

UNDERSTANDING BASEL III

BASEL III COMPLIANCE PROFESSIONALS
ASSOCIATION (BIIIICPA)



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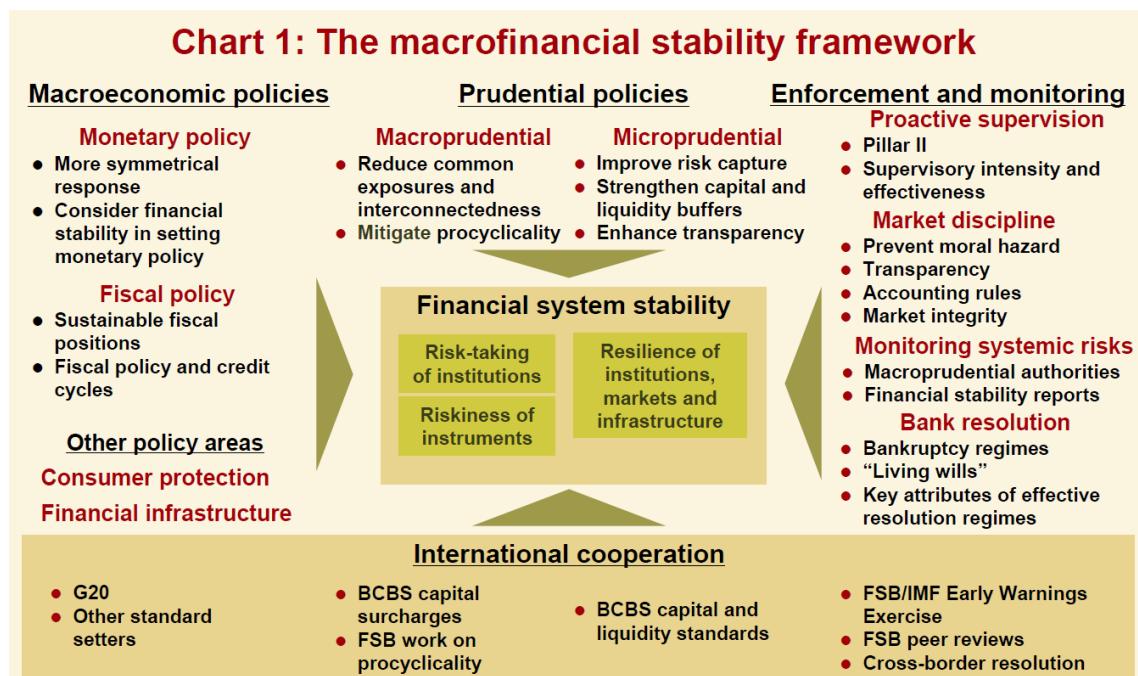
Understanding Basel iii

Basel iii, January 2012 to June 2012



Dear Member,

We have some important developments from the BIS.



Preserving financial stability involves a wide range of policy areas.

According to Jaime Caruana, General Manager, Bank for International Settlements, what Basel III brings is twofold:

1. An **enhancement of the regulatory framework** introduced by Basel II at the level of individual institutions; and

2. The set up of a macroprudential overlay so as to address systemic risk in its two dimensions, namely its time dimension (by mitigating procyclicality) and its cross-sectional dimension (by mitigating interconnection and contagion risk).

Chart 2: The Basel III reform programme – implementation

Enhanced Basel II + Macroprudential overlay = Basel III

Microprudential framework (Enhanced Basel II):

- Increase quantity and quality of capital
- Adequate risk coverage (for trading book, counterparty credit risk, securitisation)
- Enhanced risk management and disclosure
- Global liquidity standards

Macroprudential framework:

- Address stability over time (procyclicality)
 - Countercyclical capital charges
 - Capital conservation rules for stronger capital buffers
 - Dynamic provisioning
- Address stability at each point in time (system-wide approach)
 - Specific treatment for systemically important banks: systemic capital charge
- Leverage ratio

Another interesting development: **Crying is not a sign of weakness. You may let out your tears!**

Assuming full implementation of the Basel III requirements as of 30 June 2011, including changes to the definition of capital and risk-weighted assets, and ignoring phase-in arrangements, Group 1 banks would have an **overall shortfall of €38.8 billion for the CET1 minimum capital requirement of 4.5%**, which **rises to €485.6 billion for a CET1 target level of 7.0%** (ie including the capital conservation buffer); the latter shortfall already includes the G-SIB surcharge where applicable.

Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active. All other banks are considered **Group 2** banks.

As a point of reference, the sum of profits after tax prior to distributions across the same sample of Group 1 banks in the second half of 2010 and the first half of 2011 was €356.6 billion.

Under the same assumptions, the capital shortfall for Group 2 banks included in the Basel III monitoring sample is estimated at €8.6 billion for the CET1 minimum of 4.5% and €32.4 billion for a CET1 target level of 7.0%.

The sum of Group 2 bank profits after tax prior to distributions in the second half of 2010 and the first half of 2011 was €35.6 billion.

You will read the details below.

Also, a very important template is available!

The common template that the Basel Committee has developed is designed to capture the capital positions of banks after the transition period for the phasing-in of deductions ends on 1 January 2018.

The Basel Committee proposes that banks should publish the completed disclosure template with the same frequency as the publication of their financial statements (typically quarterly or half yearly).

Furthermore, it is proposed that the completed disclosure template should either be included in the bank's published financial reports or, at a minimum, these reports should provide a direct link to the completed template on the bank's website.

Banks should also make available on their websites an archive of all templates relating to prior reporting periods.

Another development: Major banks try hard to understand and implement the new Basel iii framework.

The same time, banks and financial conglomerates try hard to influence politicians and change some of the strict rules.

Are these banks right or wrong? It is hard to say. All regulatory frameworks have unintended consequences...

Fitch Ratings, the credit ratings agency, has released a statement which explains that the US Federal Reserve's adoption of the Basel III capital requirements can harm the credit markets by restricting the activities of banks that make loans.

Mr Dimon, the chief executive and chairman of JPMorgan Chase (and definitely not a fan of the new Basel iii framework) has said that banks all around the world were concentrating on increasing their exposures to assets that have advantageous risk weighting, while limiting exposure to assets that have disadvantageous risk weighting.

Where is the problem? A huge one... regulators are causing the banking system to amass enormous concentrations of assets that have advantageous risk weighting.

An important concentration risk that has a simple cause: Basel ii/iii.

The current crisis in Europe is an example of wrong Basel ii principles and capital regulations. According to Basel ii, sovereign risk is not that an important risk... so many times, banks did not have to set aside any capital at all for the government bonds they held.

Basel iii is a good framework. It is way better than Basel ii. It is good, but is not great.

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Basel III News, January 2012

Dear Member,

Interesting! We have the first important Basel iii templates.

We will start with the [Post 1 January 2018 disclosure template](#)

From the **BIS Consultative document, Definition of capital disclosure requirements**, Issued for comment by 17 February 2012, December 2011

Post 1 January 2018 disclosure template

The common template that the Basel Committee has developed is designed to capture the [capital positions](#) of banks [after the transition period](#) for the phasing-in of deductions ends on 1 January 2018

The Basel Committee proposes that banks should publish the completed disclosure template [with the same frequency as the publication of their financial statements](#) (typically quarterly or half yearly).

Furthermore, it is proposed that the completed disclosure template should either be included in the bank's published financial reports or, at a minimum, these reports should provide a direct link to the completed template on the bank's website.

Banks should also make available on their [websites](#) an archive of all [templates](#) relating to prior reporting periods.

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Certain rows are in italics. These rows would be deleted after all the ineligible capital instruments have been **fully phased out** (from 1 January 2022 onwards).

Regarding the shading (below):

- Each **dark grey** row introduces a new section detailing a certain component of regulatory capital.
- The **light grey** rows with **no thick border** represent the sum cells in the relevant section.
- The **light grey** rows with a **thick border** show the main components of regulatory capital and the capital ratios.

Proposed Basel III common disclosure template to be used from 1 January 2018

Common Equity Tier 1 capital: instruments and reserves		
1	Directly issued qualifying common share (and equivalent for non-joint stock companies) capital plus related stock surplus	
2	Retained earnings	
3	Accumulated other comprehensive income (and other reserves)	
4	<i>Directly issued capital subject to phase out from CET1 (only applicable to non-joint stock companies)</i>	
5	Common share capital issued by subsidiaries and held by third parties (amount allowed in group CET1)	
6	Common Equity Tier 1 capital before regulatory adjustments	

Notes

Row number	Explanation
1	Instruments issued by the parent company of the reporting group that meet all of the CET1 entry criteria set out in Paragraph 53 of Basel III. This should be equal to the sum of common stock (and related surplus only) and other instruments for non joint stock companies, both of which must meet the common stock criteria. This should be net of treasury stock and other investments in own shares to the extent that these are already derecognised on the balance sheet under the relevant accounting standards. Other paid-in capital elements must be excluded. All minority interest must be excluded.
2	Retained earnings, prior to all regulatory adjustments. In accordance with paragraph 52 of Basel III, this row should include interim profit and loss that has met any audit, verification or review procedures that the supervisory authority has put in place. Dividends are to be removed in accordance with the applicable accounting standards, ie they should be removed from this row when they are removed from the balance sheet of the bank.
3	Accumulated other comprehensive income and other disclosed reserves, prior to all regulatory adjustments.

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4	Directly issued capital instruments subject to phase-out from CET1 in accordance with the requirements of paragraph 95 of Basel III. This is only applicable to non-joint stock companies. Banks structured as joint-stock companies must report zero in this row.
5	Common share capital issued by subsidiaries and held by third parties. Only the amount that is eligible for inclusion in group CET1 should be reported here, as determined by the application of paragraph 62 of Basel III (see Annex 3 of Basel III for example calculation).
6	Sum of rows 1 to 5.

Common Equity Tier 1 capital: regulatory adjustments	
7	Prudential valuation adjustments
8	Goodwill (net of related tax liability)
9	Intangibles other than mortgage-servicing rights (net of related tax liability)
10	Deferred tax assets that rely on future profitability excluding those arising from temporary differences (net of related tax liability)
11	Cash-flow hedge reserve
12	Shortfall of provisions to expected losses
13	Securitisation gain on sale (as set out in paragraph 562 of Basel II framework)
14	Gains and losses due to changes in own credit risk on fair valued liabilities

Notes

7	Valuation adjustments according to the requirements of paragraphs 698 to 701 of Basel II.
8	Goodwill net of related tax liability, as set out in paragraphs 67 to 68 of Basel III.
9	Intangibles other than mortgage-servicing rights (net of related tax liability), as set out in paragraph 67 to 68 of Basel III.
10	Deferred tax assets that rely on future profitability excluding those arising from temporary differences (net of related tax liability), as set out in paragraph 69 of Basel III.
11	The element of the cash-flow hedge reserve described in paragraphs 71 and 72 of Basel III.
12	Shortfall of provisions to expected losses as described in paragraph 73 of Basel III.
13	Securitisation gain on sale (as set out in paragraph 562 of Basel II framework)
14	Gains and losses due to changes in own credit risk on fair valued liabilities, as described in paragraph 75 of Basel III.



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22	Amount exceeding the 15% threshold	
23	of which: significant investments in the common stock of financials	
24	of which: mortgage servicing rights	
25	of which: deferred tax assets arising from temporary differences	
26	National specific regulatory adjustments	
27	Regulatory adjustments applied to Common Equity Tier 1 due to insufficient Additional Tier 1 and Tier 2 to cover deductions	
28	Total regulatory adjustments to Common equity Tier 1	
29	Common Equity Tier 1 capital (CET1)	

Notes

22	Total amount by which the 3 threshold items exceed the 15% threshold, excluding amounts reported in rows 18 to 20, calculated in accordance with paragraphs 87 and 88 of Basel III.
23	The amount reported in row 21 that relates to significant investments in the common stock of financials
24	The amount reported in row 21 that relates to mortgage servicing rights
25	The amount reported in row 21 that relates to deferred tax assets arising from temporary differences
26	Any national specific regulatory adjustments that national authorities required to be applied to CET1 in addition to the Basel III minimum set of adjustments. Guidance should be sought from national supervisors.
27	Regulatory adjustments applied to Common Equity Tier 1 due to insufficient Additional Tier 1 to cover deductions. If the amount reported in row 42 exceeds the amount reported in row 35 the excess is to be reported here.
28	Total regulatory adjustments to Common equity Tier 1, to be calculated as the sum of rows 6 to 21 plus rows 25 and 26.
29	Common Equity Tier 1 capital (CET1), to be calculated as row 5 minus row 27.



Additional Tier 1 capital: instruments	
30	Directly issued qualifying Additional Tier 1 instruments plus related stock surplus
31	of which: classified as equity under applicable accounting standards
32	of which: classified as liabilities under applicable accounting standards
33	<i>Directly issued capital instruments subject to phase out from Additional Tier 1</i>
34	Additional Tier 1 instruments (and CET1 instruments not included in row 4) issued by subsidiaries and held by third parties (amount allowed in group AT1)
35	<i>of which: instruments issued by subsidiaries subject to phase out</i>
36	Additional Tier 1 capital before regulatory adjustments

Notes

30	Instruments issued by the parent company that meet all of the AT1 entry criteria set out in paragraph 55 of Basel III and any related stock surplus as set out in paragraph 56 of Basel III. All instruments issued of subsidiaries of the consolidated group should be excluded from this row. This row may include Additional Tier 1 capital issued by an SPV of the parent company only if it meets the requirements set out in paragraph 65 of Basel III.
31	The amount in row 29 classified as equity under applicable accounting standards.
32	The amount in row 29 classified as liabilities under applicable accounting standards.
33	Directly issued capital instruments subject to phase out from Additional Tier 1 in accordance with the requirements of paragraph 94(g) of Basel III.
34	Additional Tier 1 instruments (and CET1 instruments not included in row 4) issued by subsidiaries and held by third parties, the amount allowed in group AT1 in accordance with paragraph 63 of Basel III (see Annex 3 of Basel III for example calculation).
35	The amount reported in row 33 that relates to instruments subject to phase out from AT1 in accordance with the requirements of paragraph 94(g) of Basel III.
36	The sum of rows 29, 32 and 33.



Additional Tier 1 capital: regulatory adjustments	
37	Investments in own Additional Tier 1 instruments
38	Reciprocal cross-holdings in Additional Tier 1 instruments
39	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued common share capital of the entity (amount above 10% threshold)
40	Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions)
41	National specific regulatory adjustments
42	Regulatory adjustments applied to Additional Tier 1 due to insufficient Tier 2 to cover deductions
43	Total regulatory adjustments to Additional Tier 1 capital

Notes

37	Investments in own Additional Tier 1 instruments, amount to be deducted from AT1 in accordance with paragraph 78 of Basel III.
38	Reciprocal cross-holdings in Additional Tier 1 instruments, amount to be deducted from AT1 in accordance with paragraph 79 of Basel III.
39	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank does not own more than 10% of the issued common share capital of the entity (net of eligible short positions), amount to be deducted from AT1 in accordance with paragraphs 80 to 83 of the Basel III.
40	Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions), amount to be deducted from AT1 in accordance with paragraphs 84 to 85 of Basel III.
41	Any national specific regulatory adjustments that national authorities require to be applied to AT1 in addition to the Basel III minimum set of adjustments. Guidance should be sought from national supervisors.
42	Regulatory adjustments applied to Additional Tier 1 due to insufficient Tier 2 to cover deductions. If the amount reported in row 56 exceeds the amount reported in row 50 the excess is to be reported here.
43	The sum of rows 36 to 41.

44	Additional Tier 1 capital (AT1)	
45	Tier 1 capital (T1 = CET1 + AT1)	
Tier 2 capital: instruments and provisions		
46	Directly issued qualifying Tier 2 instruments plus related stock surplus	
47	<i>Directly issued capital instruments subject to phase out from Tier 2</i>	
48	Tier 2 instruments (and CET1 and AT1 instruments not included in rows 4 or 31) issued by subsidiaries and held by third parties (amount allowed in group Tier 2) <i>of which: instruments issued by subsidiaries subject to phase out</i>	
50	Provisions	
51	Tier 2 capital before regulatory adjustments	

Notes

44	Additional Tier 1 capital, to be calculated as row 35 minus row 42.
45	Tier 1 capital, to be calculated as row 28 plus row 43.
46	Instruments issued by the parent company of the reporting group that meet all of the Tier 2 entry criteria set out in paragraph 58 of Basel III and any related stock surplus as set out in paragraph 59 of Basel III. All instruments issued of subsidiaries of the consolidated group should be excluded from this row. This row may include Tier 2 capital issued by an SPV of the parent company only if it meets the requirements set out in paragraph 65 of Basel III.
47	Directly issued capital instruments subject to phase out from Tier 2 in accordance with the requirements of paragraph 94 (g) of Basel III.
48	Tier 2 instruments (and CET1 and AT1 instruments not included in rows 4 or 31) issued by subsidiaries and held by third parties (amount allowed in group Tier 2), in accordance with paragraph 64 of Basel III.
49	The amount reported in row 47 that relates to instruments subject to phase out from T2 in accordance with the requirements of paragraph 94(g) of Basel III.
50	Provisions included in Tier 2, calculated in accordance with paragraphs 60 and 61 of Basel III.
51	The sum of rows 45 to 47 and row 49.

Tier 2 capital: regulatory adjustments	
52	Investments in own Tier 2 instruments
53	Reciprocal cross-holdings in Tier 2 instruments
54	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued common share capital of the entity (amount above the 10% threshold)
55	Significant investments in the capital banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions)
56	National specific regulatory adjustments
57	Total regulatory adjustments to Tier 2 capital
58	Tier 2 capital (T2)
59	Total capital (TC = T1 + T2)
60	Total risk weighted assets

Notes

52	Investments in own Tier 2 instruments, amount to be deducted from Tier 2 in accordance with paragraph 78 of Basel III.
53	Reciprocal cross-holdings in Tier 2 instruments, amount to be deducted from Tier 2 in accordance with paragraph 79 of Basel III.
54	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank does not own more than 10% of the issued common share capital of the entity (net of eligible short positions), amount to be deducted from Tier 2 in accordance with paragraphs 80 to 83 of the Basel III.
55	Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions), amount to be deducted from Tier 2 in accordance with paragraphs 84 to 85 of Basel III.
56	Any national specific regulatory adjustments that national authorities require to be applied to Tier 2 in addition to the Basel III minimum set of adjustments. Guidance should be sought from national supervisors.
57	The sum of rows 51 to 55.
58	Tier 2 capital, to be calculated as row 50 minus row 56.
59	Total capital, to be calculated as row 44 plus row 57.
60	Total risk weighted assets of the reporting group.



Capital ratios and buffers	
61	Common Equity Tier 1 (as a percentage of risk weighted assets)
62	Tier 1 (as a percentage of risk weighted assets)
63	Total capital (as a percentage of risk weighted assets)
64	Institution specific buffer requirement (minimum CET1 requirement plus capital conservation and countercyclical buffer requirements, expressed as a percentage of risk weighted assets)
65	Common Equity Tier 1 available to meet buffers (as a percentage of risk weighted assets)

Notes

61	Common Equity Tier 1 (as a percentage of risk weighted assets), to be calculated as row 28 divided by row 59 (expressed as a percentage).
62	Tier 1 ratio (as a percentage of risk weighted assets) , to be calculated as row 44 divided by row 59 (expressed as a percentage).
63	Total capital ratio (as a percentage of risk weighted assets) , to be calculated as row 58 divided by row 59 (expressed as a percentage).
64	Institution specific buffer requirement (minimum CET1 requirement plus capital conservation and countercyclical buffer requirements, expressed as a percentage of risk weighted assets). To be calculated as 4.5% plus 2.5% plus the bank specific countercyclical buffer requirement calculated in accordance with paragraphs 142 to 145 of Basel III. This row will show the CET1 ratio below which the bank will become subject to constraints on distributions.
65	Common Equity Tier 1 available to meet buffers (as a percentage of risk weighted assets). To be calculated as the CET1 ratio of the bank, less any common equity used to meet the bank's Tier 1 and Total capital requirements.



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National minima (if different from Basel 3)	
66	National Common Equity Tier 1 minimum ratio (if different from Basel 3 minimum)
67	National Tier 1 minimum ratio (if different from Basel 3 minimum)
68	National total capital minimum ratio (if different from Basel 3 minimum)
Amounts below the thresholds for deduction (before risk weighting)	
69	Non-significant investments in the capital of other financials
70	Significant investments in the common stock of financials
71	Mortgage servicing rights (net of related tax liability)
72	Deferred tax assets arising from temporary differences (net of related tax liability)

Notes

66	National Common Equity Tier 1 minimum ratio (if different from Basel 3 minimum). Guidance should be sought from national supervisors.
67	National Tier 1 minimum ratio (if different from Basel 3 minimum). Guidance should be sought from national supervisors.
68	National total capital minimum ratio (if different from Basel 3 minimum). Guidance should be sought from national supervisors.
69	Non-significant investments in the capital of other financials, the total amount of such holdings that are not reported in row 17, row 38 and row 53.
70	Significant investments in the common stock of financials, the total amount of such holdings that are not reported in row 18 and row 22.
71	Mortgage servicing rights, the total amount of such holdings that are not reported in row 19 and row 23.
72	Deferred tax assets arising from temporary differences, the total amount of such holdings that are not reported in row 20 and row 24.



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Applicable caps on the inclusion of provisions in Tier 2		
73	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to standardised approach (prior to application of cap)	
74	Cap on inclusion of provisions in Tier 2 under standardised approach	
75	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to internal ratings-based approach (prior to application of cap)	
76	Cap for inclusion of provisions in Tier 2 under internal ratings-based approach	
Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2018 and 1 Jan 2022)		
77	Current cap on CET1 instruments subject to phase out arrangements	
78	Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)	
79	Current cap on AT1 instruments subject to phase out arrangements	
80	Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)	
81	Current cap on T2 instruments subject to phase out arrangements	
82	Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)	

Notes

73	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to standardised approach, calculated in accordance paragraph 60 of Basel III, prior to the application of the cap.
74	Cap on inclusion of provisions in Tier 2 under standardised approach, calculated in accordance paragraph 60 of Basel III.
75	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to internal ratings-based approach, calculated in accordance paragraph 61 of Basel III, prior to the application of the cap.
76	Cap for inclusion of provisions in Tier 2 under internal ratings-based approach, calculated in accordance paragraph 61 of Basel III.
77	Current cap on CET1 instruments subject to phase out arrangements, see paragraph 95 of Basel III.
78	Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities), see paragraph 95 of Basel III.
79	Current cap on AT1 instruments subject to phase out arrangements, see paragraph 94(g) of Basel III.
80	Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities), see paragraph 94(g) of Basel III.
81	Current cap on T2 instruments subject to phase out arrangements, see paragraph 94(g) of Basel III.
82	Amount excluded from T2 due to cap (excess over cap after redemptions and maturities), see paragraph 94(g) of Basel III.

Disclosure template during the transition phase

The proposed template for use during the **transition phase** is the same as the steady state disclosure template set out in Section 1 except for the following additions (all of which are highlighted in the template below using cells with dotted borders and capitalised text):

A new column has been added for banks to **report the amount of each regulatory adjustment** that is subject to the existing national treatment during the transition phase (labelled as the “**pre-Basel III treatment**”).

Basel III common disclosure template to be used during the transition of regulatory adjustments (ie from 1 January 2013 to 1 January 2018)		AMOUNTS SUBJECT TO PRE-BASEL III TREATMENT
Common Equity Tier 1 capital: instruments and reserves		
1	Directly issued qualifying common share capital (and equivalent for non-joint stock companies) plus related stock surplus	
2	Retained earnings	
3	Accumulated other comprehensive income (and other reserves)	
4	<i>Directly issued capital subject to phase out from CET1 (only applicable to non-joint stock companies)</i>	
	<i>Public sector capital injections grandfathered until 1 January 2018</i>	
5	Common share capital issued by subsidiaries and held by third parties (amount allowed in group CET1)	
6	Common Equity Tier 1 capital before regulatory adjustments	

Common Equity Tier 1 capital: regulatory adjustments		
7	Prudential valuation adjustments	
8	Goodwill (net of related tax liability)	
9	Intangibles other than mortgage-servicing rights (net of related tax liability)	
10	Deferred tax assets that rely on future profitability excluding those arising from temporary differences (net of related tax liability)	
11	Cash-flow hedge reserve	
12	Shortfall of provisions to expected losses	
13	Securitisation gain on sale (as set out in paragraph 562 of Basel II framework)	
14	Gains and losses due to changes in own credit risk on fair valued liabilities	
15	Defined-benefit pension fund net assets	
16	Investments in own shares (if not already netted off paid-in capital on reported balance sheet)	
17	Reciprocal cross-holdings in common equity	
18	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued share capital (amount above 10% threshold)	
19	Significant investments in the common stock of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions (amount above 10% threshold)	
20	Mortgage servicing rights (amount above 10% threshold)	

Example - Row 8: In 2014 banks will be required to make 20% of the regulatory adjustments in accordance with Basel III.

Consider a bank with “Goodwill, net of related tax liability” of \$100 mn and assume that the bank is in a jurisdiction that does **not currently** require this to be deducted from common equity.

The bank would report **\$20 mn in the first of the two empty cells in row 8** and report **\$80 mn in the second of the two cells.**

The sum of the two cells will therefore equal the total Basel III regulatory adjustment.

While the new column shows the amount of each regulatory adjustment that is subject to the existing national treatment, it is necessary to show how this amount is included under existing national treatment in the calculation of regulatory capital.

Therefore, new rows have been added in each of the three sections on regulatory adjustments to allow each jurisdiction to set out their existing national treatment.

