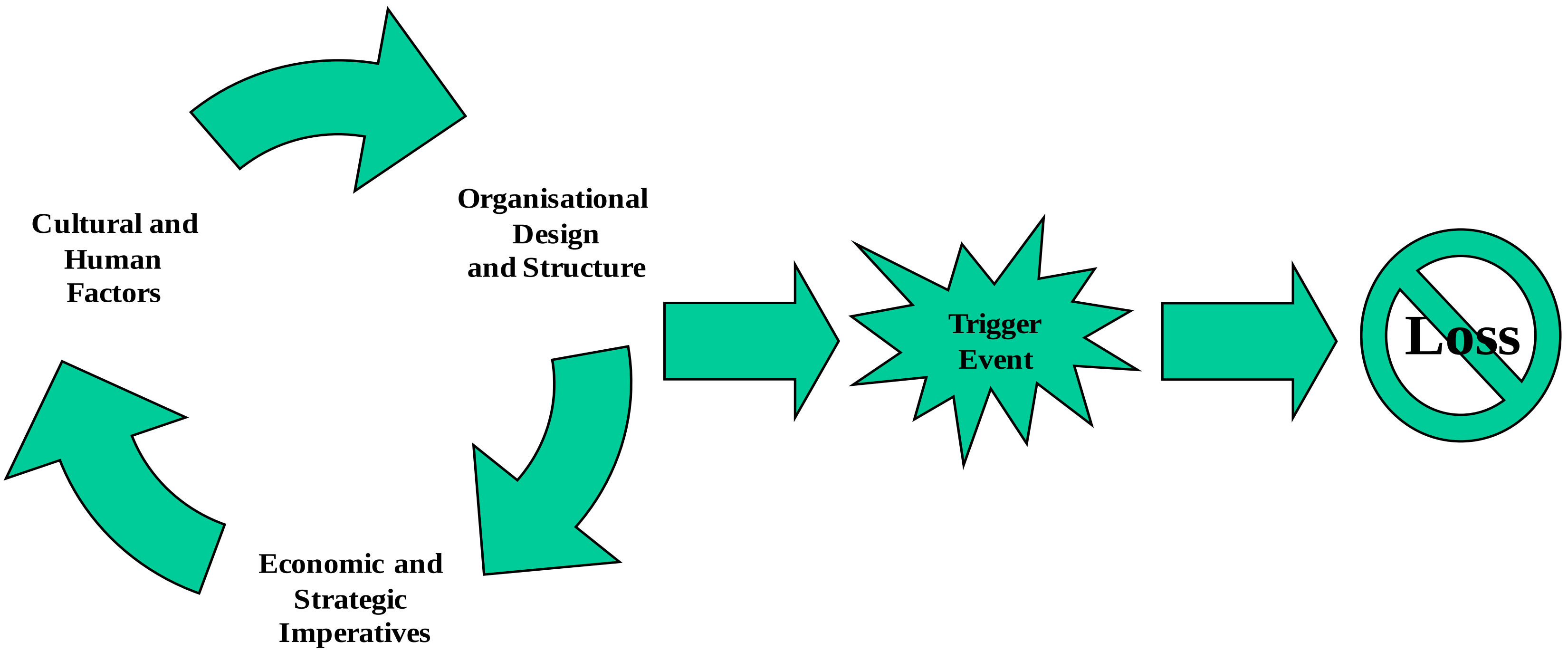
- International initiatives
  - Financial Stability Board
  - Basel III
- US: Dodd-Frank
- EU:
  - Stress tests
  - Transaction tax
- UK: Independent Banking Commission
- Bank levies
- Living wills
- The crisis and after

Recovery and resolution regimes (‘living wills’)

- FSB consultation (final paper November 2011)
  - Effective resolution regimes
    - Resolution authority
    - Bail-ins
  - Cross-border co-operation (end 2011 – end 2012)
    - Crisis Management Group
  - Improved planning by firms and authorities (recovery plans by end 2011, resolution by end 2012)
  - Fragmented systems; service providers; global payment services
- UK: all systemic firms have provided plans
- US: resolution only (for SIFIs); orderly liquidation fund (after the event) (final rule published 17 October)

- International initiatives
  - Financial Stability Board
  - Basel III
- US: Dodd-Frank
- EU:
  - Stress tests
  - Transaction tax
- UK: Independent Banking Commission
- Living wills
- The crisis and after

A Typical Crisis Model



Dr Simon Ashby, *The 6 C's of the financial crisis,* (Financial Services Research Forum, Nottingham University Business School: April 2010)

The banking crisis

- The trigger: Asset bubble – as ever
  - Sub-prime lending
  - Originate/distribute; CDS; complex instruments (?)
- Organisational design and structure
  - Failure to apply good risk management and governance
  - Credit rating agencies
  - Regulators and the regulatory regime (Basel II)
- Economic and strategic imperatives
  - The banking ecosystem: systemic risk
    - Shadow banks
  - Politicians
- Cultural and human factors
  - Human behaviour (greed, herd instinct, hubris etc)

US Congressional Financial Crisis Inquiry Commission (2011)

‘The crisis was avoidable.’

The key conclusions were that there were:

‘dramatic failures of corporate governance and risk management at many systemically important financial institutions’

‘a systemic breakdown of accountability and ethics’

Contact details

John Thirlwell

Tel: +44 (0)208 386 8019

Mob:+44 (0)781 382 9362

e-mail: info@johnthirlwell.co.uk

Web: www.johnthirlwell.co.uk