21	Deferred tax assets arising from temporary differences (amount above 10% threshold, net of related tax liability)		
22	Amount exceeding the 15% threshold		
23	of which: significant investments in the common stock of financials		
24	of which: mortgage servicing rights		
25	of which: deferred tax assets arising from temporary differences		
26	National specific regulatory adjustments REGULATORY ADJUSTMENTS APPLIED TO COMMON EQUITY TIER 1 IN RESPECT OF AMOUNTS SUBJECT TO PRE-BASEL III TREATMENT OF WHICH: [INSERT NAME OF ADJUSTMENT] OF WHICH: ...		
27	Regulatory adjustments applied to Common Equity Tier 1 due to insufficient Additional Tier 1 and Tier 2 to cover deductions		
28	Total regulatory adjustments to Common equity Tier 1		
29	Common Equity Tier 1 capital (CET1)		

Example - Between rows 26 and 27:

Consider a jurisdiction that currently filters out unrealised gains and losses on holdings of AFS debt securities and consider a bank in that jurisdiction that has an **unrealised loss of \$50 mn**.

The transitional arrangements require this bank to **recognise 20% of this loss (ie \$10 mn) in 2014**.

This means that **80% of this loss (ie \$40 mn) is not recognised**.

The jurisdiction would therefore include a row **between rows 26 and 27** that allows banks to add back this unrealised loss.

The bank would then report \$40 mn in this row as an addition to Common Equity Tier 1.

Additional Tier 1 capital: instruments		
30	Directly issued qualifying Additional Tier 1 instruments plus related stock surplus	
31	of which: classified as equity under applicable accounting standards	
32	of which: classified as liabilities under applicable accounting standards	
33	<i>Directly issued capital instruments subject to phase out from Additional Tier 1</i>	
34	Additional Tier 1 instruments (and CET1 instruments not included in row 4) issued by subsidiaries and held by third parties (amount allowed in group AT1)	
35	<i>of which: instruments issued by subsidiaries subject to phase out</i>	
36	Additional Tier 1 capital before regulatory adjustments	

Additional Tier 1 capital: regulatory adjustments		
37	Investments in own Additional Tier 1 instruments	
38	Reciprocal cross-holdings in Additional Tier 1 instruments	
39	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued common share capital of the entity (amount above 10% threshold)	
40	Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions)	
41	National specific regulatory adjustments	
	REGULATORY ADJUSTMENTS APPLIED TO ADDITIONAL TIER 1 IN RESPECT OF AMOUNTS SUBJECT TO PRE-BASEL III TREATMENT	
	OF WHICH: [INSERT NAME OF ADJUSTMENT]	
	OF WHICH: ...	
42	Regulatory adjustments applied to Additional Tier 1 due to insufficient Tier 2 to cover deductions	
43	Total regulatory adjustments to Additional Tier 1 capital	
44	Additional Tier 1 capital (AT1)	
45	Tier 1 capital (T1 = CET1 + AT1)	

Example - Between rows 41 and 42:

Assume that the bank described in the bullet point above is in a jurisdiction that **currently requires goodwill to be deducted from Tier 1**.

This jurisdiction would **insert a new row in between rows 41 and 42**, to indicate that during the transition phase some goodwill will continue to be deducted from Tier 1 (in effect Additional Tier 1).

The \$80 mn that the bank had reported in the last cell of row 8, would then need to be reported in this new row inserted between rows 41 and 42.

Tier 2 capital: instruments and provisions		
46	Directly issued qualifying Tier 2 instruments plus related stock surplus	
47	<i>Directly issued capital instruments subject to phase out from Tier 2</i>	
48	Tier 2 instruments (and CET1 and AT1 instruments not included in rows 4 or 31) issued by subsidiaries and held by third parties (amount allowed in group Tier 2)	
49	<i>of which: instruments issued by subsidiaries subject to phase out</i>	
50	Provisions	
51	Tier 2 capital before regulatory adjustments	

Tier 2 capital: regulatory adjustments		
52	Investments in own Tier 2 instruments	
53	Reciprocal cross-holdings in Tier 2 instruments	
54	Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, net of eligible short positions, where the bank does not own more than 10% of the issued common share capital of the entity (amount above the 10% threshold)	
55	Significant investments in the capital banking, financial and insurance entities that are outside the scope of regulatory consolidation (net of eligible short positions)	
56	National specific regulatory adjustments	
	REGULATORY ADJUSTMENTS APPLIED TO TIER 2 IN RESPECT OF AMOUNTS SUBJECT TO PRE-BASEL III TREATMENT	
	OF WHICH: [INSERT NAME OF ADJUSTMENT]	
	OF WHICH: ...	
57	Total regulatory adjustments to Tier 2 capital	
58	Tier 2 capital (T2)	
59	Total capital (TC = T1 + T2)	
	RISK WEIGHTED ASSETS IN RESPECT OF AMOUNTS SUBJECT TO PRE-BASEL III TREATMENT	
	OF WHICH: [INSERT NAME OF ADJUSTMENT]	
	OF WHICH: ...	
60	Total risk weighted assets	

Example – Row 60:

To take account of the fact that the existing national treatment of a Basel III regulatory adjustment may be to apply a risk weighting, jurisdictions would also be able to add new rows immediately prior to the row on risk weighted assets (row 60).

These rows would need to be defined by each jurisdiction to list the Basel III regulatory adjustments that are currently risk weighted.

Example: Consider a jurisdiction that currently risk weights defined benefit pension fund net assets at 200% and **in 2014 a bank has \$50 mn of these assets.**

The transitional arrangements require this bank to **deduct 20% of the assets in 2014.**

This means that the bank **will report \$10 mn in the first empty cell in row 15 and \$40 mn in the second empty cell** (the total of the two cells therefore equals the total Basel III regulatory adjustment).

The jurisdiction would disclose in one of the inserted rows between row 59 and 60 that such assets are risk weighted at 200% during the transitional phase.

The bank would then report a figure of \$80 mn (\$40 mn * 200%) in that row.

Capital ratios		
61	Common Equity Tier 1 (as a percentage of risk weighted assets)	
62	Tier 1 (as a percentage of risk weighted assets)	
63	Total capital (as a percentage of risk weighted assets)	
64	Institution specific buffer requirement (minimum CET1 requirement plus capital conservation and countercyclical buffer requirements, expressed as a percentage of risk weighted assets)	
65	Common Equity Tier 1 available to meet buffers (as a percentage of risk weighted assets)	

National minima (if different from Basel 3)		
66	National Common Equity Tier 1 minimum ratio (if different from Basel 3 minimum)	
67	National Tier 1 minimum ratio (if different from Basel 3 minimum)	
68	National total capital minimum ratio (if different from Basel 3 minimum)	
Amounts below the thresholds for deduction (before risk weighting)		
69	Non-significant investments in the capital of other financials	
70	Significant investments in the common stock of financials	
71	Mortgage servicing rights (net of related tax liability)	
72	Deferred tax assets arising from temporary differences (net of related tax liability)	
Applicable caps on the inclusion of provisions in Tier 2		
73	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to standardised approach (prior to application of cap)	
74	Cap on inclusion of provisions in Tier 2 under standardised approach	
75	Provisions eligible for inclusion in Tier 2 in respect of exposures subject to internal ratings-based approach (prior to application of cap)	
76	Cap for inclusion of provisions in Tier 2 under internal ratings-based approach	

Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2018 and 1 Jan 2022)		
77	Current cap on CET1 instruments subject to phase out arrangements	
78	Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)	
79	Current cap on AT1 instruments subject to phase out arrangements	
80	Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)	
81	Current cap on T2 instruments subject to phase out arrangements	
82	Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)	

Financial stability and risk disclosure

Keynote address by Mr Jaime Caruana, General Manager of the BIS, to
the FSB Roundtable on risk disclosure, [Basel, 9 December 2011](#).

Abstract

High-quality risk disclosure is good for markets, because it helps investors make more informed decisions.

It is **good for prudential supervisors**, because it makes banks more accountable to both supervisors and investors.

And it is **good for financial stability**, because it reduces the chance that unexpected events will disrupt the system.

To be effective in promoting market discipline, disclosure must be complemented by strong incentives for counterparties to engage in monitoring.

The public sector's role in promoting transparency arises from a number of market failures, including the externalities to be gained from common standards, the "free rider" problems that may lead to **too little investment in producing and gathering financial information**, and the tendency of markets to **overreact** to bad news when the information environment is clouded.

Guided by these considerations, the **Financial Stability Board** and the **Basel Committee on Banking Supervision** have long supported improvements in transparency, through their work on accounting, disclosure templates and aggregate market data.

At the same time, industry and investor representatives need to play a key role in developing disclosure standards.

Accounting standards need to converge, standards for the discussion and analysis that accompany financial statements need to be established, and external auditors need to insist on higher-quality risk disclosures.

Full speech

Good morning, and welcome to Basel. We are meeting at a time of great turbulence and uncertainty in the global economy and financial system.

But although all of us are focused on immediate challenges and risks, it is important not to lose sight of the need to carry forward our longer-term agenda towards building a better, stronger financial system.

Your discussions today are an essential part of making progress on this agenda.

If we can achieve a significant improvement in the quality, comparability and timeliness of risk disclosures by financial firms, this will without a doubt help break the vicious cycles of contagion, asset sales and pullback from risk-taking that have paralysed markets repeatedly over the last few years.

The three pillars of Basel II continue to guide our efforts to strengthen financial regulation in the Basel III era and beyond.

We've now accomplished a great deal on Pillar 1 - minimum capital requirements.

The task now is to follow through on Pillar 2 by strengthening supervisory review, with a focus on firm-wide risk management and risk governance, and on Pillar 3 disclosures, by improving market discipline.

And while Pillar 3 is a good step in the right direction, achieving our overall objective of stronger market discipline will require efforts that go beyond strictly regulatory approaches.

How do we promote market discipline?

First, we need to make sure that the market has the information it needs. And a key element of market information is sound, consistently high-quality risk disclosures.

That will be the subject of my remarks, and of course the theme of your discussions today.

But I should also point out that market discipline only works when investors have the right incentives to use the information, and banks have the right incentives to take account of the signals sent by the market. For these incentives to be right, the perception of a public safety net for banks that are "too big to fail" needs to be eliminated.

This points to the relevance of the work by the FSB and Basel Committee to reduce moral hazard by increasing loss absorbency, strengthening resolution procedures and enhancing supervisory intensity for systemically important banks.

If we successfully follow through on this work, then investors will have stronger incentives to develop a comprehensive picture of the risks and exposures facing financial institutions, and the banks should face more pressure to be as accurate and transparent as possible about these exposures.

The FSB and the Basel Committee have long supported sound accounting and robust disclosure standards and practices.

Examples include the risk disclosure template for structured credit products set out in the Financial Stability Forum's report to the G7 in April 2008, the Basel Committee's work on Pillar 3 disclosures, and the more recent work to encourage sound expected-loss provisioning rules and related disclosures.

Sound standards and practices enhance the quality of information available to investors, depositors and other market participants, as well as to prudential authorities and regulators - including about risk exposures, risk management practices and policies, governance, and capital measures and ratios.

This can lead to greater transparency that can support market confidence, improve market discipline and facilitate sound risk management practices by financial firms and other companies, and has the potential to lead to more consistent practices over time.

Together with effective supervision, these can help to foster safe and sound banking systems and more stable financial markets.

We should recognise the limitations to what improved information about risks can achieve.

The economy and the financial system are always changing and evolving, and our understanding of key relationships struggles to keep up.

Risks often appear precisely in the areas to which market participants and public authorities have paid the least attention, and about which they have demanded the least accurate information.

Given these limits to our understanding, we need to be prudent.

This means **protecting the system against the unknown and unexpected**, for example by strengthening capital and liquidity buffers at institutions and initial margin in traded markets.

Nevertheless, strengthened, transparent disclosure is good for markets, because it helps investors make more informed decisions.

It is good for prudential supervision, because it helps to make banks more accountable, both to supervisors and investors.

And it is good for the stability of the system as a whole, because it reduces the chance that unexpected events will cause major system-wide disruptions.

We should not forget that the official sector has a direct interest in promoting financial stability through increased transparency; the experience of the past four years has reminded us of the many costs that a poorly functioning financial system can impose on taxpayers and the real economy.

One might think that market participants would naturally provide comprehensive, relevant disclosure in a timely manner, since it's in the interest of investors, counterparties and institutions. **But as we have seen, this is often not the case.**

For example, during the ongoing turbulence related to **European sovereign debt**, investors and market analysts have struggled to develop a comprehensive and reliable assessment of the exposures of financial institutions to troubled sovereigns through bond holdings and derivatives positions.

Some of the disruptions to bank funding markets have reflected scepticism as to **whether enough is known about these exposures**, as well as the chain of exposures related to them - banks' exposures to other banks, and so on.

We at the BIS regularly publish information on the aggregate exposures of national financial systems, but of course this says nothing about the network of exposures of individual institutions.

Lacking adequate information to inform their risk assessments, providers of funds have naturally pulled back from European financial firms of all sorts - in the process undermining the stability of the system and putting still greater pressure on banks and sovereigns.

This suggests **the public sector has a key role in promoting market transparency**. Whenever one suggests the public sector should do something, it's good practice to identify the specific market failures that impel public action.

With respect to risk disclosure, I would emphasise the following ones. **First**, common standards have externalities.

Just as everyone benefits from common weights and measures in the physical world, or from common standards for electronic media like DVD encoding, there's a social benefit from financial statements following a single standard, including key concepts, common definitions and principles, and, to the extent possible, common formats.

In some cases, collaborative efforts by the industry can generate the needed standards; in others, especially where the subject matter is complex and there is a wide range of interested parties, some of whom may not support full, timely transparency, the public sector must play a role.

Second, producing and gathering financial information are subject to "free rider" problems.

It's **costly to produce, interpret and analyse** information from disclosures. But if one investor or counterparty does so, prices adjust and others benefit from it. So while investors can and do make money from carefully studying publicly available information, **there's still an incentive to "free ride" - to wait for someone else to gather relevant information, then to share in the benefit by trading on it.**

And preparers may face similar incentives to wait for others before providing useful information about their risk exposures and risk management practices.

As a result, everyone in the market may just watch each other, instead of making the investment in producing and obtaining accurate information. There's no way to completely eliminate such free-riding from markets, but establishing common standards goes part way, by reducing the costs - in time, effort and resources - needed to produce and acquire market-relevant information.

We want to see a richer array of information made available that is less costly to collect, more widely available to market participants, more usable and more comparable.

This should help take us towards markets where prices are moved primarily by new information, rather than by herd behaviour, leverage or sudden shifts in risk appetites.

Third, if the information environment is murky, then markets overreact to bad news.

We saw this in the 2007-09 crisis - whenever problems were discovered in one asset class, or one institution, investors started to scrutinise similarly placed assets or institutions, and downgraded their valuations of them.

This sometimes led to a self-fulfilling process that made things still worse.

The same has happened in sovereign debt crises, including the current challenges in Europe - when one country gets into trouble, investors immediately look around to see who's next.

This creates a kind of collective action problem - it makes sense for each player individually to pull back, but when many players do this the impact is devastating for the market as a whole.

Greater transparency is one way to help break this cycle, by making it possible for investors to see more precisely where, and whether, their concerns are justified.

Saying there is a public sector role in promoting transparency, for the reasons I've just laid out, is not the same as saying that strengthening transparency is the public sector's job alone.

Indeed, industry and investor efforts need to be at the centre of developing standards, since this will ensure that new requirements have the proper technical grounding and a strong buy-in by market participants.

The public sector can contribute by catalysing private sector efforts and by directing those efforts in fruitful directions.

At the same time, however, if the private sector does not step in to address these issues adequately, supervisory and regulatory authorities may need to undertake further reforms to improve disclosure standards and practices.

Alongside this work at the firm level, the international community has also been working to improve transparency by **strengthening the collection, aggregation and dissemination of financial sector data**.

The BIS, together with the Committee on the Global Financial System, has long performed this role with respect to cross-border banking and OTC derivatives market activity.

Looking forward, the FSB has made substantial progress in developing a data framework that facilitates monitoring of key interlinkages among the major global banks in a consistent manner.

While this project is still very much work in progress, it is notable that **national authorities and the FSB are considering storing and pooling the**

data collected nationally on a harmonised basis in a central hub, proposed to be hosted by the BIS.

The FSB and national supervisors are also working to make sure that the shift of derivatives market activity to central trading and clearing platforms leads to a greater availability of useful market-level data on activity in these instruments.

Also, following the FSB recommendation earlier this year, the FSB's Standing Committee on the Assessment of Vulnerabilities, which I chair, is also assessing whether newly identified risks could benefit from improved risk disclosure practices.

But even as we work to improve the assessment of risks and the availability and quality of aggregated industry and market data through efforts by the official sector, strengthened disclosures by individual institutions still offer the most promising benefits in terms of strengthening financial stability.

Going forward, I would emphasise a number of key challenges: Following through on convergence of IASB and FASB accounting standards, including their risk disclosure requirements.

Progress in converging the two main international accounting standards frameworks will help ensure that users can make meaningful comparisons across institutions and entities operating in multiple jurisdictions.

Developing standards for the discussion and analysis that firms provide to complement the figures in the financial statements.

Common standards can be useful not only for financial data, but also for the interpretations given to them.

Disclosures often seek to provide information "through the eyes of management" that reflects how organisations measure and manage their risks.

While this approach can be helpful in understanding business models and risk management practices, it can lead to disclosure of information that is not comparable across firms, and therefore difficult for investors and regulatory bodies to assess.

Strengthening the contribution of external audits to the quality of risk disclosures.

What is the degree of assurance that auditors provide about public disclosures, including those in financial statements, managements' discussion and analysis sections of financial reports, and risk information on their clients' websites?

To what extent, and in what ways, do they review or audit the accuracy and reliability of the financial reports that they examine, and how do they report on their assessments and findings to the public?

These are deep questions about how to best evolve the audit function as financial systems and investor needs evolve, and they won't be resolved overnight.

They need to be addressed, however, if we are to clarify and to strengthen the role of auditors in promoting transparency at firms.

The discussions at the FSB Roundtable today will mark important steps towards progress in many of these areas.

I am confident the FSB and its standard-setting bodies are up to the task, and I encourage key stakeholders in the private sector to join together to encourage and to support better, more transparent risk disclosure practices.



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Core principles for effective banking supervision BIS Consultative document, December 2011

The Basel Committee on Banking Supervision has issued for consultation its [revised Core principles for effective banking supervision](#).

The consultative paper [updates the Committee's 2006 Core principles](#) for effective banking supervision and the associated Core principles methodology (assessment methodology).

Both the existing Core Principles and the associated assessment methodology have served their purpose well in terms of helping countries to assess their supervisory systems and identify areas for improvement.

While conscious efforts were made to maintain continuity and comparability as far as possible, the Committee has merged the Core Principles and the assessment methodology into a single comprehensive document.

[The revised set of twenty-nine Core Principles](#) have also been reorganised to foster their implementation through a more logical structure, highlighting the difference between what supervisors do themselves and what they expect banks to do:

[Principles 1 to 13](#) address supervisory powers, responsibilities and functions, focusing on effective risk-based supervision, and the need for early intervention and timely supervisory actions.

[Principles 14 to 29](#) cover supervisory expectations of banks, emphasising the importance of good corporate governance and risk management, as well as compliance with supervisory standards.

[Important enhancements](#) have been introduced into the individual Core Principles, particularly in those areas that are necessary to strengthen supervisory practices and risk management.

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Various **additional criteria have been upgraded to essential** criteria as a result, while new assessment criteria were warranted in other instances.

Close attention was given to addressing many of the **significant risk management weaknesses** and other vulnerabilities highlighted in the last crisis.

In addition, the review has taken account of several key trends and developments that emerged during the last few years of **market turmoil**: the need for greater intensity and resources to deal effectively with systemically important banks; the importance of applying a system-wide, macro perspective to the microprudential supervision of banks to assist in identifying, analysing and taking pre-emptive action to address systemic risk; and the increasing focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of a bank failure.

The Committee has sought to give appropriate emphasis to these emerging issues by embedding them into the Core Principles, as appropriate, and including specific references under each relevant Principle.

In addition, **sound corporate governance underpins effective risk management and public confidence in individual banks and the banking system.**

Given fundamental deficiencies in banks' corporate governance that were exposed in the last crisis, a new Core Principle on corporate governance has been added in this review by bringing together existing corporate governance criteria in the assessment methodology and giving greater emphasis to sound corporate governance practices.

Similarly, the Committee reiterated the key role of robust market discipline in fostering a safe and sound banking system by expanding an existing Core Principle into two new ones dedicated respectively to

greater public disclosure and transparency, and enhanced financial reporting and external audit.

As a result of this review, the number of Core Principles has increased from 25 to 29.

There are a total of 36 new assessment criteria, comprising 31 new essential criteria and 5 new additional criteria.

In addition, 33 additional criteria from the existing assessment methodology have been upgraded to essential criteria that represent minimum baseline requirements for all countries.

The Basel Committee welcomes comments on the revised Core Principles. Comments should be submitted by Tuesday 20 March 2012 by email to: baselcommittee@bis.org.

Alternatively, comments may be sent by post to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland.

All comments may be published on the Bank for International Settlements's website unless a commenter specifically requests confidential treatment.

The 29 Core Principles are:

Supervisory powers, responsibilities and functions

Principle 1 – Responsibilities, objectives and powers: An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups.

A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorise banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.

Principle 2 – Independence, accountability, resourcing and legal protection for supervisors: The supervisor possesses operational independence, transparent processes, sound governance and adequate resources, and is accountable for the discharge of its duties.

The legal framework for banking supervision includes legal protection for the supervisor.

Principle 3 – Cooperation and collaboration: Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors.

These arrangements reflect the need to protect confidential information.

Principle 4 – Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word “bank” in names is controlled.

Principle 5 – Licensing criteria: The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria.

At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base).

Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained.

Principle 6 – Transfer of significant ownership: The supervisor has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 7 – Major acquisitions: The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 8 – Supervisory approach: An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of Core Principles for Effective Banking Supervision the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.

Principle 9 – Supervisory techniques and tools: The supervisor uses an appropriate range of techniques and tools to implement the supervisory

approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.

Principle 10 – Supervisory reporting: The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports, through either on-site examinations or use of external experts.

Principle 11 – Corrective and sanctioning powers of supervisors: The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system.

The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions.

This includes the ability to revoke the banking licence or to recommend its revocation.

Principle 12 – Consolidated supervision: An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.

Principle 13 – Home-host relationships: Home and host supervisors of crossborder banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations.

Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.

Prudential regulations and requirements

Principle 14 – Corporate governance: The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation.

These policies and processes are commensurate with the risk profile and systemic importance of the bank.

Principle 15 – Risk management process: The supervisor determines that banks have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions.

This extends to development and review of robust and credible recovery plans, which take into account the specific circumstances of the bank.

The risk management process is commensurate with the risk profile and systemic importance of the bank.

Principle 16 – Capital adequacy: The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates.

The supervisor defines the components of capital, bearing in mind their ability to absorb losses.

Principle 17 – Credit risk: The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions.

This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis.

The full credit lifecycle should be covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.

Principle 18 – Problem assets, provisions and reserves: The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.

Principle 19 – Concentration risk and large exposure limits: The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis.

Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 20 – Transactions with related parties: In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.

Principle 21 – Country and transfer risks: The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.

Principle 22 – Market risks: The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity.

This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.

Principle 23 – Interest rate risk in the banking book: The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis.

These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.

Principle 24 – Liquidity risk: The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank.

The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements.

The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons.

Principle 25 – Operational risk: The supervisor determines that banks have an adequate operational risk management framework that takes into

account their risk appetite, risk profile and market and macroeconomic conditions.

This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis.

Principle 26 – Internal control and audit: The supervisor determines that banks have adequate internal controls to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile.

These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 27: Financial reporting and external audit: The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion.

The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.

Principle 28 – Disclosure and transparency: The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures,

risk management strategies and corporate governance policies and processes.

Principle 29 – Abuse of financial services: The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

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Basel III News, February 2012



Dear Member,

Most of the major banks **try hard** to *understand and implement* the new Basel iii framework. **The same time**, banks and financial conglomerates try hard to influence politicians and **change** some of the strict rules.

Are these banks right or wrong? It is hard to say. All regulatory frameworks have unintended consequences...

Fitch Ratings, the credit ratings agency, has released a statement which explains that the US Federal Reserve's adoption of the Basel III capital requirements **can harm the credit markets** by restricting the activities of banks that make loans.

Mr Dimon, the chief executive and chairman of JPMorgan Chase (and definitely **not a fan** of the new Basel iii framework) has said that banks all around the world were concentrating on **increasing their exposures to assets that have advantageous risk weighting**, while limiting exposure to assets that have disadvantageous risk weighting. Where is the problem? A huge one... regulators are causing the banking system to **amass enormous concentrations** of **assets that have advantageous risk weighting**

An important concentration risk that has a simple cause: Basel ii/iii.

The current crisis in Europe is an example of wrong Basel 2 principles and capital regulations. According to Basel 2, sovereign risk is not that an important risk... so many times, **banks did not have to set aside any capital at all for the government bonds they held**.

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Banks in Europe also try to avoid some of the most challenging Basel iii implementation rules. France and Germany are also pushing for a delay. But the last week of January, Michel Barnier, the European Commissioner in charge of financial regulation, said that he would stick strictly to a timetable already agreed for implementing stricter Basel III bank capital requirements.

Basel iii is a good framework. Good but not great.

Basel III liquidity standard and strategy for assessing implementation of standards

**Endorsed by Group of Governors and Heads of Supervision
8 January 2012**

The Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, met on **8 January 2012**.

The main items of discussion were the Basel Committee's proposals on the **Liquidity Coverage Ratio (LCR)** and its strategy for assessing implementation of the Basel regulatory framework more broadly.

The GHOS endorsed the Committee's comprehensive approach to monitoring and reviewing implementation of the Basel regulatory framework.

GHOS Chairman and Governor of the Bank of England Mervyn King noted that "**the focus on implementation represents a significant new direction for the Basel Committee.**

The level of scrutiny and transparency applied to the manner in which countries implement the rules the Committee has developed and agreed will help ensure full, timely and consistent implementation of the international minimum requirements".

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The Committee will monitor, on an ongoing basis, the status of members' adoption of the globally-agreed Basel rules.

It will review the compliance of members' domestic rules or regulations with the international minimum standards in order to identify differences that could raise prudential or level playing field concerns.

The Committee will also review the measurement of risk-weighted assets to ensure consistency in practice across banks and jurisdictions.

Against this background, each Basel Committee member country has committed to undergo a detailed peer review of its implementation of all components of the Basel regulatory framework.

In addition to Basel III, the Committee will assess implementation of Basel II and Basel II.5 (ie the July 2009 enhancements on market risk and resecuritisations).

The GHOS also endorsed the Committee's agreement to publish the results of the assessments.

The Basel Committee will discuss and define the protocol governing the publication of the results.

The GHOS also agreed that the initial peer reviews should assess implementation in the **European Union, Japan and the United States**.

These reviews will commence in the first quarter of 2012.

Mr Stefan Ingves, Chairman of the Basel Committee and Governor of the Swedish Riksbank, noted that "the Committee's rigorous peer review process is a clear signal that effective implementation of the Basel standards is a top priority.

Raising the resilience of the global banking system, restoring and maintaining market confidence in regulatory ratios, and providing a level playing field will only be achieved through full, timely and consistent implementation".

With respect to the Liquidity Coverage Ratio, GHOS members reiterated the central principle that a bank is expected to have a stable funding structure and a stock of high-quality liquid assets that should be available to meet its liquidity needs in times of stress.

Once the LCR has been implemented, its 100% threshold will be a minimum requirement in normal times.

But during a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement.

The Basel Committee has been asked to provide further elaboration on this principle by clarifying the LCR rules text to state explicitly that liquid assets accumulated in normal times are intended to be used in times of stress.

It will also provide additional guidance on the circumstances that would justify the use of the pool.

The Basel Committee will also examine how central banks interact with banks during periods of stress, with a view to ensuring that the workings of the LCR do not hinder or conflict with central bank policies.

The GHOS also reaffirmed its commitment to introduce the LCR as a minimum standard in 2015.

Members fully supported the Committee's proposed focus, course of action and timeline to finalise key aspects of the LCR by addressing

specific concerns regarding the pool of high-quality liquid assets as well as some adjustments to the calibration of net cash outflows.

The modifications currently under investigation apply only to a few key aspects and will not materially change the framework's underlying approach.

The GHOS directed the Committee to finalise and subsequently publish its recommendations in these three areas by the end of 2012.

Governor King said, "The aim of the Liquidity Coverage Ratio is to ensure that banks, in normal times, have a sound funding structure and hold sufficient liquid assets such that central banks are asked to perform only as lenders of last resort and not as lenders of first resort.

While the Liquidity Coverage Ratio may represent a significant challenge for some banks, the benefits of a strong liquidity regime outweigh the associated implementation costs."

SIFIs: is there a need for a specific regulation on systematically important financial institutions?

Remarks of Stefan Ingves, Chairman of the Basel Committee on Banking Supervision and Governor of Sveriges Riksbank, prepared for roundtable discussion at the European Ideas Network Seminar on Long-term growth: organizing the stability and attractiveness of European Financial Markets, Berlin (Deutsche Bank), 19-20 January 2012.

Good morning and thank you for inviting me to share some thoughts with you on the question of whether a specific treatment is warranted for **systemically important financial institutions, or "SIFIs"**.

In the few minutes I have to introduce this topic, I will set out the basis for the Basel Committee's response to this question, which is an unqualified "yes".

I will say a few words about the Committee's view and the actions we have taken on SIFIs that have been strongly influenced by recent experience.

I will then review how our response will **help to address the too-big-to-fail issue**.

Our work on this issue is ongoing and I will then say a few words about the Committee's current efforts.

I will conclude by sharing with you my thoughts on the direction of future work related to global systemically important banks - or G-SIBs.

Experiences from the banking system - focus on G-SIBs

The Basel Committee's motivation for policy measures for G-SIBs that supplement the Basel III framework is based on the "**negative**

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externalities" that these firms create and which current regulatory policies do not fully address.

These adverse side effects can become amplified by the global reach of these firms - a problem in any one G-SIB could trigger problems for other financial institutions around the world and even disrupt the global economy (eg Lehman Brothers).

The impact caused by the failure of large, complex, interconnected, global financial institutions can send shocks through the financial system which, in turn, can harm the real economy.

This scenario played out in the recent crisis during which authorities had limited options other than the provision of public support as a means for avoiding the transmission of such shocks.

Such rescues have had obvious implications for fiscal budgets and taxpayers. In addition, the moral hazard arising from public sector interventions and implicit government guarantees can also have longer term adverse consequences.

These include inappropriate risk-taking, reduced market discipline, competitive distortions, and increased probability of distress in the future.

The Basel Committee's response

What has the Committee done in response to the G-SIB issue?

As a starting point, we recognised that there is **no single solution** for dealing with the negative externalities posed by G-SIBs.

Basel III will help improve the resilience of banks and banking systems in a number of ways.

These include better quality and higher levels of capital; improving risk coverage; introducing a leverage ratio to serve as a backstop to the risk-based framework; introducing capital buffers as well as a global standard for liquidity risk.

These measures are significant but are not sufficient to address the negative externalities posed by G-SIBs nor are they adequate to protect the system from the wider spillover risks of G-SIBs.

To specifically address the G-SIBs issue, the Committee's approach is to reduce the probability of a G-SIB's failure and the impact of a potential failure by increasing its loss absorbency in the form of a common equity capital surcharge.

Based on a methodology for assessing systemic importance of G-SIBs, this additional loss absorbency will complement the measures adopted by the **Financial Stability Board (FSB)** to establish robust national resolution and recovery regimes and to improve cross-border harmonisation and coordination.

But even with improved resolution capacity, the failure of the largest and most complex international banks will continue to pose disproportionate risks to the global economy.

Our empirical analysis indicates that the costs of requiring additional loss absorbency for G-SIBs are outweighed by the associated benefits of reducing the probability of a systemic financial crisis.

We have also introduced transitional arrangements to implement the capital surcharge that help ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy.

The Committee's analysis points to additional loss absorbency generally in the range of around 1% to 8% of risk-weighted assets. Our agreed

calibration from **1% to 2.5%** is in the lower half of this estimated range. As a means to discourage banks from becoming even more systemically important, there is a potential surcharge of **3.5%**.

Looking ahead

The Committee's approach to dealing with G-SIBs was endorsed by the G20 Leaders at their November 2011 summit.

At that time, an initial list of **29 banks** that were deemed globally systemically important was published.

This is not a fixed list and it will be updated annually and published each November.

Transparency is a very high priority and we expect market discipline to play an important role.

As such, the methodology and the data used to assess systemic importance will be publicly available so that markets and institutions can replicate the Committee's determination.

The requirements will be phased in starting January 2016 with full implementation by January 2019.

The basis for adopting specific requirements to address externalities posed by G-SIBs is not exclusive for the global banking system.

Measures should be developed for all institutions whose disorderly distress or failure, because of their size, complexity and systemic interconnectedness would cause significant disruption to the wider financial system and economic activity.

These could include financial market infrastructures, insurance companies, other non-bank financial institutions and domestic systemically important banks.

The Committee is now in the process of determining whether there are elements of the G-SIBs assessment methodology that could be applied to domestic SIBs.

A number of countries, notably Switzerland, the United Kingdom and Sweden have already taken action to implement higher capital requirements for banks that are deemed systemically important at the national level.

The Swiss too-big-to-fail package, which was approved by the Swiss Parliament in September 2011, is due to come into force on 1 March 2012.

The package, which is particularly demanding with respect to capital requirements, consists of the following:

A capital buffer of 8.5% of risk-weighted assets.

This is in addition to the Basel III minimum requirement of 10.5%.

Of this 8.5%, at least 5.5% must be in the form of common equity while up to 3% may be held in the form of convertible capital (CoCos).

The CoCos would convert when a bank's common equity falls below 7%.

The two big Swiss banks, Credit Swiss and UBS will have to hold a total of 10% common equity tier 1 capital.

This exceeds both Basel III and the internationally agreed capital surcharge for G-SIBs.

The package also includes a so-called "progressive component" equal to 6% of RWA consisting entirely of CoCos.

Unlike the CoCos under the buffer, the Cocos under the progressive component will convert when capital levels falls below 5% common equity.

In the [United Kingdom](#), Sir John Vickers, chair of the Independent Commission on Banking, recommended in September 2011 that systemically important retail banks defined as retail banks with RWA exceeding 3% of GDP should have primary loss-absorbing capacity of at least 17-20% of RWA.

At least 10% must be covered by equity capital while the remaining 7-10% may consist of long-term unsecured debt that regulators could require to bear losses in resolution. These are the so called bail-in bonds.

The proposed changes related to loss absorbency are intended to be fully completed by the [beginning of 2019](#).

In [Sweden](#), authorities (the Swedish Financial Supervisory Authority, the Ministry of Finance and the Riksbank) announced in November 2011 that capital ratios for the four major banks will be advocated to [at least 10% common equity to RWA from 1 January 2013, and 12% from 1 January 2015](#).

The requirements follow the Basel III definitions and include, like Basel III, a capital conservation buffer of 2.5%, but no countercyclical buffer.

The Swedish proposal goes further than Basel III, both with regard to the levels and in terms of timing

Conclusion

Basel III will [improve the resilience](#) of banks and banking systems but by itself is not sufficient to fully address the negative externalities arising from global systemically important banks.

These adverse side effects, which include an **increased risk of contagion** and moral hazard, have serious implications for fiscal budgets and taxpayers.

In response, the Basel Committee has developed assessment methodology to identify G-SIBs and has adopted an additional loss absorbency requirement for such banks that must be met through higher common equity.

This is meant to reduce the probability of a G-SIB's failure by increasing its loss absorbency in the form of a common equity capital

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Interesting parts

The Basel III framework agreement and other Basel III proposals, must be **fully implemented through US regulations by the end of 2012.**

The United States is committed to meeting these deadlines.

U.S. agencies expect to release a final rule in 2012, in order to meet the implementation timeline of **January 1, 2013.**

Stress testing forms one part of enhanced supervision under the Dodd-Frank Act (DFA).

The DFA requires **one supervisory stress test per year** to be conducted by the Federal Reserve on banks with **more than \$50 billion** in consolidated assets **and/or banks designated** for heightened supervision and two stress tests per year by large firms.

The DFA requires **both banks and supervisors to disclose results**, although the exact nature of that disclosure is still subject to rule making.

On **March 22, 2010**, U.S. supervisors issued the final interagency guidance on funding and liquidity risk management.

The policy statement emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well developed contingency funding plan as primary tools for measuring and managing liquidity risk.

In the spring of 2011, Federal Reserve completed a **Comprehensive Capital Analysis and Review (CCAR)**, a cross-institution study of the capital plans of the **19 largest U.S. bank holding companies**.

The CCAR involved a **forward-looking, detailed evaluation of capital planning and stress scenario analysis** at the **19** large bank holding companies.

As part of the CCAR, the Federal Reserve assessed the firm's ability, after taking into account the proposed capital actions, to maintain sufficient capital levels to continue lending in stressed economic environments, including under an adverse scenario specified by the Federal Reserve.

The Dodd-Frank Act requires the Federal Reserve to conduct annual stress tests for all systemically important companies and publish a summary of the results.

Additionally, the Act requires that these systemically important companies and **all other financial companies with \$10 billion or more** in assets that are regulated by a primary Federal financial regulatory agency conduct **semi-annual or annual (respectively) internal stress tests and publish a summary of the results**

Supervisory reviews are ongoing, with a focus on requiring bank organizations to have sound capital planning policies and processes for determinations regarding dividend, as well as the redemption and repurchase of common stock and other tier 1 capital instruments.

Regulators are writing rules governing stress tests under the DFA.

The deadline for implementation of rules governing stress tests is January 17, 2012.

U.S. agencies are incorporating the guidance into the supervisory process. U.S. supervisors continue to monitor the liquidity risk profiles of all banks via the field examination staff.

They also **collect liquidity data** at large and regional banks on a daily or monthly basis.

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On June 15, 2011, U.S. banking supervisors published proposed guidance on stress testing applicable to all banking organizations with more \$10 billion in consolidated assets

Addressing systemically important financial institutions (SIFIs)

The Dodd-Frank Act modifies U.S. regulatory framework by creating the **Financial Stability Oversight Council (FSOC)**, chaired by the Secretary of the Treasury, with the authority to determine that a nonbank financial company shall be supervised by the Board of Governors and subject to prudential standards if the Council determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States.

The FSOC issued a **second notice of proposed rulemaking and proposed guidance on October 11, 2011.**

The banking agencies have actively participated in drafting and commenting on the documents included in the **Key Attributes of Effective Resolution Regimes for Financial Institutions** that was approved by the FSB Plenary in Oct. 2011.

CMG meetings have been held with major U.S. banking firms and their significant host regulators.

The U.S. firms submitted initial recovery plans to U.S. regulators on August 16, 2010. U.S. regulators reviewed the plans and are working with the firms to **further refine them.**

Information from the recovery plans will help to inform the U.S. regulators in developing and maintaining firm-specific resolution plans.

The Dodd-Frank Act created new authority to resolve **nonbank financial institutions**, similar to that which the FDIC has with regard to insured banks, whose failure could have serious systemic effects.

Additionally, legislation requires resolution plans for **all large bank holding companies and non-bank financial companies subject to heightened supervision by the Federal Reserve**.

Title II of the Dodd-Frank Act allows the FDIC to be appointed as receiver for nonbank financial firms, the failure of which could cause systemic risk to the U.S. economy.

Under the Dodd-Frank Act framework, the FDIC can create a **bridge firm** in order to maximize value in an orderly liquidation process for a financial group.

While Title II became effective upon signing, the FDIC drafted regulations for the implementation of its authority under Title II to provide clarity on how the FDIC would implement a resolution under the Dodd-Frank Act.

A first set of interim final rules was adopted in January 2011. A second set of rules was proposed in March 2011, and a final rule was approved in July 2011.

The FRB and FDIC are finalizing issuance of a rule implementing the resolution plan provision in the legislation which is due 18 months from enactment.

On September 21, 2011, the FDIC adopted an interim rule requiring an insured depository institution with \$50 billion or more in total assets to submit to the FDIC a contingency plan for the resolution of such institution in the event of its failure. Comments are due by November 21, 2011.

Extending the regulatory perimeter to entities/activities that pose risks to the financial system

The FSOC has authority to expand the U.S. regulatory perimeter by designating the largest, most interconnected nonbank firms for heightened prudential standards and supervision by the Federal Reserve.

The FSOC has proposed a rule regarding the criteria and process for designating nonbank financial firms.

FSOC issued a second more detailed proposal on this framework, with interpretive guidance on October 11, 2011 for public comment.

Hedge funds

Operators and managers of commodity pools are required to register with the CFTC as Commodity Pool Operators, and those who make trading decisions on a pool's behalf must register with the CFTC as Commodity Trading Advisors.

Certain exemptions from registration apply, however, including for operators of pools that accept no more than 15 participants or are “otherwise regulated” as an SECregistered investment company, as well as operators of pools that have limited futures activity or that restrict participation to sophisticated persons.

Pursuant to legislation passed by Congress, CFTC and SEC staff have jointly proposed regulations for public comment that establish the form and content of the reports that dual-registered investment advisers to private funds are required to file.

The regulations will require investment advisers to maintain records and may require them to file information related to: use of leverage; counterparty credit risk exposure; trading and investment positions;

valuation policies and practices of the advised fund(s); types of assets held; side arrangements or side letters; trading practices; and any other information deemed necessary.

Reports of dual registrants are expected to be filed SEC and made available to the CFTC.

On January 26, 2011, the CFTC and SEC jointly proposed rules that would require certain private fund advisers to maintain records and certain private fund advisers to file non-public information designed to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system.

Under the proposal, **each private fund adviser** would file certain basic information annually, and certain large private advisers (i.e. those advisers managing hedge funds that collectively have at least \$1 billion in assets as of the close of business on any day during the reporting period for the required report) would file basic information each quarter along with additional systemic risk related information concerning certain of their private funds.

The comment period closed on April 12, 2011, and the CFTC and SEC plan to finalize the rules this fall.

Recordkeeping and reporting requirements will include disclosure of:

- (i) assets under management;
- (ii) use of leverage;
- (iii) counterparty credit risk exposure;
- (iv) trading and investment positions; and
- (v) trading practices, as well as other specified information.

The Dodd-Frank Act provides for a one-year transition period from the date of enactment before the private fund adviser registration and recordkeeping/disclosure obligations go into effect.

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The SEC will engage in rulemaking to implement certain provisions.

The Dodd-Frank Act generally requires all advisers to hedge funds (and other private pools of capital, including private equity funds) whose assets under management exceed \$100 million to register with the SEC.

The Act authorizes the SEC to impose recordkeeping and reporting requirements on not only those advisers required to register, but also certain other private fund advisers (i.e. advisers to venture capital funds).

The recordkeeping and reporting requirements are designed to require private fund advisers to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.

Securitisation

In April 2010, the SEC proposed revisions to its rules relating to ABS shelf eligibility.

In July 2010, US Congress passed the Dodd-Frank Act, which requires rulemaking to implement further changes related to the offering of securitized products in the United States.

Section 943 of the Dodd-Frank Act requires issuers of ABS to disclose the history of the requests they received and repurchases they made related to their outstanding ABS.

The SEC approved final rules to implement Section 943 on January 20, 2011.

The final rules require ABS issuers to file with the SEC, in tabular format; the history of the requests they received and repurchases they made relating to their outstanding ABS.

The table will provide comparable disclosures so that investors may identify originators with clear underwriting deficiencies.

The SEC also adopted final rules to implement Section 945 of the Dodd-Frank Act, which requires ABS issuers to review assets underlying the ABS and to disclose the nature of the review.

In July 2011, the SEC issued a follow up re-proposal to the April 2010 proposal on ABS shelf eligibility.

As part of this re-proposal, the SEC solicited comments on provisions requiring issuers of private ABS to represent that they will make the same information available to investors that would be provided if the securities were publicly registered.

The July 2011 re-proposal also solicited comments on whether the April 2010 proposal appropriately implemented **Section 942(b) of the Dodd-Frank Act** with regard to the disclosure of asset-level or loan-level data for ABS, if such data are necessary for investors to independently perform due diligence.

In August 2011 the SEC adopted final rules to implement Section 942 of the Dodd Frank Act to eliminate the automatic suspension of Exchange Act reporting obligations for ABS issuers as long as securities are held by non-affiliates of the issuer.

Also pursuant to Section 942, the SEC adopted rules to allow for the suspension of reporting obligations for ABS issuers for a semi annual period if there are no longer any ABS of the class sold in a registered transaction held by non-affiliates of the issuer.

In April 2010, IOSCO issued its Disclosure Principles for Public Offerings and Listings of Asset-backed Securities.

The SEC adopted new rules related to ABS in January and August 2011. Implementation is ongoing.

Section 941(b) of the Dodd-Frank Act requires federal banking agencies and the SEC to jointly prescribe regulations that require securitizers of ABS, by default, to maintain 5% of the credit risk in assets transferred, sold or conveyed through the issuance of ABS.

To implement this, the SEC and other Federal agencies proposed rules in March 2011 relating to credit risk retention requirements.

The proposed rules would permit a sponsor to retain an economic interest equal to at least 5% of the credit risk of the assets collateralizing an ABS issuance.

The proposed rules would also permit a sponsor to choose from a menu of retention options, with disclosure requirements specifically tailored to each form of risk retention.

The New York Department of **Insurance** considered legislation to revise oversight of financial guaranty insurers, which would have served as the basis for additional state activity in this area.

This legislative response was in addition to increased monitoring and supervision of financial guaranty insurers that is ongoing.

The New York Department of Insurance has taken **proactive steps** to ensure that other relevant state insurance department regulators remain current and up-to-date on the solvency of financial guaranty insurers through quarterly updates and interstate regulatory communication.

However, the market has contracted such that there is only one active writer of financial guaranty insurance focusing primarily on municipal bond insurance coverage (and not structured products) and consequently there has not been a need for legislative revisions at this time.

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State insurance regulators are closely monitoring, and collaborating on supervision of financial guaranty insurers.

Given the current scrutiny and the significant market contraction into more traditional bond insurance coverage, there is no additional legislative or regulatory changes anticipated at this time.

Credit rating agencies

The [Credit Rating Agency Reform Act of 2006](#) (Rating Agency Act) provided the SEC with exclusive authority to implement a registration and oversight program for [Nationally Recognized Statistical Rating Organizations \(NRSROs\)](#).

In June 2007, the SEC approved rules implementing a registration and oversight program for NRSROs, which became effective that same month.

The rules established [registration, recordkeeping, financial reporting and oversight rules for credit rating agencies that apply to be registered with the SEC](#).

These rules are consistent with the principles set forth in the IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

Since adopting the implementing rules in 2007, the SEC has adopted additional amendments to its NRSRO rules.

The [Dodd-Frank Act](#) contains a number of provisions designed to strengthen the SEC's regulatory oversight of NRSROs.

On May 18, 2011, the SEC voted to propose new rules and amendments that would implement certain provisions of the Dodd-Frank Act and enhance the SEC's existing rules governing credit ratings and NRSROs.

The Rating Agency Act was enacted in order “**to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.”**

To that end, the Rating Agency Act and the SEC's implementing regulations prohibit certain conflicts of interest for NRSROs and require NRSROs to disclose and manage certain others.

NRSROs are also **required to disclose their methodologies** and underlying assumptions related to credit ratings they issue in addition to certain performance statistics.

Under the new rules and rule amendments proposed by the SEC on May 18, 2011 to implement certain provisions of the Dodd-Frank Act, **NRSROs would be required to, among other things:**

- Report on internal controls.
- Protect against certain additional conflicts of interest.
- Establish professional standards for credit analysts.
- Publicly provide – along with the publication of the credit rating – disclosure about the credit rating and the methodology used to determine it.
- Enhance their public disclosures about the performance of their credit ratings.

Risk management

The Dodd-Frank Act requires the Federal Reserve to conduct annual stress tests for all systemically important companies and publish a summary of the results.

Additionally, the Act requires that these systemically important companies and all other financial companies with \$10 billion or more in assets that are regulated by a primary Federal financial regulatory agency conduct semi-annual or annual (respectively) internal stress tests and publish a summary of the results.

The Federal Reserve has created an enhanced quantitative surveillance program that will use supervisory information, firm specific data analysis, and market based indicators to identify developing strains and imbalances that may affect the largest and most complex firms.

Periodic scenario analysis across large firms will enhance understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole.

This work will be performed by a multi-disciplinary group comprised of economic and market researchers, supervisors, market operations specialists, and accounting and legal experts.

The Federal Reserve is currently developing rules to implement the provision in coordination and consultation with the other relevant agencies.

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The Basel iii Compliance Professionals Association (BiiiCPA) has established the Basel III Speakers Bureau for firms and organizations that want to [access the Basel iii expertise](#) of Certified Basel iii Professionals (CBiiiPros).

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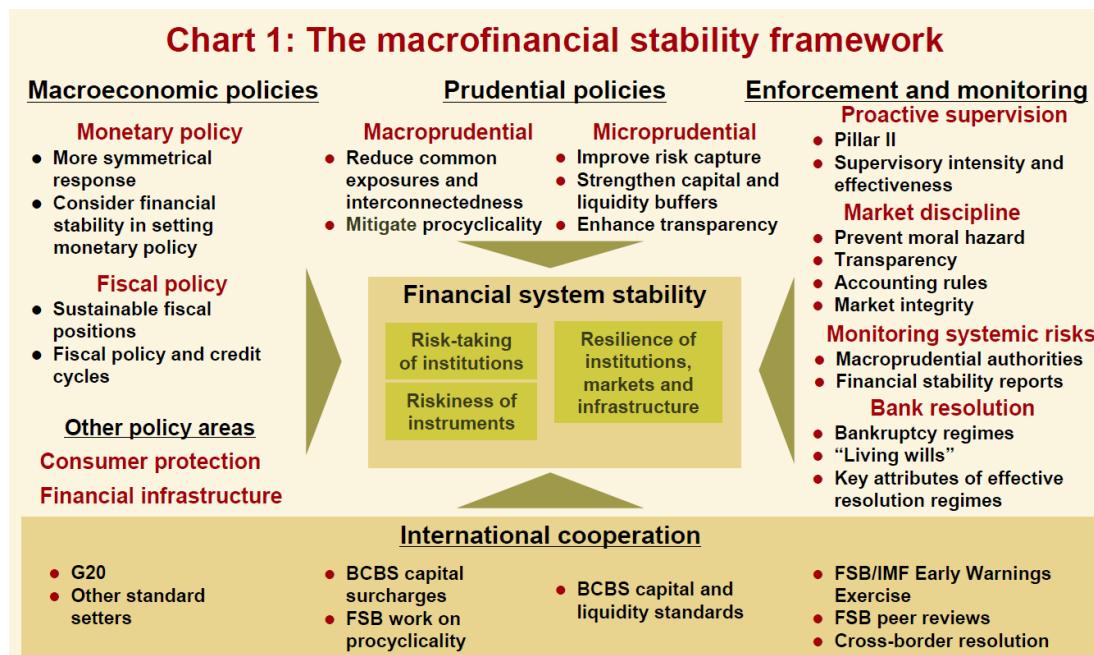
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Basel III News, March 2012



Dear Member,

Today we will start from a very interesting speech and 4 really interesting slides



Building a resilient financial system

Keynote speech by Jaime Caruana, General Manager, Bank for International Settlements, 2012 ADB Financial Sector Forum on “Enhancing financial stability – issues and challenges” Manila, 7 February 2012

The global financial system is facing an especially complex set of challenges.

Some countries and regions are slowly recovering from the financial crisis of 2007–09, while others, especially in Europe, are confronting renewed turbulence.

Financial systems in Asia face a number of challenges from both short-term and structural factors.

The sovereign debt crisis in the euro area has raised questions about the stability of portfolio flows and bank funding.

Pressures are being felt in specialised financial sectors such as trade finance.

European banks face pressure to sell assets and scale back their operations, especially outside their home markets.

From a somewhat longer-term perspective, several countries in the region have experienced rapid credit growth and possible asset price bubbles over the past few years, in part because of portfolio inflows related to weak global growth and accommodative monetary policy in the major economies.

Managing these rapid asset price developments has posed challenges to domestic micro- and macroprudential policies.

The uncertain and uneven recovery has led to calls in some quarters to weaken financial reform.

I would argue, to the contrary, that it makes it all the more important that we carry through on what we have promised to do.

While the short-term challenges that threaten the system are real, and should be dealt with promptly using a variety of policies, it would be wrong to let them weaken our commitment to financial reform.

Considerable thought has been given on how to manage the transition, but the endpoint needs to be beyond question.

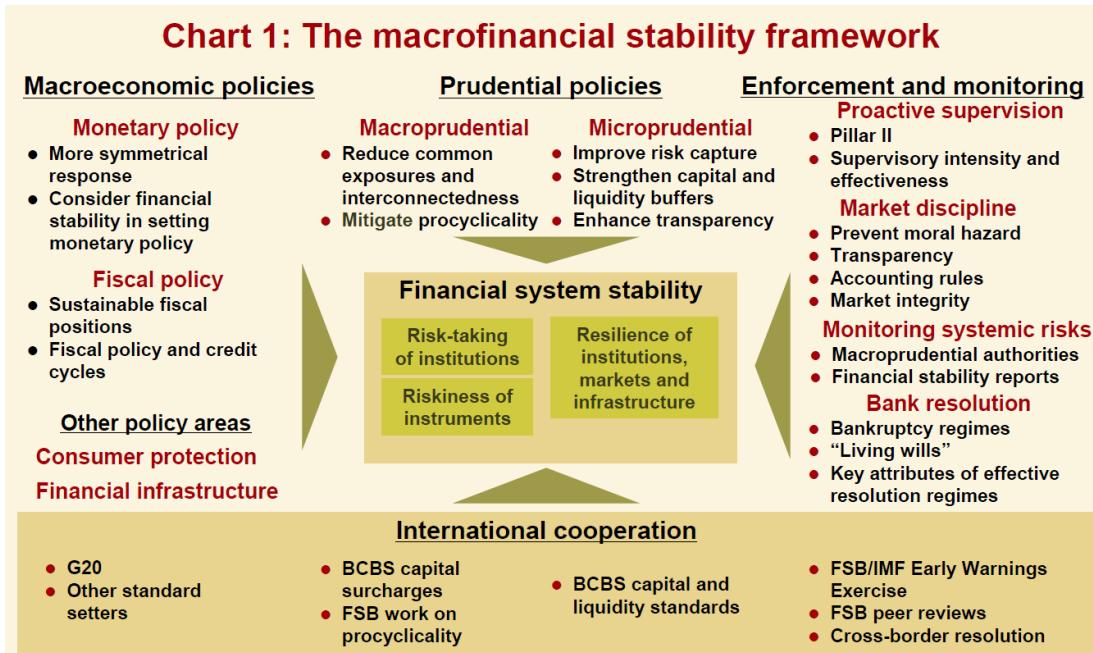
This morning I would like to outline the key elements of the global financial reform agenda, reviewing both what has been done and what we still need to do. In many cases, the policies have been developed, and the key task now is to implement what has been agreed.

In other areas, we still have important work to do in terms of identifying the key risks and crafting appropriate responses. Before I go into details, however, however, I'd like to outline some of the broad principles that are guiding the work.

First, financial stability is about resilience and should be prepared in advance.

We need to have reliable buffers in the system – **capital, liquidity, sound infrastructure, strengthened resolution** – that will prevent macroeconomic surprises, or problems at a specific institution or market, from disrupting the broader financial system.

Second, preserving financial stability involves a wide range of policy areas (Chart 1, follows).



Today I will focus mainly on micro- and macroprudential policies.

But it is also important to pursue sound monetary and fiscal policies; to protect consumers; to safeguard financial infrastructure; and to improve market discipline by enhancing the transparency of firms and markets, including through stronger accounting standards.

All of these are necessary components of financial stability; none of them, by itself, is sufficient.

Third, a globalised financial system requires global rules.

This does not mean that identical rules must be applied for every country or region.

But it does mean that, to be effective, financial regulation and supervision should be guided by **broadly consistent approaches**.

The alternative is a race to the bottom as market players seek to arbitrage across divergent national regimes – and no financial centre would want to win such a race.

In this respect, policymakers worldwide have a lot to learn from the reforms that were put in place in many emerging economies, especially in Asia, in the aftermath of the crises of the late 1990s.

A key lesson is that, done right, financial reform can provide a foundation for strong, sustainable growth.

And fourth, we should stay focused on the end result we want to achieve, namely a financial system characterised by less leverage, better risk management especially for liquidity, better incentives, less moral hazard, stronger oversight and more transparency.

As we learned during the crisis, these goals are vital for protecting the system from shocks.

In implementing them, policymakers should work to reinforce and enhance the discipline provided by markets.

Banks and other institutions that incorporate these objectives into their business models are already being rewarded by the market with higher valuations and lower borrowing costs.

With these broad goals in mind, we have worked out appropriate timetables.

We should monitor implementation for unintended consequences.

But at the same time we should set out the endpoints as clearly as possible.

This will aid the decision-making of banks, firms and households, by providing them with an unambiguous vision of the framework of financial regulation that we are aiming for.

Progress in defining this framework has been impressive.

It has emerged from an intensive, collaborative effort involving top policymakers and technical experts from the largest advanced and emerging economies.

While we should not lose sight of the achievements, which have been substantial, today I will focus on the remaining challenges for financial reform.

In my view the challenges fall into four broad groups.

First, consistently implementing what has already been agreed, especially with respect to stronger bank capital.

Second, building a resilient financial system given a still weak recovery.

This has been the question of designing the right transition, to which a lot of thought is being given by the international regulatory community – what is the right speed, and the right sequencing, at which we should move to a more robust system? How do we monitor material unintended consequences, and respond to them effectively?

Third, completing the regulatory reform agenda.

I will focus on four main issues: **liquidity standards, resolution regimes, OTC derivatives, and the shadow banking system.**

And **fourth, ensuring adequate oversight**. This has two main parts: macroprudential oversight, and more proactive prudential supervision.

Consistent implementation of what has been agreed

Basel III is a crucial regulatory response to the crisis and a major step towards creating a stronger and safer financial system.

To simplify, what Basel III brings is **twofold (Chart 2, follows):**

1. An **enhancement of the regulatory framework** introduced by Basel II at the level of individual institutions; and
2. The **set up of a macroprudential overlay** so as to address systemic risk in its two dimensions, namely its time dimension (by mitigating procyclicality) and its cross-sectional dimension (by mitigating interconnection and contagion risk).

Chart 2: The Basel III reform programme – implementation

Enhanced Basel II + Macroprudential overlay = Basel III

Microprudential framework (Enhanced Basel II):

- Increase quantity and quality of capital
- Adequate risk coverage (for trading book, counterparty credit risk, securitisation)
- Enhanced risk management and disclosure
- Global liquidity standards

Macroprudential framework:

- Address stability over time (procyclicality)
 - Countercyclical capital charges
 - Capital conservation rules for stronger capital buffers
 - Dynamic provisioning
- Address stability at each point in time (system-wide approach)
 - Specific treatment for systemically important banks: systemic capital charge
 - Leverage ratio

But agreeing on Basel III is only a first step: the next phase is just as critical, and that is implementation.

One of the most important lessons we learned from the crisis is the need for full, timely and consistent implementation and enforcement of rules.

Today I will not go through the details of Basel III, but let me summarise a few elements that are relevant for consistent implementation and outline what remains to be done.

1. Better and more capital – ensuring effective loss absorption capacity

As you all know, Basel III raises the level and quality of capital in the system (Chart 3, follows).

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Chart 3: Implementation: from Basel II to Basel III

As a percentage of risk-weighted assets	Capital requirements							Additional macroprudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter -cyclical buffer	Additional loss- absorbing capacity for SIFIs
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	2			4		8			
Memo:	Equivalent to around 1% for an average international bank under the new definition			Equivalent to around 2% for an average international bank under the new definition					
Basel III New definition and calibration	4.5	2.5	7.0	6	8.5	8	10.5	0–2.5	1–2.5%
10.5% — 15.5%									

When the whole Basel III package is implemented, banks' common equity will need to be at least 7% of risk-weighted assets.

This compares to a Basel II level of 2% – and that's before taking account of the changes to definitions and risk weights, which make the effective increase in capital all the greater.

The 7% figure includes a 2.5% capital conservation buffer, which is designed to be drawn on in difficult times.

Among the improvements in capturing risk on the assets side, I would especially point to the stronger treatment of risks related to securitisation and contingent credit lines.

Moreover, these risk-based capital requirement measures will be supplemented by a non-risk-based leverage ratio, which will serve as a backstop and address model risk.

As from January 2013, a minimum Tier 1 leverage ratio of 3% – that is, the ratio of Tier 1 capital to the bank's total non-weighted assets plus

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off-balance sheet exposures – will be tested and is expected to become a requirement in 2018.

Banks will be required to **disclose the ratio and its components from 2015**.

The basics of the framework have been settled, and the members of the Basel Committee are committed to implementing them.

The challenge now is to ensure consistency, in terms of timing, enforcement and results.

In terms of timing, supervisors have agreed to implement the wider capital buffers gradually, starting in 2013 and reaching their target levels by the start of 2019 (Chart 4, follows).

Chart 4: Implementation: a lengthy phase-in timetable

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1		
Leverage ratio									
Minimum common equity capital ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer					0.625%	1.25%	1.875%		2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1			20%	40%	60%	80%	100%		100%
Minimum tier 1 capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum total capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core tier 1 capital or tier 2 capital			Phased out over 10-year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins			Introduce minimum standard					
Net stable funding ratio		Observation period begins						Introduce minimum standard	

As I will discuss further in a moment, this lengthy transition period is intended to mitigate the negative macroeconomic impacts that might occur if banks try to adjust their balance sheets too quickly.

Enforcement will be tracked through rigorous monitoring and review of members' progress in implementation, which will include peer reviews of members' progress in adopting the Basel regulatory framework as well as thematic reviews on specific issues.

And results will be tracked through regular monitoring of capital levels, as well as any unintended consequences that need to be addressed.

Higher capital ratios are accompanied by improvements in the quality of capital.

The focus will shift from Tier 1 and similar kinds of intermediate instruments, to common equity, which was shown during the crisis to be the most important capital concept in terms of its capacity to absorb losses.

In addition, the risk weights in Basel III are intended to better capture the underlying risks.

Alongside work to reduce the riskiness of individual banks, I would also highlight the elements of Basel III that are intended to address systemic risk, in both of its dimensions: The time dimension, mitigating procyclicality, and the cross-sectional dimension, mitigating interconnection and contagion risk.

With respect to the time dimension, Basel III allows supervisors to impose a countercyclical buffer on their banking system when credit growth seems to be getting out of hand.

They will be able to apply this equally to foreign and domestic banks.

Additionally, the leverage ratio will help contain the build-up of excessive leverage in the system in good times, even if it is used to purchase supposedly safe assets.

The rules for the countercyclical buffer also represent an important step forward in terms of home-host cooperation.

They require an internationally active bank to take account of the prevailing buffers in each jurisdiction in which it has a credit exposure in calculating its overall capital requirement.

In other words, a host supervisor can increase the capital buffer required of a foreign-headquartered bank if this is called for by domestic conditions.

Since credit booms and busts are not always correlated across countries and regions around the world, this is an important and useful step forward.

With respect to the cross-section of risks, the key initiatives relate to reducing the impact of stress or failure at systemically important financial institutions, or SIFIs.

The rationale for adopting additional measures, including higher loss absorption capacity for so-called global, or G-SIFIs, is based on the negative cross-border externalities they create and which current regulatory policies do not fully address.

The framework for SIFIs that has been developed by the Financial Stability Board (FSB) – and by the Basel Committee for global systemically important banks, or G-SIBs – comprises four main components:

1. Greater loss absorbency
2. More intense supervision
3. Stronger resolution and
4. Stronger infrastructure.

These complement each other, and aim at a common set of objectives.

We know that the distress or failure of certain institutions has a greater impact on the system than the distress of others.

So we want to **do more to reduce the probability** of such a failure, by insisting that these institutions have more capital to absorb losses and by strengthening the ability of supervisors to spot potential problems early.

Complementing this, we want to reduce the impact of a SIFI's distress or failure, by making it possible to close or restructure such an institution without causing excessive disruption to the rest of the financial system, even if its activities span national borders.

Strengthening market infrastructure – including platforms for trading, clearing, and settlement – can reduce the impact of the failure of a large market participant on the stability of the system, by ensuring that trading markets keep functioning in such an event.

And we want to develop a framework that reduces the probability and impact of a SIFI's failure without increasing moral hazard or providing an implicit too-big-to-fail subsidy to the banks that are subject to the framework.

Improved resolution regimes, including cross-border cooperation in bank resolution, perform this task by strengthening the credibility of the commitment by authorities that insolvent institutions, no matter how large or complex, should and will be resolved without disrupting the broader system.

On 4 November 2011, the Basel Committee issued final rules for G-SIBs.

As endorsed by the G20 Leaders at their summit in Cannes, these represent an important step forward on the SIFI agenda.

The G-SIB framework includes a methodology for assessing the systemic importance of G-SIBs, based on an objective set of indicators that will be updated annually.

A preliminary list of 29 banks that would potentially qualify for this framework under the agreed methodology was released in November.

This list will be modified as the methodology is refined and the data brought up to date.

The rules also specify additional loss absorbency requirements, which are to be met with a Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance.

They also provide for a surcharge of up to 3.5% as a disincentive for G-SIBs to become even more systemically important.

In a nutshell, a bank would be required to have a capital ratio **between 10.5% and 15.5%**, depending on how systemic it is and on the position in the credit cycle (Chart 3).

I should emphasise that this is just the global framework, which is to be applied to the world's largest banks.

A number of countries are likely to supplement these rules with additional loss absorbency requirements and other rules applicable to banks that are systemic within their national financial systems – the so-called domestic SIFIs, or D-SIFIs.

The Basel Committee is working to develop broad principles to guide these supplemental rules, which will understandably differ across countries.

Finally, I should note that, while most of the recent discussions have related to systemically important banks, there are other financial institutions that, although different in nature, are potentially systemic.

Rules are being developed for insurance companies, asset managers and providers of market infrastructure.

Discussions on how to strengthen the regulation and supervision of these entities are proceeding, under the leadership of the relevant global bodies.

But the underlying principle is the same: that the risks potentially posed by these institutions to the broader financial system call for more intensive supervision, for greater loss absorbency, and for measures to reduce both the probability and impact of distress or failure.

2. Monitoring implementation

Full, consistent and timely implementation by national jurisdictions is now at the top of the Basel Committee's agenda.

Through the work of its Standards Implementation Group, the Committee has started to conduct peer reviews and thematic reviews to help ensure **timely and consistent implementation of Basel II, Basel II.5**

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(that is, the enhanced framework for trading risk exposures), and Basel III.

These reviews look closely at adoption of the framework into legislation and regulations on the national level and, more broadly, assess whether the standards are producing the desired results.

Last October the Committee published its first progress report on members' implementation of what they have agreed; these reports will now be produced on a regular basis.

Each member will also undergo a more detailed peer review, starting with the EU, Japan and the United States.

The Basel Committee has decided to follow a three-level approach to analyse how the Basel Framework will be implemented.

The aim is to ensure that Basel III is adopted in a timely fashion (level 1), that domestic regulations are framed in accord with Basel rules (level 2), and that the outcome of capital calculations is globally consistent (level 3).

The Committee has already begun its level 3 assessment by reviewing the measurement of risk-weighted assets in the banking and trading book.

The goal is to ensure consistency in practice across banks and jurisdictions.

At present, risk-weighted assets calculations of similar exposures vary significantly across borders.

Such differences have led some to argue that the risk-based capital regime is fundamentally broken or that it is biased against certain jurisdictions.

This is an exaggeration: many of these concerns are based on aggregated data that mask the actual differences in the underlying portfolios of banks.

Moreover, the Basel Framework lets banks use their own internal data and models as inputs for the calculation of capital requirements, so that some variation in risk-weighted assets is inevitable.

That said, these calculations do vary enough to warrant further investigation.

The bottom line is that minimum capital requirements must accurately reflect the risk that banks actually face.

Regulators are therefore doing studies based on benchmark or hypothetical portfolios.

The Basel Committee will publish the results of this very promising work in the near future.

Transparency should be an important component of any eventual solution.

For its part, the FSB is working to promote implementation of global standards through its own peer review process.

It has set up a coordination framework, in collaboration with the Basel Committee and other standard-setting bodies, to intensify monitoring and public reporting of implementation on a country-by-country basis.

Priority areas include the Basel capital and liquidity framework, OTC derivatives market reform, compensation practices, G-SIFI policies, resolution frameworks, and shadow banking.

We should not forget that the Basel III standards collectively represent a set of minimum requirements.

They were agreed based on this understanding and were not developed as a menu of options. If jurisdictions were to choose only certain elements of Basel III, it would dilute the effectiveness of the framework.

On the contrary, one of the lessons of the crisis is that jurisdictions that adopted higher capital requirements and more active or, if you want, more intrusive, supervision performed better than those which favoured “light-touch” supervision.

Some jurisdictions are already above the capital standard and others may decide to impose higher standards.

So let me emphasise once again that Basel III is a minimum, and that its calendar is also a minimum.

Building strength in a still fragile recovery

Let me now turn to the second set of challenges.

A lot has been done to ensure the building of a more resilient financial system.

But what should be the right transition?

Both during the debate before the publication of Basel III and since, some have expressed concerns that strengthening bank capital, together with other measures, would be harmful to growth and could delay recovery.

This discussion has emerged again in the context of the current stresses in Europe.

These risks need to be analysed to avoid the possibility that critical elements of financial reform could be delayed, weakened or not fully carried through.

From the beginning, this question has been taken very seriously by policymakers, and has been analysed carefully.

A series of studies conducted in 2010 and 2011 under the auspices of the BIS concluded that the growth costs, both in the transition and in the steady state, are likely to be modest, and far outweighed by the benefits.

The **Macroeconomic Assessment Group, or MAG**, a group of modelling experts convened by the FSB and the Basel Committee, concluded that, while banks may attempt to raise credit spreads and to reduce lending growth in the transition to higher capital levels, this is likely to have only a modest impact on the real economy.

The longer the transition period, the lower the costs – this is because banks will have more time to accumulate capital through retained earnings, and will have less need to cut back on their lending or to raise costly new capital on the public market.

A follow-up analysis by the MAG found that the G-SIB framework would have no more than a **modest additional cost** in terms of temporarily slower growth.

While the MAG was tasked with examining transitional issues, a separate group studied the costs and benefits of the requirements over the long run.

This **long-term economic impact (LEI) group** found that **additional permanent GDP costs should be small, while the benefits from reducing crisis risks will be substantial.**

The costs will be low **because, as economic theory teaches, investors will eventually recognise that well capitalised banks are less risky, and will accept a lower return on equity.**

This sets limits on any long-term rise in credit spreads. At the same time, potential benefits will be gained from reducing the risk of financial crises and the resulting permanent losses to GDP.

The LEI group found that the range of capital ratios at which the benefits exceed the costs is quite wide.

The MAG and LEI analyses informed the calibration of the capital buffers and the transition paths under Basel III.

Supervisors chose to set the regulatory minima at levels substantially above where they are now, but they allowed a lengthy transition period to avoid the adjustment costs from banks trying to achieve higher capital ratios too quickly.

Completing the regulatory reform agenda

My third point is that we have **not yet finished doing everything** we can at the global level to reduce both the probability and the severity of financial crises.

As I said at the outset, tremendous progress has been already made, and the financial reform agenda has moved forward rapidly with the agreement reached on Basel III.

Banks have already increased their capital base significantly. These are no mean achievements, and not one of them was assured just a year ago.

But more needs to be done to complete the regulatory reform agenda.

The Basel Process, in particular the FSB and the various associated standard setters, is moving full speed with the support of the BIS to enhance financial regulation in many areas, especially concerning liquidity risk, resolution regimes, OTC derivatives markets and shadow banking.

1. Liquidity standards

A central element of Basel III, complementing capital, is **liquidity**.

Before the crisis, many banks saw liquidity as a free good.

They did not imagine that entire markets could freeze up, nor did they anticipate an extended period of funding illiquidity.

Some banks became excessively reliant on short-term wholesale funding, which they used to fund long-term, illiquid assets.

When the crisis erupted, central banks were forced to step in and provide money markets and banks with unprecedented amounts of liquidity to help stabilise the system.

The crisis thus **exposed a number of deficiencies in banks' liquidity risk management and risk profiles**.

Basel III tries to address these deficiencies.

Central bank governors and heads of supervision approved a new global liquidity standard in September 2010.

The standard comprises two main elements: a liquidity coverage ratio, or LCR, and a net stable funding ratio, or NSFR.

The LCR is intended to address short-term shocks to liquidity.

The central principle is that a bank is expected to have a stable funding structure and a stock of high-quality liquid assets which should be

available to meet the liquidity needs that it might encounter under a stress scenario, such as a credit downgrade or loss of wholesale funding.

The NSFR targets stresses under a somewhat longer time frame.

It requires banks to maintain stable funding sources that match the liquidity profiles of its assets and its potential contingent liquidity needs.

Since this is the first time that detailed global liquidity rules have been formulated, we do not have the same experience and high-quality data as we do for capital.

There are a number of areas that require careful potential impact assessment as we implement these rules.

The Basel Committee has therefore agreed to take a gradual approach in adopting the standards between 2015 and 2018, and will meanwhile assess the impact during an observation period.

This may result in modifications to some of the liquidity standards, if the Committee's assessments yield compelling evidence and analysis to support them.

The observation period runs until mid-2013, but the Committee recently decided to accelerate its review, with a goal of completing the review by the end of this year, so that the Committee can make any adjustments well in advance of implementation.

This should give banks more time to adapt their balance sheets and business models to the new standards.

The liquidity standards are meant to ensure that banks have a stable funding structure and a stock of high-quality liquid assets that is available to meet their liquidity needs in times of stress.

At their meeting on 8 January, the group of governors and heads of supervision that oversees the Basel Committee confirmed that this liquidity buffer is there to be used. Specifically, banks will be required to meet the 100% LCR threshold in normal times.

During a period of stress, however, banks would be allowed under specific guidance to draw down their pools of liquid assets and temporarily fall below the minimum requirement.

The Committee will clarify its rules to state this explicitly, and will provide additional guidance on the circumstances that would justify use of the pool.

At the same meeting, the governors and heads of supervision reaffirmed their commitment to introducing the LCR as a minimum standard in 2015.

They supported the Basel Committee's proposed focus, course of action and timeline for finalising key aspects of the LCR.

The modifications currently being investigated are fairly minor, and address specific concerns about the pool of liquid assets and the calibration of net cash outflow.

They do not materially change the framework's underlying approach, which is mainly to induce banks to lengthen the term of their funding and to improve their risk profiles, instead of simply holding more liquid assets.

2. Strengthening resolution

As I've noted, another critical element of the global effort to address SIFIs is the strengthening of resolution frameworks.

The goal is to significantly reduce the possibility that authorities will find themselves forced to bail out institutions in order to prevent a disorderly wind-down of a failed firm.

By reducing the impact of failure, we also reduce the expectation of an official bailout, and thereby reduce moral hazard.

In general terms, a sound resolution regime needs to have a number of key elements.

There needs to be clear authority for the designated authorities to initiate the wind-down of a troubled institution.

There need to be mechanisms for coordination and information-sharing across agencies within a jurisdiction, as well as across borders.

There needs to be advanced planning, both for the immediate management of a crisis situation and for the longer process of winding down a closed entity.

There needs to be financing available to support the operations of an institution that is operating in legal bankruptcy, and to ease the transfer of viable operations to other firms.

And there need to be mechanisms for safeguarding the assets of depositors and other clients.

More specifically, last November the FSB set out Key Attributes of Effective Resolution Regimes for Financial Institutions.

These set out the responsibilities, instruments and powers for national resolution regimes that should apply to any financial institution that could be systemically significant or critical if it fails.

Among other things, jurisdictions should:

- Make sure that there is a **designated authority** with a broad range of powers to intervene and to resolve a financial institution that is no longer viable.
- **Remove impediments** to cross-border cooperation, including information-sharing. The solution should take account of financial stability impacts in all jurisdictions affected by a financial institution's failure.
- Put recovery and resolution plans, so-called "**living wills**", in place for all G-SIFIs, and review and update these regularly.
- Maintain **crisis management** groups for all G-SIFIs, including both home and host authorities.

Working out all elements of this framework in key jurisdictions will take time. Higher loss absorbency for SIFIs can in the meantime reduce our reliance on untested resolution regimes.

The FSB will initiate an iterative process of peer reviews of its member jurisdictions to assess implementation of the Key Attributes, which it plans to complete by the middle of 2013.

This assessment methodology would then be used on an ongoing basis by the IMF and World Bank in their Financial Sector Assessment Program work.

For the initial group of 29 G-SIFIs, FSB members have committed to meet the resolution planning requirements by end-2012 – including resolvability assessments, resolution plans and cross-border cooperation agreements.

This is a very tight schedule, but it is critical to make rapid progress on this work in order to convince the market that authorities are ready, willing and able to take the steps necessary to resolve a troubled financial institution, no matter how large.

3. OTC derivatives markets

A third critical item on the regulatory agenda is strengthening the infrastructure for derivative instruments, in particular those that are currently traded over the counter (OTC).

The way market infrastructures are designed and how they function have important implications for financial stability because they can either dampen or amplify disruptions.

Hence, proper design of these infrastructures can mitigate the risks arising from the interconnectedness of market participants and can reduce the risk of contagion.

Even before the financial crisis, striking weaknesses were revealed in the way that widely traded OTC derivatives, in particular credit default

swaps, were valued, collateralised, and managed in the post-trade phase. Many of these transactions were inadequately reported, and many of the bilateral exposures between counterparties were insufficiently collateralised.

Against this background, **authorities from around the world are pushing for a number of significant changes in the infrastructure for OTC derivatives.**

First, most standardised OTC derivatives will need to be traded on an exchange and cleared through a central counterparty, or CCP, instead of bilaterally.

A CCP interposes itself between the two original counterparties of a financial transaction.

Thus, it makes financial institutions less interconnected.

However, since risks become concentrated in the CCP, the CCP itself needs to be highly robust: it must protect itself against the default of one or more of its members.

International standard setters have been hard at work in developing safeguards for these important institutions, to ensure that they are well capitalised, that they are well supervised, and that they provide a level playing field for dealers and end users.

The Committee on Payment and Settlement Systems and the International Organization of Securities Commissions have developed standards for addressing risks related to systemically important financial infrastructures, including CCPs, and will release finalised standards in the coming months.

Second, OTC derivatives will need to be reported to a trade repository (TR), which is an electronic registry that keeps a record of all relevant details of an OTC derivative transaction over its lifetime.

If TRs had existed before the crisis, the build-up of huge derivative positions, such as those at AIG, would have been observed much earlier.

In January, international regulators published recommended standards for minimum requirements and formats for the data reported to the TRs.

They also put forth recommendations for aggregating these data, so that they can be used in spotting and responding to potential risks to financial stability.

And third, banking supervisors have developed rules to make sure that the risks of derivatives that are not centrally cleared are covered by an appropriate amount of capital.

This will help provide the right incentives to route trades through CCPs and organised trading platforms wherever feasible.

We need to ensure that progress is made towards the implementation of OTC derivatives market reforms.

In particular, the FSB will review the consistent and non-discriminatory implementation of various G20 commitments concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivative transactions to TRs.

We don't know yet whether we are moving towards a system characterised by a small number of clearing houses based in major financial centres that will clear a wide range of instruments, or a system where there is a larger number of interlinked national and regional platforms.

This is something that will evolve in line with the needs of dealers and end users, provided the minimum standards set by global regulators are satisfied.

But in any event, for any global system of derivatives platforms to be robust and resilient, a number of safeguards need to be in place.

There need to be multilateral arrangements for different national supervisors to cooperate, to exchange information, and to coordinate their oversight.

Arrangements for providing cross-border liquidity to CCPs need to be in place.

Resolution regimes need to cover CCPs so that, if needed, the failure of a CCP can be managed with limited impact on the broader financial system.

And, finally, market participants should be able to benefit from both direct and indirect access to CCPs on a fair and open basis.

Global regulators are looking carefully at these issues and aim to address them as the improvements to derivatives infrastructure are put in place.

4. Shadow banking

A fourth critical element of the reform agenda is to monitor and, where appropriate, address the risks that may come from the shadow banking system.

Last October, the FSB published a report on “Shadow Banking: Strengthening Oversight and Regulation”, which defines shadow banking as “credit intermediation involving entities and activities outside the regular banking system”.

The report offers a number of initial recommendations for strengthening regulation, and sets out a workplan on specific aspects of the shadow banking system that will involve parallel workstreams over the course of this year.

Shadow banking can perform valuable functions, including facilitating alternative sources of funding and liquidity and providing banks and investors with a range of vehicles for managing credit, liquidity and maturity risks.

However, as the financial crisis has shown, the shadow banking system can also contribute to systemic risk, both directly and through its interconnectedness with the regular banking system.

It can also create opportunities for arbitrage that might undermine stricter bank regulation and lead to a build-up of additional leverage and risks in the system.

Therefore, it is important to monitor the evolution of shadow banking.

Where called for, we should enhance the oversight and consider regulation of the shadow banking system in areas where systemic risk and regulatory arbitrage evidently pose risk.

At the international level, the FSB has set forth a two-pronged approach to addressing risks related to the shadow banking system.

The first element is a monitoring exercise.

Authorities have agreed to regularly exchange data and information on shadow banking activities in their jurisdictions.

The process starts at a broad level, using economy-wide data such as flow of funds statistics to identify elements of the financial system that lie outside traditional regulated sectors and seem to be large, or growing, in systemic importance.

Those aspects that raise specific concerns, such as regulatory arbitrage, leverage, maturity transformation or credit risk transfer, merit further attention and further analysis.

This more focused analysis would then be used to identify emerging aspects of the system that will benefit from prompt regulatory intervention.

The process is being overseen by the FSB's Standing Committee on Assessment of Vulnerabilities, which I chair.

Second, and complementing this, the FSB will conduct yearly supervisory exercises.

In addition the aim is to look at regulatory responses to specific aspects of the shadow banking system.

Workstreams have been set up in **five areas**:

1. How banks interact with shadow banking entities;
2. Regulatory reform of money market funds;
3. Regulation of securitisation;
4. The regulation of repo markets; and
5. Regulation of other shadow banking entities.

These groups are meeting regularly and are expected to report in the course of 2012.

The FSB and other international bodies will then respond appropriately.

Proactive oversight of the financial system

So, in my remarks so far today I have emphasised that, first, a lot has already been achieved, and now it's time to implement; second, we have put a transition period in place; and third, we need to complete the reform agenda and to finish the job.

But my fourth point is that regulation is not enough, and progress will need to be made in developing the institutions and processes that will ensure that the goals of the new regulatory framework are achieved consistently and effectively.

I'll make **two points**.

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First, countries are putting in place macroprudential oversight bodies and frameworks that will support and complement these essentially microprudential measures.

Basel III includes important macroprudential elements, for example the countercyclical capital buffer.

But discretionary measures may be needed at some point in time, and more work is needed in a number of areas to support these decisions, such as developing techniques to anticipate systemic risk and gathering the consistent global data needed to make proper assessments.

For example, we need accurate, up-to-the-minute assessments of market conditions to guide our decisions with regard to the strengthening of haircutting and margining practices in securities markets.

This means that the relevant authorities – including market regulators, prudential regulators, and central banks – need to be in constant communication with one another and need to work together to develop effective, consistent policies.

Indeed, the new macroprudential features of Basel III are already being complemented in many regions by the establishment of key institutions to monitor systemic risk.

In the EU, for instance, the European Systemic Risk Board has been set up as an independent body responsible for the macroprudential oversight of the financial system within the Union.

In the United States, the Financial Stability Oversight Council is in charge of comprehensive monitoring to ensure the stability of the US financial system.

Second, efforts to implement the new rules need to be supported by strong and enhanced supervision of individual banks.

Strong supervision is needed to ensure that banks operate with capital levels, liquidity buffers and risk management practices that are commensurate with the risks taken.

Supervision must also address the consequences of financial innovation or risks of regulatory arbitrage that regulation cannot fully capture and, more generally, it must address the firm-level consequences of emerging risks and economic developments.

National authorities must supervise in a more intensive and more intrusive fashion, especially for the largest and most complex banks.

It will also be important to reinforce both the firm-specific and macroprudential dimensions of supervision and the way they interact.

Conclusion

Some observers have suggested that, in the current global environment, regulatory reform should take a back seat to addressing more immediate concerns, such as sovereign risks, weak global growth and inflation risks.

In this view, banks are being asked to do too much, too soon.

On the contrary, I would suggest that the persistence of vulnerabilities and the uncertainty about further setbacks argue in favour of building strength now, so as to be prepared for further unexpected strains.

In other words, it's rather the case that too little has been done, and too late, to strengthen financial institutions at the global level since the start of this crisis.

Hence, instead of taking the maximum agreed time to achieve the minimum capital strength, where possible, authorities and banks ought to go faster and further.

A sound recovery requires a secure financial system. Businesses and households will not regain the confidence to plan, to invest and to innovate until they have been reassured that the financial system is not at risk of another crisis.

We need to be better able to provide support for longer-term financing.

Building a strong, resilient financial system is not just a task for the official sector.

I've outlined the large volume of work that has been accomplished, or is underway, in the international regulatory agenda.

But the private sector also has to contribute to reaching a new equilibrium in which the financial system is more resilient, can absorb shocks and avoids amplifying them.

This requires better risk management and governance and re-aligned incentive structures.

It also calls for a new approach to risk-taking which recognises existing uncertainties, limitations in our knowledge and the complexity of systemic risk.

It may, for example, require investors to accept a lower, although more stable, return on equity.

A more prudent approach towards risk is the best insurance policy against tail risks: **returns may be more modest and stable in good times, but in turmoil losses would be much smaller.**

Measures to strengthen the regulatory framework, complemented by a more prudent risk approach on the part of the private sector, are also important to Asia.

Looking past the current set of risks and vulnerabilities to the longer term, strong economic growth and rapid urbanisation are placing increased demands on the financial system throughout the region.

Financing is needed for building infrastructure, for investment and innovation by private businesses, and to support rapidly growing household consumption.

These needs call for the development of transparent, smoothly functioning capital markets, including securitisation structures, to complement the evolving role of banks.

Sound regulation, as part of a broader framework of macrofinancial policies, is essential in building a stable financial system that plays an effective role in supporting growth.

Completing the regulatory reform agenda and seeing to its implementation at the global level are critical tasks for authorities as we continue to recover from the crisis.

They are **part of the broader challenge** of providing a framework for macroeconomic stability, along with bringing debt back to sustainable levels and normalising monetary policy.

All three elements of policy – fiscal, monetary and prudential – will need to work together to deliver strong, sustainable global growth.

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Interesting news about the recapitalisation plans of the European Banking Authority (EBA)

The EBA's Board of Supervisors made a preliminary assessment of banks' capital plans submitted in response to the EBA's Recommendation on recapitalisation.

Their review highlights that, in aggregate, the shortfalls are expected to be met primarily through direct capital measures.

The measures are not viewed as having a negative impact on lending into the real economy.

The Board of Supervisors also agreed that, in the context of the ongoing recapitalisation exercise, [the EBA would undertake its next EU-wide stress test in 2013.](#)

The Board of Supervisors undertook a preliminary overview of the proposed measures highlighting the following:

The total actions give a capital surplus of approximately 26%, creating some leeway in case some actions do not materialise.

The actions predominantly focus on **direct capital measures which account for 96% of the capital shortfall and for 77% of the total amount of actions proposed.**

The majority of these are capital raising, retained earnings and conversion of hybrids to common equity.

Measures impacting risk-weighted assets (RWAs) account for the remaining 23% of total amount of actions.

After taking account of the measures arising from EU State Aid decisions on banks restructuring or other country programmes, the impact of actions reducing lending into the real economy would be less than 1% of the total amount.

Next steps

The Board of Supervisors has **not yet assessed the viability of the plans.**

In-depth analysis of these will be undertaken by National Authorities in close cooperation with the EBA and other relevant authorities in Colleges of supervisors.

The Supervisory Colleges of the banks concerned will, throughout February and beyond, ensure adequate consultation between home and host authorities on the plans and the impact in their jurisdictions.

The analysis will assess the credibility of measures such as forecasts of retained earnings, the effectiveness of the process for the approval of new advanced models and the reliability of assumptions underlying the planned disposal of assets and their geographical impact.

During this process, **capital plans may be challenged and in some cases revised.**

If earning forecasts, or other assumptions, look optimistic, back-up plans will be requested.

Capital relief for new models will be subject to scrutiny by consolidating supervisors and Colleges.

Banks should expect to receive clear guidance on their plans from National Authorities in early March after which the EBA's Board of Supervisors will continue to monitor the viability of the plans ahead of the June deadline.

All National Authorities signalled their commitment to comply with the Recommendation using their supervisory powers.

The EBA will liaise with the European Systemic Risk Board (ESRB) to ensure that due consideration is given to macro-prudential issues and to the aggregate impact on the real economy.

The EBA, with the support of the ESRB, will continue to monitor the need for the sovereign buffer.

Background

The EBA's Recommendation adopted by the Board of Supervisors on 8 December 2011 is part of a broader European package, agreed by the European Council on 26 October and confirmed during the ECOFIN Council on 30 November, to address the current situation in the EU by restoring stability and confidence in the markets.

The Recommendation calls on National Authorities to require banks included in the sample to strengthen their capital positions by building up an exceptional and temporary capital buffer against sovereign debt exposures to reflect market prices as at the end of September.

In addition, banks are required to establish an exceptional and temporary buffer such that the Core Tier 1 capital ratio reaches a level of 9% by the end of June 2012.

As required by the EBA's Recommendation, relevant banks submitted their capital plans by 20 January 2012 to their respective national supervisors.

The plans were discussed by the EBA's Board of Supervisors on 8 and 9 February 2012.

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Intra-group support measures

Intra-group support measures are very important, and can vary from institution to institution. They are **driven by regulatory, legal and tax environments** as well as the management style of the particular institution and the cross-border nature of the business.

We have a **great paper from the Joint Forum today**, and we must study it carefully.

To ensure that everybody can understand this paper, we will start from the ...

Glossary

Committed facilities (senior loans):

Are an extension of credit whereby the lender contracts to lend up to a specific sum under pre-defined terms and conditions.

Subordinated loans:

A type of loan that is **junior** to other debts should a company be wound up.

Typical providers of subordinated loans are **major shareholders or a parent company**.

A third-party providing funds through a subordinated loan would seek higher compensation (eg higher interest) relative to a senior loan due to the loan's subordinated status.

(A loan's status, whether subordinated, secured or unsecured, is spelled out in the contract between borrower and lender.)

Letter of credit:

A legal commitment issued by a bank or other entity stating that, upon receipt of certain documents, the bank will pay against drafts meeting the terms of the letter of credit.

Letters of credit are frequently used for **risk financing** purposes to collateralize monies owed by an insured under various cash flow programs such as: incurred but not paid losses in paid loss retrospective rating programs, a means of meeting the capitalization requirements of captives, and to satisfy the security requirements of the excess insurer in "fronted" deductible or retention programs.

For captives, letters of credit serve two possible purposes: they may be used in lieu of or in addition to cash or other securities as capital, and /or to securitise the fronting insurer's reinsurance receivable created by a non-admitted reinsurer.

Letter of comfort:

A letter issued to a lending institution by a parent company acknowledging the approval of a subsidiary company's attempt for financing.

The 'letter of comfort' in no way guarantees the loan of the subsidiary company.

It merely gives reassurance to the lender that the parent company is aware and approves of the situation.

Declaration of backing:

Unrestricted letter of comfort.

With a declaration of backing the issuer ensures (with only certain specific exception, eg in the case of political risk) that selected group entities are able to meet their contractual liabilities.

If this should not be the case, the receiver of this declaration (typically a lender to one of the selected group entities) can sue the issuer for damages.

Profit transfer agreement:

In a profit transfer agreement, one company agrees to transfer its profits to another company.

This type of contract is used in Germany.

The profit transfer agreement is used to consolidate profits between companies.

The controlling company in this arrangement is the one that receives the profits of the controlled company.

Under the rules of the agreement, the controlled company must act and operate in the best interests of the controlling company.

The arrangement is essentially that of a parent company and subsidiary.

However, if the controlled company suffers losses, the controlling company is obliged to provide it compensation for its losses.

Guarantee:

Non-cancellable indemnity bond that guarantees timely payment of interest and repayment of principal to the buyers (holders) of a debt security.

Equity injections:

The provision of cash by one entity to a second entity in the form of equity capital (ie permanent capital with no legal obligation of capital return or fixed payment) of the second entity.

Bond swaps:

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A strategy in which an investor sells a bond and simultaneously purchases a different bond with the proceeds of sale.

There are several reasons why entities use a bond swap: for tax benefits, to alter investment exposures (eg to upgrade a portfolio's credit quality or speculate on the performance of a particular bond).

Bond/security lending agreements:

An agreement between entities (eg parent and subsidiary) according to which the parent can borrow securities on the balance sheet of the subsidiary in order to improve the liquidity position of the parent.

The Joint Forum

Report on intra-group support measures

February 2012

Executive summary

The objective of this report prepared by the Joint Forum is to assist national supervisors in gaining a better understanding of the **use of intra-group support measures** in times of stress or unexpected loss by financial groups across the banking, insurance and securities sectors.

The report provides an important overview of the use of intra-group support at a time when authorities are increasingly focused on ways to ensure banks and other financial entities can be wound down in an orderly manner **during periods of distress**.

The report may also assist the thematic work contemplated by the Financial Stability Board (FSB) on deposit insurance schemes and feed into the ongoing policy development in relation to recovery and resolution plans.

The report is based on the findings of a high-level stock-take which examined the use of intra-group support measures available to banks, insurers and securities firms.

The stocktake was conducted through a survey by the **Joint Forum Working Group on Risk Assessment and Capital (JFRAC)** that was completed by 31 financial institutions headquartered in ten jurisdictions on three continents: Europe, North America and Asia.

Participants were drawn from the banking, insurance and securities sectors and from many of the jurisdictions represented by Joint Forum members.

Many participating firms were large global financial institutions.

The report provides an overview and analysis of the types and frequency of intra-group support measures used in practice.

It is based only on information provided by participants in the survey.

Responses were verified by supervisors only in certain instances.

The survey's main findings are as follows:

1. Intra-group support measures can **vary** from institution to institution, driven by the regulatory, legal and tax environment; the management style of the particular institution; and the cross-border nature of the business.

Authorities should be mindful of the **complicating effect of these measures on resolution regimes** and the recovery process in the event of failure.

2. The majority of respondents surveyed indicated **centralised capital and liquidity management systems were in place**.

According to proponents, this approach promotes the efficient management of a group's overall capital level and helps maximise liquidity while reducing the cost of funds.

However, the respondents that favoured a “self-sufficiency” approach pointed out that centralised management potentially has the effect of increasing contagion risk within a group in the event of distress at any subsidiaries.

The use of these systems impacts the nature and design of intra-group support measures with some firms indicating that the way they managed capital and liquidity within the group was a key driver in their decisions about the intra-group transactions and support measures they used.

3. Committed facilities, subordinated loans and guarantees were the most widely used measures.

This was evident across all sectors and participating jurisdictions.

4. Internal support measures generally were provided on a one-way basis (eg downstream from a parent to a subsidiary).

Loans and borrowings, however, were provided in some groups on a reciprocal basis.

As groups surveyed generally operated across borders, most indicated support measures were provided both domestically and internationally.

Support measures were also in place between both regulated and unregulated entities and between entities in different sectors.

5. The study found no evidence of intra-group support measures either

- a) being implemented on anything other than an arm's length basis, or

b) resulting in the inappropriate transfer of capital, income or assets from regulated entities or in a way which generated capital resources within a group.

However, this does **not necessarily mean that supervisory scrutiny of intra-group support measures is unwarranted.**

As this report is based on industry responses, further in-depth analysis by national supervisors may provide a more complete picture of the risks potentially posed by intra-group support measures.

6. While the **existing regulatory frameworks for intra-group support measures are somewhat limited**, firms do have certain **internal policies and procedures to manage and restrict internal transactions.**

Respondents pointed out that the regulatory and legal framework can make it difficult for some forms of intra-group support to come into force while supervisors aim to ensure that both regulated entities and stakeholders are protected from risks arising from the use of support measures.

For instance, upstream transfers of liquidity and capital are monitored and large exposure rules can limit the extent of intra-group interaction for risk control purposes.

Jurisdictional differences in regulatory settings can also pose a challenge for firms operating across borders.

7. Based on the survey and independent of **remaining concerns and information gaps**, single sector supervisors should be aware of the risks that intra-group support measures may pose and should fully understand the measures used by an institution, including its motivations for using certain measures over others.

In order to obtain further insight into the intra-group support measures put in place by financial institutions within their jurisdiction, national supervisors should, where appropriate, conduct further analysis in this area.

Scope

Financial groups which encountered problems or which failed between 2007 and 2009 during the financial crisis typically had to consider the question of whether to support a subsidiary or related entity.

Although these decisions largely hinge on the potential damage to franchise and reputation, the starting point for making such decisions is based on intra-group contractual and legal obligations.

The level of intra-group support and interconnectedness of legal entities within the group affects the extent to which the failure of one entity poses contagion risk for other entities within the group.

It is also these contractual obligations which determine the losses ultimately suffered by creditors of each entity in the group.

As noted earlier, the objective of the Joint Forum is to assist members of its parent committees and the FSB in further understanding the types and purposes of intra-group support within financial groups.

This international and cross-sector stock-taking permits comparisons of industry approaches across jurisdictions and sectors.

Definition of “intra-group support measures”

Intra-group support consists of various types of support measures, in particular capital and liquidity support measures, extended between entities within a group in times of stress or unexpected loss.

For the purpose of this study, intra-group support measures are

- **legally enforceable commitments** for financial assistance or assurance made by one group entity (usually a parent) upon which another group entity (usually a subsidiary) can call in times of stress or unexpected loss; or
- **commitments which regulators would regard as reliable means of support.**

These measures typically increase the risk of loss to the provider when called upon by a beneficiary that subsequently fails.

Support measures can vary between jurisdictions due to differing regulatory, legal or tax regimes.

Support measures can stem either from contractual agreements or as a matter of law or regulation.

They can take the form of ongoing or contingent support, secured or unsecured, within national boundaries or cross-border.

These intra-group support measures may exist between regulated entities or between regulated and unregulated entities and can take place on a cross-sectoral basis.

The direction of support may also vary in relation to the hierarchy of the group's legal control structure.

Support provided by a subsidiary to its parent is referred to as "upstream" support whereas support provided by a parent to its subsidiary is referred to as "downstream" support.

Differing regulations related to intra-group support measures and the varying types of contractual agreements determined by specific market

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practices and/or business models have resulted in a broad range of intra-group support measures across financial groups.

Concerns relating to intra-group support

The importance and variety of intra-group support measures within financial groups has increased the supervisory challenges of ensuring that regulated entities and their stakeholders are protected from risks arising from the use of such support measures.

In general, supervisory concerns arise when intra-group support measures:

- result in capital, income or assets being inappropriately transferred from the regulated entity, or result in intra-group creation of capital resources (ie double or multiple gearing);
- are used as a substitute for financial resources (eg using a guarantee or loan rather than capital held at the subsidiary);
- are implemented on terms or under circumstances which third parties would not accept;
- adversely affect the solvency, liquidity and profitability of individual entities within a group;
- result in contagion risk, thereby precipitating knock-on effects on financially sound entities when one entity within the group experiences stress;
- complicate group structures and therefore obscure the supervisor's view of the group and/or legal entities that operate within their jurisdictions, thus affecting both the ability to supervise on an ongoing basis, and resolution and recoverability; and

- are used as a means of regulatory arbitrage to evade capital or other regulatory requirements altogether.

There may however be positive aspects to intra-group support measures as they can provide financial resilience and create a stabilising effect on the wider group.

Intra-group exposures/transactions

Intra-group exposures/transactions take the form of an often complex netting of direct and indirect claims which entities within financial groups typically hold on each other.

The most transparent form of intra-group exposure is a credit or a line of credit which either the parent grants to a subsidiary or one subsidiary makes available to another subsidiary.

Intra-group exposures, however, can originate in a variety of other ways: for example through

- (a) intragroup cross shareholdings;
- (b) trading operations whereby one group entity deals with or on behalf of another group entity;
- (c) central management of short term liquidity within the group and
- (d) guarantees and commitments provided to or received from other companies in the group.

For the purposes of this report, intra-group support measures should be considered a subset of intra-group exposures/transactions.

Wider intra-group exposures/transactions relating to “business as usual” activities are not considered to be intra-group support measures.

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Instead this paper focuses on intra-group support measures that are put in place in times of stress or unexpected losses.

Wider intra-group exposures/transactions not captured by this narrower definition of intragroup support may be put in place for the following reasons:

- to promote the development of group business activities (eg facilitate acquisitions, integration of acquired business, distribution arrangements, internal restructurings, sales or other disposals of assets or businesses or similar transactions);
- to enable the group to operate on an integrated basis across different legal entities, some of which may not be in the same jurisdictions;
- to support entity credit ratings in a group (eg parental support of an entity in order to obtain the same credit rating as the parent entity) and therefore ensuring competitive financing terms for entities of the group;
- to promote efficient use and fungibility of the group's capital resources across the different legal entities; and
- to manage and provide liquidity and capital resources across the group.

Notwithstanding their economic and commercial benefits, both intra-group exposures/transactions and support measures have the potential to adversely affect the solvency, liquidity and profitability of individual entities within a group.

They can impede effective supervision and resolution efforts, and increase contagion risk across the group.

Gathering information on existing “business as usual” intra-group exposures/transactions was not an objective of this study.

However, it should be noted that making a clear separation between intra-group exposures/transactions and intra-group support measures was not always possible in practice.

For this reason, “business as usual” intra-group exposures/transactions were considered to the extent that they might change materially or be extended in times of stress or unexpected loss (thus becoming forms of “intra-group support” as defined for this study).

Table of participating firms

The following table shows the sector and continent (Europe, North America and/or Asia) of origin of the 31 financial groups from ten countries which participated in the survey.

Both for confidentiality reasons and because many responses provided by firms were high-level rather than detailed, firm names and firm-specific responses to the questionnaire have not been included.

Anonymous and summary extracts and themes have instead been provided.

	Banking	Insurance	Securities	Cross Sectoral
Home Jurisdiction	Europe North America Asia	Europe North America Asia	Europe North America Asia	Europe North America

Key findings

Responses illustrated a varying understanding of the term “intra-group support” as certain firms provided information on “intra-group exposures” more generally rather than on intragroup support-measures.

Information on intra-group exposures can provide insight into the interconnectedness of financial groups, shedding light on avenues for contagion and on the group’s ability to stand as an integrated single entity against adverse conditions.

However, this can complicate the distinction between what is “business as usual” and what is extraordinary support in times of stress.

A measure can be part of normal business practices, but can also become a support measure in a financial crisis (eg the extension of a credit line). As such, intra-group exposures that are likely to become a support measure in times of stress were given consideration.

The survey found that the measures used varied from institution to institution.

Three institutions stated that intra-group support measures represent a very small portion of total intra-group exposures.

Another group expressly stated that they do not have any prearranged support mechanisms in place, but decide on a case-by-case basis if and how they can support a group entity in times of stress.

They pointed out that this is a crucial part of the management function and they choose mainly between guarantees, loans and equity injections.

A key factor to consider when assessing the interconnectedness of group entities is whether the groups manage capital and liquidity on a

centralised basis or whether each entity manages in a self-sufficient or self-contained manner.

The model chosen impacts the nature and design of intra-group support measures.

Certain firms stated that the management of group-wide capital and liquidity was a key driver of intra-group transactions and support measures.

The most common support measures used by groups were committed facilities (senior loans), subordinated loans and guarantees.

Insurance groups and conglomerates use internal group reinsurance, however, due to the nature of reinsurance, it was not considered a support measure for the purposes of this study as it is generally called upon only when certain events specified in the contract materialise and generally not when other stressful events occur.

Internal support measures generally were found to be provided on a one-way basis (eg downstream from a parent to a subsidiary).

Loans and borrowings, however, were found in some groups on a reciprocal basis.

The groups included within the survey generally operate across borders and, as such, stated that their support measures were provided domestically as well as internationally.

Support measures also take place between regulated and unregulated entities.

Of the groups which had activities both in the banking and insurance sectors, three out of five respondents indicated that intra-group support occurred on a cross-sectoral basis.

The following sections set out

- a description of, including **advantages and disadvantages** of, centralised and decentralised capital and liquidity management as explained by firms - an important driver for engaging in intra-group support in times of stress;
- the **nature and frequency of the specific types of intra-group support** measures commonly used by respondent firms including the rationale that firms put forward in relation to the advantages/disadvantages of different types of intra-group support measures;
- respondents' views on the restrictions and regulatory requirements which apply to intra-group support measures.

2. Centralised and decentralised capital and liquidity management

(a) Centralised capital management

Seventeen of 25 respondents addressing this issue stated that they centralise their capital management.

Respondents commented on the centralised capital management arrangements they used and their advantages:

- Respondents confirmed that active **centralised capital management increases the efficiency of a group's overall capital management**.

A group's available financial resources can be managed to cover the capital requirements determined both by the internal risk model and by the requirements of supervisory authorities and rating agencies on a consolidated basis.

- One respondent stated that it **used centralised capital management at a regional level.**

That is, centralised capital management is taking place not at the parent level but on regional level covering all the group entities (branches and subsidiaries) that are located in that region.

- One respondent stated that it **operates in such a way that its various businesses operate on a standalone basis and therefore need fewer intra-group support measures than would be expected for a similar group.**

Notwithstanding this, its group aims to maintain excess capital centrally in order to allow maximum flexibility and to deliver on its long term strategy.

- One respondent advised that they manage capital on a group basis whereby capital is raised at the parent holding company and then injected as required into subsidiary entities.

The firm stated that any excess capital generated by a subsidiary is **repatriated by the parent holding company** unless local tax or regulatory capital requirements justify retaining it.

Capital re-allocation from the group parent to subsidiaries is then governed by a “group application” process with a goal of optimising the use of capital across the group.

- One respondent noted that it **manages its material subsidiaries on an “arm’s length basis”** whereby each subsidiary is required to manage its own capital (and liquidity) resources without reliance on other group entities except where support is explicitly approved.

The firm stated that the group’s core capital is allocated to subsidiaries in line with their local regulatory capital requirements

and subsidiaries are then required to generate an appropriate return on these resources.

- One respondent stated that it **manages capital centrally at its corporate treasury under a framework of internal governance rules**.

The firm noted that their treasury department sets domestic and international legal entity risk-based capital and solvency targets in line with regulatory and competitive business requirements.

Capital plans are aligned to targets and monitored and updated throughout the year. Excess capital is directed to the holding company and managed centrally.

- One respondent noted that the objectives of their capital management process ensure that the group optimises capital whilst **minimising tax** through governance and control of external and internal capital movements (eg between subsidiaries).

Some respondents noted disadvantages to centralised capital management including the potential for a deterioration of the capital/funding position of a subsidiary to have contagion effects across the group.

(b) Centralised liquidity management (cash pooling)

In general, many of the respondents that had centralised capital management in place also used centralised liquidity management.

- Two respondents who used centralised capital management also stated that the group's liquidity was managed country by country.
- One of these firms explained that its group treasury function determines the policies, processes, controls, systems and reporting requirements for each country treasury which then is responsible for

applying those controls across the activities of all business units in their respective country.

- Another respondent stated that its group pooling activities take place only in certain legal entities.

One group stated each currency is managed in one geographic competency centre for the entire group (eg the dollar is managed from New York, Sterling and the Euro from Brussels, etc) with consolidated monitoring of all currencies by the treasury at group level.

These firms did not however provide further information as to why their capital and liquidity was not managed on the same basis.

- One respondent stated that it runs a centralised liquidity stress modelling process as well as a separate legal entity stress modelling process when required by host country regulators.

This group maintains a combination of substantial pools of liquidity held in various areas (in various entities, eg broker dealers).

These pools are held on an as-needed basis (entity by entity) or as required by local law/regulation.

This group stated that it is unable to allocate liquidity cross sectors from a bank to a non-bank affiliate as regulatory guidelines generally prohibit support across sectors.

- Another respondent noted that it maintains an excess pool of liquidity sufficient to meet requirements in both a normal environment and a modelled stress environment.

Potential outflows in a stressed environment are determined through an internal stress analysis.

The group's excess liquidity is held at the group level as well as at the level of major operating entities which also maintain their own pools. Corporate Treasury manages the funds centrally.

For subsidiaries with no legal, regulatory, tax or other restrictions, the group employs a central cash management framework it receiving and distributing cash to entities as required.

With certain exceptions, most loans to affiliates have open/overnight maturities in order to allow for maximum flexibility.

Respondents using centralised liquidity management outlined their cash management objectives as **maximising liquidity while minimising the cost of funds**.

One respondent noted that the objective of its liquidity management is to meet the group's commitments as they fall due whilst maintaining market confidence in the firm.

Respondents stated that central liquidity management enabled their groups to prepare for and mitigate various risks to the group's liquidity position.

They noted that this ensured sufficiently high liquid assets at all times in the event of potential liquidity outflows under both normal and stress conditions, including acute stress conditions (eg in the case of a potential downgrade of the credit rating at the parent or local level).

Certain respondents also explained that cash pooling is important because it can reduce consolidated leverage.

It can also reduce the need for third-party placements at the subsidiary level (and the credit risk attached) because the highest rated entity in the group, the parent company, is best positioned to access the most

cost-effective funding, provide a single face to the market and effectively manage the relationships with rating agencies and institutional investors.

Unlike many of the subsidiaries, the parent also has fewer restrictions on both lending and recouping funding to and from subsidiaries.

One respondent stated that centralised liquidity management had been particularly beneficial to them during the 2007-2009 financial crisis, as it limited their potential exposure to banks that ultimately failed.

Another respondent pointed out that in many cases there is an economic trade-off between intra-group support measures (eg guarantees) and intra-group funding in the normal course of business.

A decision to reduce centralised funding requires higher amounts of funding to be obtained by subsidiaries in their local markets.

In order to do so economically, subsidiaries have a greater incentive to use the stronger name of the parent through a parental guarantee.

(c) Decentralised capital and liquidity management (“subsidiary self-sufficiency”)

In contrast, ten of 25 respondents that addressed this issue stated they did not operate on a centralised basis, but rather relied on decentralised management - an operating mode premised on the self-sufficiency of subsidiaries within a group.

Two respondents explained that they demand that individual subsidiaries try to obtain resources (eg capital and funding) themselves from their own markets, rather than using centralised resources.

Even though this strategy implies an increase in cost, according to these groups, it provides better diversification and clear liability pricing (ie cost pricing).

One respondent noted that although their group core capital (ie equity) is allocated to subsidiaries, this could be supplemented by locally issued Tier 2 capital (ie debt).

Respondents suggested that soundness of capital and liability pricing at the subsidiary level is critical and that groups operating without it cannot truly understand their cost of resources, making them susceptible to less rational group capital allocation decisions over time.

Furthermore, centralisation can result in subsidiaries becoming too dependent on their group parents for other functions (eg risk management and strategic decisions).

Domestic risk models translate the group's risk expertise into a local implementation of risk assessment strategies.

A key advantage noted by respondents operating self-sufficient subsidiaries was that they allow for easier separation from the rest of the group - for example, in terms of the sale of any particular unit for commercial gain or in situations when it is necessary to isolate an entity during a crisis to limit contagion to the rest of the group.

One respondent from the insurance sector explained that they do not manage liquidity centrally.

Various insurance subsidiaries in the group write different product mixes in different jurisdictions, resulting in claim patterns that can vary locally.

Liquidity needs can therefore vary with local conditions.

However, there is central control over what investments a subsidiary is permitted to make, and local subsidiaries have access to crisis capital from the parent.

Specific types of intra-group support measures

The following table provides an overview of the different intra-group support measures used by respondents grouped by financial sector.

It should again be noted that a number of these measures, although used for business as usual purposes, are also available for and would be used in periods of stress.

Support measure	Banking groups Total :11	Insurance groups Total :11	Securities groups Total :4	Cross Sectoral groups Total :5
Committed facilities (senior loans)	8	7	3	4
Subordinated loans	9	8	3	3
Letter of credit	0	4	0	0
Guarantee	9	9	4	5
Equity injection	4	4	1	1
Bond swaps	0	0	0	1
Bond lending / repo agreement	0	2	0	2
Letter of comfort	6	6	4	3
Declaration of backing	1	0	1	0

(a) Committed facilities (senior loans)

Of the 26 respondents that addressed this issue, 22 (covering all participating jurisdictions and all sectors) stated that they use committed facilities to supplement liquidity management.

According to one respondent the primary rationale for the funding arrangements is to provide working capital financing in support of business activities.

One respondent mentioned that an advantage of committed facilities/senior loans is that they generally require only simple documentation and can be arranged quickly.

Another respondent notes that it views loan facilities as an efficient method of transferring funds among legal entities in a manner that is flexible in terms of both extensions and repayments.

Subordinated loans and capital are slower and more difficult to execute and repay, resulting in reduced flexibility/speed of repayment.

Certain respondents also noted disadvantages of committed facilities, specifically that they commit the liquidity of the parent.

One respondent stated that credit facilities to subsidiaries are often required by local regulators (for example in the UK and Ireland) to obtain waivers for local liquidity regulation.

One respondent stated that most of its subsidiary loans were provided by the parent entity on an unsecured basis and were to subsidiaries located in another jurisdiction.

It also noted that its committed funding lines were provided to subsidiaries due to the request of host regulatory authorities in order to demonstrate the funding resilience of the group in stress tests.

One European respondent from the insurance sector noted that in the majority of cases loans from the subsidiary to the parent were used as a form of capital support.

The stated rationale for using loans was to assist with group cash flow management.

It noted that this is an advantage for the group as a whole.

It also explained that in terms of intra-group management, these loans are agreed to on a quarterly basis and any increase in intra-group lending is subject to board agreement.

Another respondent (also an insurance group) stated that loans obtained by the unregulated holding company or other subsidiaries are in turn used by these entities to provide capital to operating insurance companies.

One respondent stated that in the normal course, the holding company provides senior loans to its subsidiaries for funding purposes.

These are mainly revolving lines of credit which may be amended by the holding company.

The group's banking entity provides senior lines of credit to its subsidiaries and its sister banks.

In addition, selected senior loans exist between affiliates.

However, any arrangement between a banking entity and a non-bank affiliate has to be collateralised in accordance with regulatory requirements.

(b) Subordinated loans

Twenty-three of the 28 respondents which addressed this issue, covering almost all participating jurisdictions, stated they use subordinated loans as a means of providing intragroup support.

The groups that use subordinated loans use them to provide capital support for funding organic growth and acquisitions, and explained that these represent an alternative to equity capital due to their tax efficiency and non-dilutive nature.

One respondent explained that it uses subordinated loans to meet regulatory capital or liquidity requirements of group subsidiaries as needed.

Respondents also cited disadvantages of subordinated loans, specifically, that they are of lower capital quality – ie their utility is limited from a capital requirements perspective as they are subject to regulatory limits and internal guidelines.

(c) Letters of credit

Four respondents stated that they use letters of credit. Two European respondents from the insurance sector stated that they use letters of credits for capital support purposes (specifically to meet US regulatory requirements), as they are a more efficient and cost effective alternative to paid-up capital.

Letters of credit are necessary in certain jurisdictions to obtain regulatory approval for internal reinsurance agreements.

One insurance group explained that letters of credit are primarily used as source of capital to support variable annuity reserves and finance redundant life insurance reserves, and serve to satisfy the requirement that the assuming reinsurer post collateral to support its reinsurance obligations.

Another insurance group explained that they used letters of credits for the capital support of a Bermuda-based subsidiary.

(d) Guarantees

Twenty-seven of the 31 respondents use guarantees.

Several stated that the main motivation for the use of guarantees is capital relief for rating agency capital measurement purposes.

In certain instances, guarantees are issued because the beneficiary subsidiary does not have its own credit rating and therefore the guarantee provides the subsidiary with the rating of its parent.

Respondents also noted that the use of guarantees reduces the necessity for a parent to provide a subsidiary with liquidity as a subsidiary is better able to source funds independently at cost-effective levels.

Another respondent explained that guarantees can be used to meet certain customer and third-party requirements with respect to an affiliate (eg to meet industry guidelines, central counterparty or regulatory requirements).

Another respondent also confirmed that guarantees are typically used when the parent provides a guarantee of subsidiary obligations to a third party (or guarantees funding obligations issued by that subsidiary).

According to that respondent they most typically relate to International Swaps and Derivatives Association (ISDA) transactions (some are non-ISDA), involving commodities/repos or prime brokerage agreements in the global market space.

One insurance group stated that it used a parental guarantee, to a third party in respect of the beneficiary entity's obligations to that third party, to be called upon should the entity fail to meet its reinsurance targets.

This parental guarantee was subject to monitoring by the group's audit committee and board on an annual basis.

Other respondents stated that guarantees are often used to market an entity's financial strength in pursuit of market opportunities or for debt

issuance purposes including securitisation issuance, and are also provided to securitisation vehicles (SPVs, conduits).

One respondent explained commercial paper can be issued by the subsidiary and guaranteed by the parent bank.

However, according to the firm, these guarantees do not necessarily represent an additional economic risk at the parent as proceeds from issuing debt at a subsidiary are often up-streamed to the parent entity.

One respondent noted that guarantees are also required by certain central banks (ie Primary Dealer Requirement), clearing houses, and by certain major clients.

Another group, however, stated that it is not aware of any instances where guarantees are posted strictly due to a central bank requirement.

This particular group does provide a blanket guarantee for substantially all of its subsidiaries (some of which may deal with central banks); however, the guarantee is not driven by a central bank requirement.

One respondent stated that unlimited guarantees to foreign subsidiaries often have to be issued by the parent in order to obtain the approval of foreign supervisors.

Another respondent noted that a number of unlimited guarantees were provided in the past - with the nature of these liabilities fully disclosed to its home regulator but where in the future no unlimited guarantee would be provided without first discussing it with the regulator.

It was not clear however if this was as a result of regulatory requirements or if the regulator had requested this on a firm-specific basis.

Most guarantees, however, were provided on a limited basis with certain of them secured against collateral received from the beneficiary entity.

One respondent claimed that a disadvantage of using guarantees is that there is no regulatory capital relief.

One insurance group cited a further disadvantage of guarantees: that they reduce Solvency 1 excess capital in extreme situations.

(e) Equity injections

Ten of the 31 respondents cited equity injections as a possible intra-group support measure (as stated above, a number of groups operate on a centralised capital management basis and it would seem reasonable to assume that equity injections are important to their capital management strategy).

According to one respondent, the main advantage of equity capital is the permanence of the funds and the improvement in the leverage ratio.

Respondents cited that the key disadvantages of equity injections are that they permanently drain resources from the holding company and they are legally complex to arrange.

Also, for the subsidiary, equity carries a higher cost relative to debt and is more dilutive.

(f) Bond swaps

One financial conglomerate stated that it uses bond swaps where an insurance entity swaps part of its liquid asset portfolio in return for a lower quality asset from a bank's balance sheet.

This improves the liquidity position of the banking entity and reduces the liquidity of the insurer, presumably in return for the insurance entity receiving a higher yield.

(g) Bond lending agreements / Repo agreements

Similarly, two respondents used bond lending agreements between subsidiaries and the parent where the parent borrows the securities from the balance sheet of the subsidiary in order to improve the liquidity position of the parent.

One respondent stated they have a repurchase agreement in place as a form of liquidity support. Another respondent stated that on occasion, repos are used between group legal entities providing financing on a portfolio of segregated collateral.

According to the group, repos are used to provide funding for select portfolios of affiliates and to allow for investment of excess funds by the lending entity.

(h) Letters of comfort / Declarations of backing / Letters of support

Nineteen of the 31 respondents (drawn from all sectors and participating jurisdictions) stated that they use letters of comfort while two respondents also use declarations of backing.

However, four of the respondents stated that they use letters of comforts very rarely.

Given that a letter of comfort is not a legally binding financial contract, it is not considered to be an intra-group support measure for the purposes of this paper, however, due to its prevalence it was deemed useful to include in our findings.

According to one respondent, a commonly used letter of comfort states that the parent of the subsidiary, for a certain period of time or as long as the parent is the major shareholder of the subsidiary:

- shall exercise its right as major shareholder in such manner as to support the company in accordance with the principles of sound business practice; and
- shall do everything in its power to ensure that the company is properly managed in accordance with prudent financial policies.

Respondents explained that a letter of comfort is not a legally binding financial contract with a third party but rather is an assurance that the parent will do its best to ensure that the subsidiary is properly managed.

Only in cases where the parent does not meet the above commitments can one claim for damages therefore, if the subsidiary is properly managed and the above criteria are met, the recipient of the letter of comfort has no claim on the parent company.

Another respondent stated that a letter of comfort is sometimes provided in order to assure that the subsidiary will be maintained as a going-concern from a solvency perspective.

Two groups stated that their preference is to avoid giving any form of parental support or guarantees, but where necessary would provide a letter of comfort to support an economically viable business.

For one group in question, all letters of comfort were provided on an unlimited basis to (mainly foreign) subsidiaries from the parent entity.

One insurance group noted that certain of its letters of support were provided as a form of guarantee to third parties in respect of the other group entity's obligations, whereas others were provided as contingent support in order to meet an adequate level of capital under host jurisdictions' regulatory requirements.

For this group in question the letters of support were provided by the parent (an unregulated holding company) to its subsidiaries (regulated

insurance companies), and some were provided on a cross-border basis.

For this group, all of its letters of support were provided on an unlimited basis.

According to respondents that use declarations of backing, the issuer provides that selected group entities will be able to meet their contractual liabilities at all times.

If this ceases to be the case, the receiver of this declaration can sue the provider for damages.

Contrary to letters of comfort, a declaration of backing is legally binding and therefore an intra-group support measure in line with our definition.

I have to confess: I like securitization very much. It converts illiquid assets into liquid instruments, and it can reduce regulatory capital dramatically (if we know how to do it, and it is perfectly legal).

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No, I do not like the way some used securitization before the market crisis, and I hate NPLs (non-paper loans), poor credit underwriting and all the fraud around it. But, as a category of structured products, securitization is so smart!

Today we will see where we are. We will read the remarks by **John Walsh, Acting Comptroller of the Currency**, before the American Securitization Forum (Annual Conference January 24, 2012)

Thank you. It's a pleasure to be here with you today, and to have this opportunity to speak to a group that represents such a broad range of participants in the securitization business.

Securitization is sometimes maligned and frequently misunderstood, and its importance to our nation's economy is often **not fully appreciated**.

Whether in mortgages, credit cards, auto finance, or student loans, meeting the needs of American consumers depends heavily on securitization.

It is hard to imagine full recovery of the financial system **without the liquidity and funding** avenues provided by a well-functioning securitization market.

Certainly, it is **hard to foresee a strong recovery for the housing industry without securitization**.

And it seems unlikely we will experience strong and sustained economic growth without a rebound in the housing sector.

Unfortunately, the fragile state of securitization is a result, in part, of its role in the financial crisis.

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While the principal trigger of the crisis was poor credit underwriting, particularly of subprime mortgages, securitization of those mortgages fueled the surge in bad lending by transferring risk from the originator of the loan to other investors.

The tranching of pooled instruments into different investment classes offered a means of matching risk and risk appetite, promoting the depth and liquidity of markets, but many of these financial structures did not withstand the stress of a market meltdown.

Structured finance and the credit ratings on which it was based were discredited, and securitization itself came to be seen as a significant cause of the crisis in the financial markets.

Clearly, a range of abuses triggered and sustained the crisis, and the **Dodd-Frank Act took a number of steps to deal with them**.

And when I say a “number of steps,” believe me, I know all too well just how many steps there actually are.

Since the day that Dodd-Frank was signed into law, we at the OCC and our colleagues at the other financial regulatory agencies have been devoting an enormous amount of time to implementing the law.

Some of the provisions of Dodd-Frank were aimed at early identification of risks with potentially systemic consequences, and at heightened supervision and orderly resolution of systemically significant firms, particularly those outside the safety net like **AIG, Bear Stearns, or Lehman Brothers**.

Creation of the **Financial Stability Oversight Council, or FSOC**; heightened supervisory standards for firms of systemic consequence; and FDIC orderly resolution authority are the responses to these challenges.

Other provisions were directed at perceived sources of risk that were implicated in the crisis, and would change the way certain businesses are conducted inside banking entities and other financial institutions.

The risk retention rule, the **Volcker rule**, limits on use of credit ratings, and derivatives regulation all fall into this category, and have proven more controversial.

The problems the Dodd-Frank Act tackled are very real, but the new law came at them from many directions.

Risk can be mitigated through activity limits or prohibitions, through increases in capital and liquidity requirements, through new standards for underwriting or product offerings, through enhanced supervision and controls on risk taking and leverage, and through enhanced transparency and disclosure.

Dodd-Frank does some of all of these things, in the process making very significant changes in the way business is done by financial institutions.

There are so many moving parts that it is very hard to judge how these many approaches will interact, or what their cumulative effect will be.

In our rulemaking, the goal of the agencies must be to **strike a balance** that meets the objectives of Dodd-Frank, while enabling financial firms to continue conducting business in a manner that is safe, sound, and profitable; ensuring appropriate monitoring and management of risk; promoting healthy and liquid markets; and supporting a strong and growing economy.

The challenges we face in formulating some of these very complex rules offer good news and bad news.

The news is good if you believe that the time it is taking to develop consensus among diverse agencies defers regulatory burden; it's bad if

you believe that delay in implementation translates to delay in recovery of financial markets.

Markets hate uncertainty and struggle with adjusting to the unknown. So let me turn to a couple of the issues on which we are working that I think are of specific interest to this audience, then finish with some thoughts on the role of derivatives in banking and financial markets.

We're in the midst of rulemakings that affect these issues, so I will of necessity be somewhat more limited than I might like in what I can say.

But these are extremely important matters, and it's worth taking some time to update you on where we are.

The **risk retention proposal** has been of great interest to the American Securitization Forum, and we are intensely involved in reviewing the comments received and discussing them with our interagency colleagues.

The **proposed rule** included a number of **approaches to risk retention**, including vertical slices, horizontal slices, and the Premium Capture Cash Reserve Account, as well as a proposed definition of a Qualified Residential Mortgage, or QRM, securitizations of which would be exempt from risk retention.

I don't have to describe for you the extent of the comments or the many aspects of the risk retention proposal they addressed, because many of you wrote them. But I don't think any element of the proposal attracted as much criticism as the QRM.

Clearly, **Congress intended the risk retention requirement as a discipline on the quality of the loans securitized—and thus indirectly on the quality of the loans made.**

The debate is over the scope of the QRM exception from that risk retention premise.

Should the exception be narrow—to recognize the unusual nature of a total exemption from the statute's risk retention premise?

Or should it be broader—recognizing that a range of mortgage types could demonstrate acceptably low default rates?

These are the types of issues under discussion among the rulemaking agencies right now.

The role of credit ratings is another challenging area, particularly because of the role such ratings play in the Basel capital framework, and in part because so many small banks lack the capacity to do the kind of independent analysis that would be necessary without some degree of reference to credit ratings.

We were unable to persuade Congress to ease Dodd-Frank's total prohibition on references to credit ratings in regulations, but even without the ban, we would have been moving in this direction.

Having seen the highest-rated tranches of asset-backed securities generate huge losses during the financial crisis, it was clear that myopic reliance on ratings was not acceptable—not by investors and not by regulators.

In this area, different alternatives to credit ratings may be appropriate depending on the context.

In the OCC's proposed rulemaking addressing the use of credit ratings in our regulations—such as the criteria for investment securities in which national banks may permissibly invest—we proposed alternative definitions for such investment securities and reemphasized longstanding guidance on the need for independent assessment of risks.

In the more complex context of the market-risk capital rule, where credit ratings translate into multiple risk weighting categories, the OCC and the other federal banking agencies have proposed a **different approach** that looks to different sources of substitute criteria to establish risk weights of various assets for market-risk capital purposes.

Let me turn now to the **Volcker Rule** proposal. Implementing the Volcker Rule provisions of the Dodd-Frank Act is a **very complex** undertaking, even though the general objective of the statute—**barring banks from engaging in proprietary trading or investing in or sponsoring “hedge funds” and “private equity” funds**—initially seems straightforward.

As the interagency group drafted the proposal, it became clear that this rule could have a **significant impact on securitizations**; so we wrote more than two dozen questions directly related to securitization, asking commenters to supply us with additional information.

For example, one question asks **whether securitization vehicles could be subject to the Volcker Rule’s restrictions** on proprietary trading, as well as the rule’s detailed compliance regime, because of the nature of the relationship between the vehicle and a depository institution.

We asked if this result would **increase the costs of securitization**, deter banking entities from the securitization business, or have other consequences.

Another important set of questions relates to **whether various securitization vehicles would be considered “hedge funds” under the proposal.**

Banks could find it **more difficult to structure securitizations** with vehicles that were considered “hedge funds,” so the proposal asks several questions about whether the definition of “hedge fund” captures current securitization structures.

We also asked several questions on how we should interpret a rule of construction in the statute stating that the Volcker Rule should not be construed to limit or restrict the sale or securitization of loans.

Comments on the proposal are due by February 13, and I encourage you to take a close look at the proposal and comment on these and other issues that affect securitization structures and practices.

Finally, we and the **other federal regulatory agencies** have a number of rulemakings in the works to address Dodd-Frank provisions aimed at managing risks inherent in the use of swaps and other types of derivatives.

This is the issue I'd like to spend the rest of my time on, in part because it has such important implications for banks and the economy, and in part because it is perhaps the least understood.

This is an area in which the OCC has considerable expertise.

We supervise the large banks that dominate this market, and we have devoted very substantial resources to monitoring and managing the risks posed by derivatives.

We maintain full-time teams of examiners within our large banks, and they are supplemented by specialists who provide support for the most complex activities.

These include Ph.D. economists and examiners recruited from the industry for their specialized knowledge.

Our quarterly report on bank trading and derivatives activities has become the most important source of data available on the subject, and we are well aware of both the risks and benefits that arise from the use of derivatives by banks.

So, as you might imagine, we have followed very closely the debate over derivatives.

In the popular retelling of the financial crisis, derivatives played a crucial role in both hiding and amplifying risk.

The Financial Crisis Inquiry Commission, for example, characterized the moment in 2008 when our largest financial institutions were teetering on the brink of failure as a “derivatives crisis.”

The Commission focused on unknowns involving counterparties and individual holdings, among other things.

The report went on to say, “Market participants and regulators would find themselves straining to understand an unknown battlefield shaped by unseen exposures and interconnections as they worked to keep the financial system from collapsing.”

Clearly, some problems did arise specifically because of the way that derivatives were used by financial institutions in the run-up to the crisis, and as a starting point, it’s important to acknowledge them.

Credit default swaps shifted risk exposures among market participants in ways that were sometimes unclear and often highly-leveraged, and they enabled the creation of synthetic securitizations that sometimes multiplied the risk from one set of poorly-underwritten loans many times over.

The lack of transparency in derivatives transactions among dealer banks and between dealer banks and their counterparties did create uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty.

The Proposed Swaps Margin Rule under Dodd Frank is intended to incent institutions to migrate business to exchanges to address the

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transparency and interconnectedness issues that proved problematic during the financial crisis.

But, the critique of derivatives that has emerged is far broader than the specific instruments or circumstances implicated in the crisis.

Warren Buffet colorfully labeled derivatives “financial instruments of mass destruction” and, for some, they are not just a sophisticated component of a bank’s product portfolio, but toxic instruments that should be pushed out of the banking system entirely.

That is a vast overreaction, and it worries me that misperception could motivate redesign of the system.

Lack of understanding feeds misperception, and derivatives are not particularly well understood, even by some top policymakers.

This is not just a matter of the risks involved, but extends even to **the size of the market.**

The OCC’s most recent quarterly report on bank trading and derivatives activities noted that the notional value of derivatives contracts was \$248 trillion at the end of September, which is a multiple of the world’s annual economic activity.

The notional value of derivatives contracts is a number that is frequently cited in somber terms to describe the size—and risk—of the market, but of course that’s far from the mark.

I’m not trying to suggest that this isn’t a big market or that it doesn’t involve sizeable risks, but the risk ascribed to derivatives is often many orders of magnitude greater than the reality.

As the members of the American Securitization Forum know all too well, **the biggest risk from derivatives is not the market risk, but rather the credit risk.**

At the end of the third quarter of 2011, insured U.S. commercial banks had \$504 billion of net current credit exposures from derivatives contracts.

That's after accounting for legally enforceable netting agreements and represents just 0.2 percent of the notional values.

When we consider liquid collateral protection, the net uncollateralized exposure number drops to \$181 billion—or less than one tenth of one percent of the notional values.

Now, that's still a significant amount of credit risk, so the OCC spends a lot of time evaluating the counterparty credit risk exposures of bank derivatives portfolios.

Since 1997, banks have charged off an average of about \$117 million of their derivatives exposures each quarter.

While the numbers have increased recently, reflecting the adverse economic environment and rising exposures, charge-offs are running at 0.02 percent—just two basis points of the net current credit exposures.

Banks are in business to take credit risk, which is the key risk in derivatives activities.

The data demonstrates that banks have effectively managed these credit risks over time and, going forward, **the mandate in Dodd-Frank to move toward central clearing of derivatives transactions should lead to a reduction of these credit exposures.**

Then, to the extent that an appropriate worry is the role played by credit default swaps, CDS represent only 6.3 percent of total derivative notional

and 8 percent of the gross credit risk, a distant third in order of magnitude.

Interest rate contracts comprise 79 percent of risks with foreign exchange representing an additional 11 percent.

Can CDS still be used to replicate securities?

The answer is “yes”, but the core problem was not CDS but synthetic CDOs based on the replication of poorly underwritten sub-prime mortgage securitizations which are being directly addressed through the risk retention provisions.

But even if we accurately recalibrate the risks involved, the financial crisis demonstrated the need to improve regulation of derivatives.

Dodd-Frank includes a number of provisions aimed both at mitigating risk and increasing transparency, through improved risk practices, increased official oversight, and the use of clearinghouses and exchanges.

Again, however, provisions that seem straightforward in theory have proven to be controversial in practice.

For example, the OCC, along with other federal regulators, published a proposal to **establish minimum margin and capital requirements** for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants subject to agency supervision.

The agencies proposed to **require swap entities to collect margin for all uncleared transactions with other swap entities and with financial counterparties.**

One element of the proposal involved the application of margin requirements to foreign branches and affiliates of U.S. banks.

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Commenters strenuously opposed this aspect of the proposal and indicated it would have a severe effect on their competitive position.

These commenters noted that U.S. regulators are ahead of their G20 counterparts in formulating margin requirements, and imposition of U.S. margin rules on their foreign derivatives business at a time when foreign competitors are not required to collect margin from similar customers will effectively destroy this aspect of their business.

They called for the agencies to delay imposition of this aspect of the proposal and work with foreign authorities to harmonize margin requirements internationally, phasing them in on a coordinated basis.

We understand these concerns, and we will be carefully considering all of the issues raised in the comment letters as we move ahead on the regulation.

Our rulemakings in this area are likely to be of great consequence to many of you, given how important derivatives are in securitizations.

Derivatives are commonly used to hedge risk in securitization deals.

Many securitizations include swaps that trade floating-rate interest payments for fixed-rate payments, for example, or hedge foreign exchange risk.

And, credit default swaps that offer protection against negative credit events will continue to be important to investors in securitized assets. All of which brings me to my final point. Even if derivatives were implicated in the market collapse of 2008, they continue to provide important benefits for lenders and their customers.

Derivatives provide the banks we supervise with important and prudent means of managing credit exposures; for example, hedging the risk of a

loan by using a credit default swap for protection in the event that the borrower defaults.

Likewise, banks can help customers hedge against risk; for example, selling a “cap” to a borrower with a floating-rate loan to hedge against the risk of rising interest rates.

And of course, there are the classic examples of derivatives being used by bank customers to guard against price increases in commodities that are important to their businesses.

Airline companies hedge fuel costs; farmers lock in prices for their harvests and protect against the possibility of bad weather; and manufacturers protect themselves against increases in the prices of their raw materials.

These are products that benefit bank customers and that banks offer in a safe and sound manner.

As we write regulations to address the excessive risk taking and failures of risk management that helped bring on the financial crisis, we must take care to avoid making it more difficult for banks to manage their own risks and to serve the legitimate needs of their customers.

Much work remains to complete the implementation of the Dodd-Frank Act and to restore the health of the financial system.

Strengthening risk management and improving market transparency for derivatives is an important part of this, as is ensuring sound underwriting in securitizations.

While these are diverse objectives, what they have in common is that new regulatory frameworks are being erected around them, and the way in which we set limits and define terms in those frameworks will importantly affect which activities remain part of the basic business of banking, how

banks manage their own risks, and how they provide liquidity to markets and financial intermediation to customers.

New regulatory contours are being laid out in the provisions I have described, and I encourage the industry to engage actively in the comment process to make sure we get it right when we fill them in.

Thank you for your attention.

Speech by Clive Adamson, Director of Supervision, Conduct Business Unit, FSA - British Bankers' Association (BBA) Conference, London

Good afternoon ladies and gentleman, it's a pleasure to be here today.

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I'd like to give you an insight into how the Financial Conduct Authority's (FCA's) supervision of firms will deliver the vision of the new regulator that Martin set out for us just now.

You've all heard about the bolder approach to ensuring that you are getting the best outcomes for your customers. It will fall upon my supervision teams to deliver that in practice through our day-to-day work with your firms.

Conduct strategy

One of the building blocks for this evolution into the FCA is the FSA's revised conduct strategy, which we launched in 2010.

This, in essence, set out the key change in approach that we wanted, which was to move from a primarily reactive to a pre-emptive style of retail conduct supervision.

We also wanted to **shift our approach from focusing at the firm level on systems and controls to what consumers actually experienced from firms.**

The FCA approach builds on this and will emphasise five main elements:

- **Firstly**, to be more forward-looking in our assessment of potential problems – so as Martin said, we're looking at how we can tackle issues before they start to go wrong. The new powers of intervention will allow the FCA to take this a step further.
- **Secondly**, it is to intervene earlier when we see problems including earlier intervention in the development or marketing of retail products – and we can see that in the examples on death bonds and the structured products guidance that Martin mentioned. When I say see problems, we will look at these through the eyes of consumers.
- **Thirdly**, we will want to attack underlying causes of problems that we see, not just the symptoms, as this will be more effective and efficient in the longer term for consumers and firms.

- **Fourthly**, it's to secure redress for consumers if failures do occur – and so we're asking those firms that are moving customers into risky investments, or mis-handling their complaints, to put customers right.
 - **And finally** to take meaningful action against firms that fail to meet our standards through levels of fines that have a deterrent effect.
- Embedded in this supervisory approach are important philosophical changes.

These include moving away from a philosophy in retail conduct that relied primarily on transparency at the point of sale and, in the wholesale markets going beyond relying on the caveat emptor principle in ensuring integrity of these markets.

Supervision model

I would like to turn now to the supervision model we are developing to deliver the greater intensity of conduct supervision envisaged in the FCA approach that I have outlined.

The key components of this are:

- a clearer sector-based approach;
- greater use of forward-looking analysis to understand what is happening in particular sectors and to help in determining risks;
- more focus on intelligence and data;
- greater use of thematic reviews;
- continued, but more focused, programme of firm level assessments;
- more responsive and flexible use of our resources with fewer firms having a fixed team facing off against them.

We will communicate more on our model over the coming weeks and months but I would like to touch on the firm assessment aspect of our model.

As you know this is conducted currently through the ARROW process at the large firm end of the spectrum and what we call the Revised Approach to Small Firm Supervision (or RASFS) at the small end.

We currently intend to keep a firm-assessment framework across the firm population but to replace the ARROW framework with a new process that is easier to communicate to the senior executives and boards of firms so that they can align good business practice with good regulatory practice.

The intensity of this will depend on the FCA's categorisation of firms that we are developing.

The new framework will focus much more clearly on the main drivers of conduct risk at the firm level, but the overall assessment, which will continue to be in the form of a letter to the Board, will be based on all the work that has happened on the firm, including thematic work.

At the most intensive end of the spectrum we will look at a firm's business model and strategy to see whether these deliver good outcomes for consumers.

An important message is that we want the creation of a conduct focused regulator to ensure that a firm doesn't trade consumer treatment off against financial performance or prudential strength.

We will look at product design to see whether products or services marketed and sold are designed to meet the needs of identified consumer groups and targeted accordingly.

And we will also delve into sales to see whether firms have appropriate systems and controls in place to ensure the delivery and fair outcomes to consumers and that this is reflected in what consumers actually experience.

Alongside this we will be looking at what happens after the sale, to see whether firms can deliver fair outcomes for consumers after they have

bought their product, such as whether complaints are being handled appropriately.

And we will be looking to see whether a firm's governance arrangements are effective from a conduct perspective.

Very important here is the culture of the firm.

We see this as a potential root cause of poor outcomes for both retail consumers and wholesale participants.

It is clear to us that culture determines a lot about how a firm meets its regulatory obligations.

The FCA will look to firms' boards and other governing bodies to set, put in place and maintain a culture that will bring about good outcomes for their customers.

In creating that culture, they will need to take into account factors such as their business plan, risk appetite and how they pay and incentivise staff – and this means not just the senior executives, but also their front-line staff who deal with consumers on the ground.

I have talked about the firm-level framework but want to emphasise our greater use of cross-firm issue and product-based reviews.

Our view is that conduct risk can often be more efficiently addressed through thematic work and we intend to execute a higher proportion of our conduct priorities, including at the product level, through this type of work.

In undertaking this we will wish to ensure that we are clear to firms about our conclusions and what we expect them to do.

An example of this is at the moment is our work on wealth managers – those firms that manage a portfolio of assets or investments, on either an advisory or a discretionary basis for retail clients.

This includes many types of firms, from major international banks to smaller UK-focused firms.

What brings them together is an obligation to consider the suitability of the service they are offering to the client.

In a review last year we found that for every five files we looked at, four had a high risk of unsuitability, or suitability could not be determined.

This is obviously not where customers or we want firms to be, and this gulf between regulatory expectations and what customers sometimes experience is an example of what the FCA will need to narrow.

So, what we have tried to do in that work is to set out our conclusions and expectations for firms as clearly as possible and I am pleased to say that many firms have put in place major rectification programmes to deal with the issues we identified.

Turning now to how our new approach will feel to firms as this, I expect, will be of more interest.

I would like to highlight several aspects here:

- First, and perhaps you have already sensed this from what I have said, it will be more intensive.
- There will also be more concentration on whether your business models deliver acceptable outcomes for consumers.
- There will be greater appetite for pre-emptive intervention.
- There will be more purposeful engagement through firm assessment and thematic delivered by a range of sector-skilled supervisors.
- There will be more focus on causes of problems that we see.
- We will have a greater expectation of a strategic approach to the conduct agenda and senior management and board engagement in it.

- There will be a greater expectation that firms will demonstrate that they have resolved issues promptly rather than the FCA devoting resources to monitoring this.
- There will be more engagement of FCA senior management particularly for the larger firms.
- Last, for those firms subject to dual regulation by the Prudential Regulation Authority (PRA) and FCA they will receive independent, but coordinated supervision from FCA/PRA.

But while there will be a new emphasis and new ways of working, there will be familiar features in the FCA's approach to supervision.

We know that we need to keep the things that currently work well, and one of our tasks is to weave current good regulatory practice in with the FCA's new approach.

So, for example, we intend to continue to publish the Retail Conduct Risk Outlook as a way of setting out for firms and the wider community our view of the key conduct risks that we see both currently and emerging.

This is consistent with our greater emphasis on forward-looking risks and will be an important part of our move to more transparency and engagement with the wider community.

Being more forward looking will mean that we will undertake more research and analysis in order to look at the risks that may be on the horizon, and this will be complemented by additional intelligence gathering.

We know we must speak to you and bodies like the BBA as we look at understanding market developments.

You can help us make the clearest sense of the variety of information that we get and help us as we seek to get early insights into potential conduct problems.

Wholesale conduct

So far I have talked about **retail conduct** but I would also like to cover **wholesale conduct** as well.

In our FCA Approach Document we also said **we would put greater emphasis on wholesale conduct and the risks attached to activities in the wholesale markets.**

Wholesale conduct covers how firms conduct their business in wholesale markets and, as such is not new — the FSA has been doing this but perhaps has not badged it as wholesale conduct.

As an integrated conduct regulator, the FCA will look across the whole financial services sector, not only in investment and capital markets but also in banking and wholesale insurance markets.

Our focus here will be to ensure the integrity and resilience of these markets rather than to seek to introduce concepts of detriment and redress that we use in retail markets to wholesale markets.

This has been the approach in the FSA and we intend to carry this forward into the FCA.

However, we will want to place more emphasis in particular on three areas.

Firstly, where wholesale products filter down or are distributed to retail consumers.

Secondly, where certain behaviours in wholesale markets can cause damage to market integrity and thirdly, where market structures can result in participants being disadvantaged or the market being inefficient.

We intend to flesh out our thinking on these areas over the coming months but, apart from the FCA intending to be more systematic and

focused on wholesale conduct issues, I do want to flag that there is a degree of philosophical change in these areas from what I have said.

Namely, that whereas in the FSA we may have relied on the ‘caveat emptor’ principle and focused our efforts on market abuse and transparency and disclosure, we in the FCA are likely to go beyond relying on caveat emptor where we see potential damage to market integrity and intervene ourselves.

Transition to the FCA

Before I finish, I just want to touch briefly on **where we are now in terms of the transition from the FSA to the new regulators, and our intentions for the months ahead.**

We are expecting final approval from Parliament sometime in early 2013, after which the PRA and the FCA will officially begin their separate lives.

To get to that point we are undertaking a large amount of preparatory work including incorporating into our design work helpful feedback from a wide variety of stakeholders.

As you may recall, a key milestone for us was the move we made in April last year to the creation of the Conduct (CBU) and Prudential business units within the FSA. At that time we moved all firms that will be solo regulated in the future into the Supervision Division within the CBU.

The next milestone is the splitting of conduct and prudential supervision of firms that will be dual regulated in the future and the move of these into CBU Supervision for conduct purposes.

I hope though you’ll have seen from what I’ve said and from Martin earlier that we are intent in achieving a step change in conduct supervision as the FCA comes into existence in order to achieve better outcomes for retail consumers and ensure market integrity for wholesale market participants.

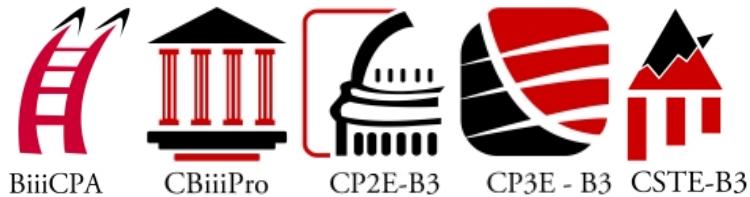
In doing this we will embed a pre-emptive approach that will be based on making forward-looking judgements and intervening early to tackle potential risks to consumers and market integrity.

There are still many unanswered questions that we need to work through as we move to the FCA. We very much welcome engagement with you as we do this and we will certainly keep you informed of our progress during the transition.

Thank you for listening, I look forward to hearing your questions

News from the European Central Bank (ECB) - Who is monitoring the *European Growth to GDP ratio?* (A very important ratio in the Basel iii framework)

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**Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, 9 February 2012**

Based on our regular economic and monetary analyses, we decided to keep the key ECB interest rates unchanged.

The information that has become available since mid-January broadly confirms our previous assessment.

Inflation is likely to stay above 2% for several months to come, before declining to below 2%.

Available survey indicators confirm some tentative signs of a stabilisation in economic activity at a low level around the turn of the year, but the economic outlook remains subject to high uncertainty and downside risks.

The underlying pace of monetary expansion remains subdued. Looking ahead, it is essential for monetary policy to maintain price stability for the euro area as a whole.

This ensures a firm anchoring of inflation expectations in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term.

Such anchoring is a prerequisite for monetary policy to make its contribution to supporting economic growth and job creation in the euro area.

A very thorough analysis of all incoming data and developments over the period ahead is warranted.

Through our non-standard monetary policy measures we will continue to support the functioning of the euro area financial sector, and thus the financing of the real economy.

Since the first three-year **longer-term refinancing operation (LTRO)** was conducted in December 2011 we have approved specific national eligibility criteria and risk control measures for the temporary acceptance in a number of countries of additional credit claims as collateral in Eurosystem credit operations, which should lead to an increase in available collateral.

Let me now explain our assessment in greater detail, starting with the economic analysis.

Real GDP growth in the fourth quarter of 2011 is likely to have been very weak.

According to the survey data for the last two months, there are tentative signs of a **stabilisation in economic activity at a low level**.

Looking ahead, we expect the euro area economy to **recover very gradually in the course of 2012**.

The very low short-term interest rates and all the measures taken to foster the proper functioning of the euro area financial sector are lending support to the euro area economy.

Moreover, stress in financial markets has diminished in response to our monetary policy measures, but also in response to the progress made towards a stronger euro area governance framework and intensified fiscal consolidation in several euro area countries.

However, subdued global demand growth, the remaining tensions in euro area sovereign debt markets and their impact on credit conditions, as well as the process of balance sheet adjustment in the financial and

non-financial sectors, continue to dampen the underlying growth momentum.

This outlook is subject to **downside risks**.

They notably relate to [tensions in euro area debt markets and their potential spillover to the euro area real economy](#).

Downside risks also relate to possible adverse developments in the global economy, higher than assumed increases in commodity prices, protectionist pressures and the potential for a disorderly correction of global imbalances.

Euro area annual **HICP inflation was 2.7% in January 2012, according to Eurostat's flash estimate, unchanged from December**.

The average inflation rate for 2011 was 2.7%, mainly driven by higher energy and other commodity prices.

Looking ahead, **inflation is likely to stay above 2% for several months to come, before declining to below 2%**.

This pattern reflects the expectation that, in an environment of weak growth in the euro area and globally, underlying price pressures in the euro area should remain limited.

Risks to the medium-term outlook for price developments remain broadly balanced.

On the upside, they relate to higher than assumed increases in indirect taxes and administered prices, as well as increases in commodity prices.

The main downside risks relate to the impact of weaker than expected growth in the euro area and globally.

The monetary analysis indicates that the underlying pace of monetary expansion remains subdued.

The annual growth rate of M3 decreased to 1.6% in December 2011, after 2.0% in November, reflecting a further weakening of monetary dynamics towards the end of the year.

The annual growth rates of loans to non-financial corporations and loans to households, adjusted for loan sales and securitisation, also decreased further in December, and stood at 1.2% and 1.9% respectively.

The volume of MFI loans to both sectors declined in December, and this was particularly pronounced in the case of the non-financial corporate sector.

In addition, there are indications that bank lending conditions tightened further, affecting loan supply in several euro area countries in late 2011.

It is not yet possible to draw firm conclusions from these developments, particularly given that the impact of the first three-year LTRO on bank funding is still unfolding and may not have been fully reflected in the most recent bank lending survey.

In addition, other non-standard monetary policy measures announced in December are still to be implemented. Accordingly, close scrutiny of credit developments in the period ahead is essential.

The soundness of bank balance sheets will be a key factor in facilitating an appropriate provision of credit to the economy over time.

It is essential that the implementation of banks' recapitalisation plans does not result in developments that are detrimental to the financing of economic activity in the euro area.

To sum up, the economic analysis indicates that underlying price pressures should remain limited and risks to the medium-term outlook for price developments remain broadly balanced.

A cross-check with the signals from the monetary analysis confirms this picture.

A combination of structural reforms and fiscal discipline is essential for boosting confidence and delivering a favourable environment for sustainable growth.

Regarding fiscal policies, all euro area governments need to continue to do their utmost to ensure fiscal sustainability.

It is essential that all countries adhere to the fiscal targets they announced for 2012.

This should help to anchor expectations of sound fiscal policies and strengthen confidence.

The rules guiding the design and implementation of national fiscal policies are being strengthened at the EU level as well as in the legal frameworks of several Member States.

These are important steps in the right direction.

With regard to structural reforms, these are key to increasing the adjustment capacity and competitiveness of euro area countries, thereby strengthening growth prospects and job creation.

Notably, far-reaching and ambitious reforms should be implemented to foster competition in product markets, particularly in services sectors, while rigidities in labour markets should be reduced and wage flexibility should be enhanced.

Transcript of the questions asked and the answers given by Mario Draghi, President of the ECB, and Vítor Constâncio, Vice-President of the ECB

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Question: Could you clarify the position of the ECB with regard to the Greek bonds that you hold in various forms from the SMP and also investment, and would it be feasible for you to deliver them to the EFSF and get EFSF bonds in exchange?

Also, with the national central banks now setting criteria for the acceptance of credit claims, is there a risk of fragmentation of the financial markets in Europe, which is already apparent during the repatriation of a lot of the lending activities?

Draghi: On Greece, I am sorry but I cannot say anything about how holdings of Greek bonds, both under the SMP programme and under national central banks' other holdings will be treated.

What I can say, however, is that, a few minutes ago, I received a call from the Prime Minister of Greece saying that an agreement has been reached and endorsed by the major parties.

This afternoon we will be having the Eurogroup meeting with the ministers and we will have a full report of the agreement, and also a discussion of the further steps.

On the second point, with the first three-year LTRO, **we avoided a major credit crunch.**

I have already said that **€230 billion worth of bank bonds were coming due in the first quarter.**

Furthermore, as I just read in the introductory statement, in the last two quarters of last year credit tightening started and then progressively accelerated, especially in some countries such as Italy and Spain.

Once we had provided the first three-year LTRO, we also asked ourselves how we could make sure that this facility would reach not only the large banks, which usually have plenty of collateral and packaged in a way that

corresponds to our eligibility criteria, but also the small and medium-sized banks that are most important for financing small and medium-sized enterprises (SMEs).

Their collateral does not come in a way that naturally fits our criteria.

This is why we extended the eligibility criteria for this collateral.

The big question that I saw in at least one press article was: ‘but this is going to be very risky, isn’t it?’

Sure, it is going to be more risky.

Does it mean that we take more risk? Yes, it means that we take more risk. Does it mean this risk has not been managed?

No, it has been managed, and it is going to be managed very well because there will be a strong over-collateralisation for these additional credit claims. The conditions will be very stringent.

Each national central bank (NCB) will assess these credit claims on the basis of common guidelines, common rules, and the various NCB proposals will be evaluated by the Governing Council. So, we will be reviewing the situation in six months’ time.

Incidentally, it will also increase the differentiation of the sort of collateral we have in this facility.

So if we have taken more risk, we have also made sure that this is going to be very well managed, and the purpose, as I said, is to finance the real economy and especially SMEs, which account for almost 80% of employment.

Question: How exasperated or concerned are you by the fact that we have a problem with lending?

I think a recent study from one of the major banks says that only 7% of lending is being passed on to the so-called real economy.

You said it is a bit early to say whether all the measures have landed yet, but how concerned are you that we are indeed heading for a credit crunch at a critical time for the euro area economies?

And what is the latest stance of the ECB on potentially taking famous haircuts on bonds in the case of Greece – or possibly other countries, but we are talking about Greece at the moment?

Draghi: On the second question, I have no comment.

On the first question, **we are indeed concerned by this slowdown in credit.**

I said that we have to wait and see, because partly it relates to the funding pressures that banks anticipated for the first quarter of this year and that we have removed with our three-year LTRO.

The second part relates to the capital requirements expected following the EBA stress tests. And the third part of the reason relates to risk aversion.

The data we just gave you from the bank lending survey do not fully reflect the impact of the LTRO, because the bank lending survey was carried out in the middle of that period.

We have to look at two things now: we have to wait a little time to see whether things are changing for the better, and we also have to see what happens regarding the second LTRO.

We must not forget that some banks use these proceeds (i.e. the borrowing from the LTRO) to refund their own bonds. In this sense, it was not new, fresh money available for lending.

But, as I have said repeatedly, these operations address the liquidity risk, not the lack of capital.

To some extent, they also address risk aversion – to the extent that the risk aversion results from a perceived lack of liquidity on the part of a counterparty.

Question: Given the downside risks to the economy, the financial markets expected another move downwards in the benchmark rate in the next few months. Do you think that they would understand the situation correctly?

And, second, after the three-year LTRO we did see a significant downward movement in the yields on Italian debt in particular. Certain bank CEOs said that they had even used the three-year LTRO to buy Italian government debt.

Was it your intention that they do that?

Draghi: On the first question, we did not discuss any prospective or current change in interest rates.

On the second question, the use of these proceeds is a business decision and, as I have said repeatedly, our primary interest is in lending to the real economy. That is where we see most of the credit tightening in all categories, namely corporate, housing and consumption.

The composition changes from country to country, but in some countries there is credit tightening for all categories.

Incidentally, of the fall in rates in government bond yields, the most marked was not in Italy, it was in Spain.

But that is not necessarily a negative thing in itself, because when banks set their pricing for their credits they look at what their other investment

opportunities are, to the extent that they might invest in government bonds.

They look at debt prices and, if the debt price goes down, one would expect that credit prices would also go down. We are looking with great intensity at current developments to see if what we do makes a difference from the point of view of credit to the real economy.

Question: In the introductory statement you no longer describe the downside risks to the economic outlook as substantial.

Does that mean that you are confident that the recent improvement in financial markets is here to stay? Even if you did not discuss it, does that reduce the chances of further ECB easing measures?

Second, for the forthcoming three-year LTRO, how large do you expect demand to be for that? And are reports of demand for up to €1 trillion exaggerated in your view?

And, as a follow-up to a previous question, on the collateral you say you will manage the risk. Why will the Eurosystem not share the risk? Why does it have to stay with the national central banks?

Draghi: As regards your first question I would not say that we are confident.

The fourth quarter of 2011 was very weak, but we have seen a stream of both survey and hard data that seem to point to a stabilisation in economic activity at a low level.

In other words, when we presented the baseline scenario last time, the amount of evidence that this stabilisation was on track was smaller than the amount of evidence that we have today.

As I have constantly said, uncertainty is high – uncertainty relating to the global economy, to sovereign tensions, to the credit markets and to global growth.

Regarding the level of the second LTRO the specialists in this field say that it should be substantial and possibly around the level of the previous one. I have no more information on this.

Concerning the collateral, on top of all the risk management measures and on top of all the strong over-collateralisation – which, once you apply these haircuts, reduces the amount of acceptable collateral by almost two-thirds – to assess the creditworthiness of a credit claim it is essential to know the economy where this credit claim originated.

In other words, knowledge of the domestic economy is essential for understanding the creditworthiness of a bank credit claim.

The assessment by the national central banks is very important, even though it is conducted on the basis of a common guideline.

Therefore, we want to keep the risk related to these assessments with national central banks so they bear the full risk of their choices.

In a sense, it is a further mitigating measure for the risk we are assuming.

The Banca d'Italia, for example, would carry out the assessment and then it would present the assessment to the Governing Council on the basis of a common guideline and on the basis of common haircuts.

So, with a credit claim of about 9, strong over-collateralisation would yield around four – or three, probably – as acceptable collateral.

Of this three, the risks must be assessed according to the common guideline and presented to the Governing Council.

Question: Mr. Draghi, you warned two months ago about legal tricks that circumvent the spirit of the Treaty and that the ECB's credibility depends on the spirit of the Treaty.

All of this talk about what the ECB is going to do with its bond holdings centres around getting money to Greece.

Draghi: There is a hole of 50 billion euro or so, a hole in the funding, and the governments and the banks seem to want the ECB's money.

Is it still your position that the ECB needs to avoid legal tricks? And are these options legal tricks?

Draghi: Absolutely, you can rest assured that this is still my position. So, all the talk about the ECB sharing the losses is unfounded.

But I cannot say what we can do about this until tonight, probably after the Eurogroup meeting. We will have to see.

Let me add one thing, because perhaps I am not being completely clear. The idea that the ECB could actually give money to the programme would violate the prohibition of monetary financing.

Question: Your predecessor, Mr. Trichet, always used to say that the bonds that the ECB buys under the SMP programme will be held to maturity. Can you confirm that this is something you will still do?

And my second question: since the first LTRO was really successful, and it looks like the second one will be similar, is this a tool that you will keep in your tool box and may apply later on?

Draghi: On the second question, these are non-standard monetary policy measures. So they are of a temporary nature.

Because of their size and complexity, one would certainly not want to pre-commit to making them a permanent feature of our monetary policy. Let me clarify, a well-functioning banking system does not need to go through the central bank for its financial intermediation.

In a well-functioning banking system, both the interbank market and the senior unsecured bond market would be working.

It is only because of the extraordinary conditions in these two markets, especially the first one, that we are taking these special measures.

Indeed, the unsecured bond market has only now, after the first LTRO, shown some signs of reopening.

So, we should always bear in mind that once the financing conditions in banking markets return to normal, our special operations will no longer be necessary.

Question: Will you hold the bonds in your SMP programme until maturity?

Draghi: We have **no reason to change** this commitment. If we do, we will tell you.

Question: You once said that the euro area fiscal accounts were stronger than those of the United States and Japan. Do you remember saying so? Can you explain why?

Draghi: I was clearly referring to the euro area as a whole. The overall euro area budget is in far better shape than the one in the United States or in Japan.

Within the euro area, some countries are stronger than others. But if you take the euro area as a whole, we are in better shape.

I do not have the exact figures to hand right now, but when you asked me before, I remember giving you the figures explaining why this is so.

Question: I have just a follow-up on **collaterals**: you told us that the national central banks will present their risk assessment to the Governing Council, but what exactly will happen if some members of the Council aren't satisfied with what is presented?

And a second question, a personal one: you have already shown us that you are a good risk manager, but what about your stance as a central banker, and what is your personal conclusion after your first 100 days in office?

Draghi: On the first question, it would be like any other discussion in the Governing Council.

We will look -- obviously together with the risk management officers and other very competent staff, -- at the assessments, we will have a discussion and if the Governing Council is not satisfied it will not be accepted. It's like any other discussion.

Now, the second question was about my first 100 days. Well, it's hard to respond but if you read a few newspapers that are also represented here you will get a full documentation of what they think.

Question: But what about your principles as a central banker then? You've shown us that you are a good risk manager, but it is hard to get any statement about you or your stance.

Draghi: Well, I think the proof is in the eye of the beholder. I have respected the mandate of the ECB, which is to maintain price stability in the medium term. Inflationary expectations have remained firmly anchored – both before I became president, in the years of my predecessor, and in the first 100 days.

But admittedly, it is a very short time to judge someone, it could get much worse.

Question: I was a bit confused by your initial statement when you said: “Yes, we take on more risks, but we manage them well.”

Could you perhaps just clarify on balance: is the Eurosystem more at risk or less at risk, or is it equal, as a result of your decision?

And secondly, could you give us a flavour, please, on how the discussion went on extension of the collateral framework and the changes in the quality standards?

Was it unanimous, was there a wide agreement, were there lively discussions, as you called it last time when the interest rates were lowered?

And do you have an appraisal of how much the potential collateral will be extended, can be extended, as a result of your decisions that you took today for the banks to take advantage of? How much in sum, if you have an estimation?

Draghi: We, the Governing Council, thought that the amount of risk that was taken on board was perfectly acceptable and very well managed.

We take risks with everything: we take risks with normal monetary policy operations, with LTROs, with the SMP.

The important thing is that once we take these risks, firstly we don't judge them to be excessive and secondly, and most importantly, we manage them well. We have full confidence in our staff that these risks can be well managed.

As regards your second point, the discussion was not unanimous, but it was not particularly contentious. There was wide agreement, although there was no unanimity.

On the amount: if I'm not mistaken (but here you have to take my figures with a grain of salt), we have from about 600 to 700 billion euro as the estimated amount of credit claims, of which only about 200-billion euro plus would become acceptable, because of the strong over-collateralisation that we asked for.

So you can see how hard and stringent the selection of these claims is.

Question: A follow-up to Greece, as you discussed the issue of Greece during the Governing Council session: could you tell me if there is, in the discussion, a priority in the sequence?

Once you have the PSI agreement and the measures to be proposed today that you will discuss in your Eurogroup – once these two priorities are on the table, I mean there are sufficient clear results, then the question of the ECB participating in the restructuring of Greece may be discussed, so you cannot rule this out as a matter of principle, but the priorities are very important in the sequence.

Draghi: I think the most important thing about Greece is this agreement, if it has been reached and endorsed by all parties.

This is the major thing really. We always, for some mysterious reason, focus on the need to finance things, we always talk about firewalls, but I think the most important thing is the reforms that countries make and we should focus first on that, then on the rest.

So, that is one thing, the second thing is the PSI.

On that, as you know, we are not a negotiating party but the vibrations that we are getting is that the different parties are very close to an agreement.

The third thing is the financing gap.

There may be a gap, but I frankly don't know how much that is and we will know more in the Eurogroup.

The fourth issue is, 'what about the ECB'? As you noticed, everybody has been talking about what the ECB could or could not do, what would be nice for the ECB to do and so on, but the ECB did not say anything.

And so, the only thing that I can say today is still nothing other than what I said before, i.e. it is not our intention to violate the monetary financing prohibition.

Question: If the ECB were to transfer the bonds it has acquired under the SMP to a vehicle such as the European Financial Stability Facility, would that be monetary financing and therefore illegal?

Just to come back on the debate about extending collateral to include credit claims, can you give us a figure for the additional amount that banks would be able to borrow from the ECB as a result? I think the €200 billion figure you gave was the volume of credit claims. Is that the same amount as the banks would actually be able to borrow? Is it mostly Spanish and Italian banks that would benefit?

Draghi: On your second question: we do not know who is going to benefit most from these because it has more to do with the size of the bank and how the interbank market works within the countries.

Ideally, small banks do not come to the ECB, but get their liquidity from the large banks that do.

If you have an interbank market that functions, there is no need for these measures. In some countries, however, you do not have a functioning interbank market.

Large banks come to the facilities, but instead of giving liquidity to the small and medium-sized banks they hoard it. So you have a further reason for credit tightening.

The figure I gave you is not the amount that banks will be able to borrow because it has to be polished further before you can actually get the amount banks will borrow. I cannot be any clearer than that at the moment.

Question: I also had a question on the EFSF. If the ECB were to transfer the bonds it has acquired under the SMP to the EFSF, would that be monetary financing?

Draghi: The EFSF is like a government. Giving money to governments is monetary financing.

Question: I just wanted to ask you a broader question on your assessment that the euro area economy would gradually recover in 2012.

And I wonder whether you think this differs markedly from the IMF recent world outlook assessment?

Draghi: Yes, it does differ. I would not say markedly, but it does differ in the sense that we are less pessimistic than the IMF.

You might have heard what Jens Weidmann said recently about the IMF forecast for Germany. So we are certainly less pessimistic than the IMF.

Question: You were speaking of a mild recession before. Are you changing your view now in a more positive way, given the signs you have seen of a certain degree of stabilisation?

Do you consider the fiscal compact signed by the EU Member States as a durable “quantum leap”?

Draghi: I said before that we now have more survey and hard data confirming what I presented to you last time as our baseline scenario, namely a gradual stabilisation of economic activity at low levels.

That is what I can say about the real economy. As we all know, uncertainty is high at the present time, and downside risks for growth still persist.

In my view, the fiscal compact is **a major political event**.

It testifies to the willingness of the Member States to release sovereignty – partly, naturally – in the budgetary area and, in a sense, to accept this partial loss of sovereignty in their primary legislation, for example by means of constitutional changes.

It is also a sign of the commitment by all the Member States, including the larger ones, to the euro. It is a sign that the euro is a strong reality.

If one is bold, one would even say that it is the first timid step towards a fiscal union.

A fiscal union should not start from being a fiscal transfer union where you have some countries that pay and other countries that spend.

It should actually start from a compact that shows that all countries can stand on their own without a need to be continuously subsidised by others.

If one is bold and interprets it in this way, it also shows a track of a fiscal union where each member is responsible and strong.

Question: Mr Trichet always emphasised that the ECB distinguishes between standard measures and non-standard measures. I haven't heard that from you yet.

Maybe you could say a few words, if that has changed?

And the second question is regarding the TARGET system.

In Germany, an increasing number of economists are focusing on that, and the rating agency S&P said that the TARGET claims of the Deutsche Bundesbank could one day be a problem for Germany's rating.

Maybe you could also say a few words on that.

Draghi: No, there is no difference between the vocabulary used by Jean-Claude Trichet and by myself. There are standard measures and there are non-standard measures.

The non-standard measures respond to exceptional circumstances that are temporary in nature. So there is no difference in the vocabulary.

With regard to the second question, TARGET imbalances are normal, are inherent in a monetary union.

Usually, under normal circumstances, you do not observe high imbalances between countries, because in each country and across countries the interbank market would function.

But when funding conditions become stressed in some parts of the euro area, the countries that are not stressed accumulate claims vis-à-vis the countries that are under stressed conditions.

But this does not imply any more risk for the so-called 'creditor countries'. It is part of the normal functioning of a monetary area with a central platform, which is the ECB.

Question: Mr President, you reacted very cautiously to the news from Athens. Maybe you can elaborate on that, or maybe that could also bring us to the question: “Do you have a plan B in case that doesn’t fly?”

You also dodged the question of the volume of Greek debt you are holding. Can you explain to us on what grounds you cannot elaborate on the volume the ECB is holding?

Draghi: No, we never have a plan B. To have a plan B means defeat already. I’m actually quite confident that all the pieces of this will fall into the proper places.

On your second question as I said before, I don’t want to comment on ECB holdings because I want to see what comes out of the Eurogroup tonight. It would be highly premature for me to say anything about that.

Question: My first question is: so far the LTRO seems to be working very well, like a magic stick, or something like that, and people may think that the ECB might prefer this further LTRO to a rate cut. What is your comment on that?

My second question is: this week, the Japanese Government announced that it has been intervening in the foreign exchange market for several days, from the end of October of last year, and without announcement.

Your predecessor, Mr Trichet, said last August that such interventions need to be done on the basis of multilateral agreement and that that was not the case with the actions of Japan. The US Treasury has also made a similar critique. What do you think about that?

Draghi: In answer to the first question, there is no trade-off between the two measures. The LTRO addresses the quantitative shortages and liquidity constraints of certain parts of the euro area financial and banking system.

The interest rate changes address pricing conditions, assuming that the euro area banking and financial conditions are working well, that the circumstances are normal.

In that case you change the price of assets; you change the price of short-term rates, and so on. So they are two different things in the sense that they address different situations, different problems.

Regarding the Japanese interventions, I can confirm what my predecessor said on that occasion: the interventions, if they are needed, should be done in a multilateral framework – they should not be unilateral.

Question: First of all, in the event that the ECB does make some kind of arrangement for Greece, would you see that as being something done exclusively for Greece, or could it also be extended to other programme countries like Ireland, and would it be in the interests of a country like Ireland to try to get relief on its sovereign bonds holdings?

Second, you recently had a meeting with the Irish Finance Minister Michael Noonan about addressing the cost of the Anglo-Irish bank bonds.

Can you tell us if you are optimistic that there will be a successful resolution to that, and if Ireland has the ECB's support on that issue?

Draghi: We had a meeting with Minister Noonan and we reviewed the progress that the Government is actually making.

In spite of the enormous challenges it is facing, the Irish Government ought to be praised for the constant progress that it is making in its reforms.

Regarding your first question, we have already mentioned that Greece is unique and we don't want to repeat the experience. As I have not yet said

what the ECB is going to do about Greece, it is a very difficult question to answer.

Question: Which national central banks are going to have programmes for having credit claims as collateral?

And the second question for clarification, you gave two figures, 600 and 200. I would like to understand if these relate to all banks in the Eurosystem or to all banks in the programme countries?

Draghi: These figures are for all banks in the Eurosystem.

These are the first figures, which I have only just seen, about half an hour before the press conference.

I'm not in a position to say which countries these figures relate to. They in any case relate to the whole euro area, so I'm not talking about large figures.

Question: You just said that if the ECB sold its bonds at a loss that would amount to monetary financing. So giving up gains, would that also be a loss?

Secondly, you are certainly aware that, despite all the success of the LTRO, that in this country some people at least argue that this is a sort of hidden government financing. What is your position on these critical remarks?

Draghi: As regards your second questions, the 3-year facilities are there to be used. There is no stigma whatsoever attached to these facilities. This has to be understood by everybody.

I would describe some of the statements made as “statements of virility”.

Namely, that it would be undignified for a serious bank to access these facilities.

Now let me say that the very same banks that made these statements actually already access different kinds of facilities such as the euro dollar credit swap facility.

Another bank, which according to a newspaper report made an indignant statement that there would be a stigma, actually accessed the LTRO. So, some of these “virility” or “manhood” statements are often incorrect.

I think it's a business decision. Some banks thought that it is far better for banks to fully access these facilities, unlike those that made these statements. So they saw no stigma.

It's a business decision that should be presented as such. I should add that the crisis, which the banking system and the funding system is currently facing, originates from a sovereign crisis.

So the banks that happen to be located in countries that do not have any fiscal crisis, that have always undertaken the appropriate reforms, should give more credit to their governments for having been virtuous all along.

On your first question, consider the EFSF as euro area governments -- if the ECB gives money to governments that is monetary financing. If the ECB redistributes parts of its profit to euro area member countries (via the euro area national banks) according to its capital key, that is not monetary financing.

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Basel III News, April 2012



Dear Member,

“Prediction is very difficult, especially if it's about the future”
Nils Bohr, Nobel laureate in Physics

In Basel iii, Solvency ii, and many other laws and regulations, we **have to make economic projections**.

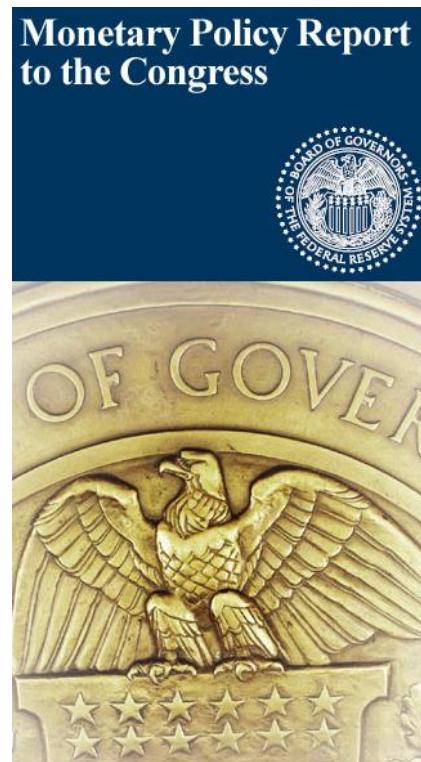
What I really love is the need for **“realistic assumptions”**.

So, we have a crystal ball: The Monetary Policy Report to the Congress where we can find the **“Summary of Economic Projections”**

Monetary Policy Report to the Congress Summary of Economic Projections

In conjunction with the January 24–25, 2012, Federal OpenMarket Committee (FOMC) meeting, the members of the **Board of Governors and the presidents of the Federal Reserve Banks**, all of whom participate in the deliberations of the FOMC, submitted **projections** for growth of real output, the unemployment rate, and inflation for the years 2012 to 2014 and over the longer run.

The economic projections were based on information available at the time of the meeting and participants' individual assumptions about



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factors likely to affect economic outcomes, including their assessments of appropriate monetary policy.

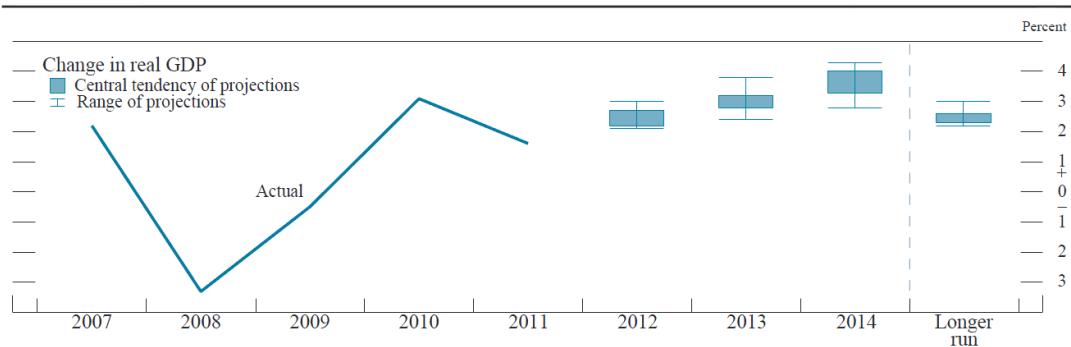
Starting with the January meeting, participants also submitted their assessments of the path for the target federal funds rate that they viewed as appropriate and compatible with their individual economic projections.

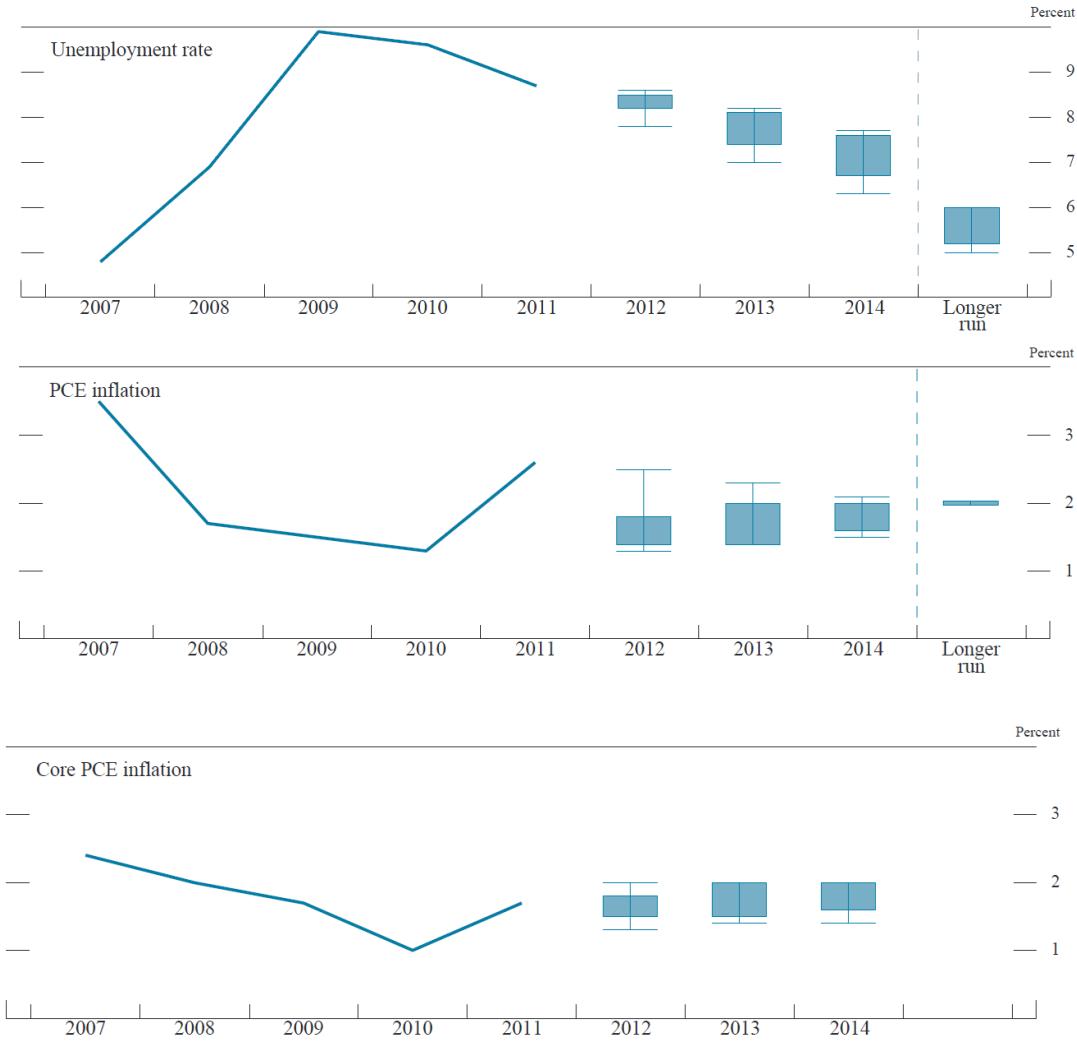
Longer-run projections represent each participants' assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks.

"Appropriate monetary policy" is defined as the future path of policy that participants deem most likely to foster outcomes for economic activity and inflation that best satisfy their individual interpretation of the Federal Reserve's objectives of maximum employment and stable prices.

As depicted in figure 1, FOMC participants projected continued economic expansion over the 2012–14 period, with real gross domestic product (GDP) rising at a modest rate this year and then strengthening further through 2014.

Figure 1. Central tendencies and ranges of economic projections, 2012–14 and over the longer run





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Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, January 2012

Percent

Variable	Central tendency ¹				Range ²			
	2012	2013	2014	Longer run	2012	2013	2014	Longer run
Change in real GDP	2.2 to 2.7	2.8 to 3.2	3.3 to 4.0	2.3 to 2.6	2.1 to 3.0	2.4 to 3.8	2.8 to 4.3	2.2 to 3.0
November projection	2.5 to 2.9	3.0 to 3.5	3.0 to 3.9	2.4 to 2.7	2.3 to 3.5	2.7 to 4.0	2.7 to 4.5	2.2 to 3.0
Unemployment rate	8.2 to 8.5	7.4 to 8.1	6.7 to 7.6	5.2 to 6.0	7.8 to 8.6	7.0 to 8.2	6.3 to 7.7	5.0 to 6.0
November projection	8.5 to 8.7	7.8 to 8.2	6.8 to 7.7	5.2 to 6.0	8.1 to 8.9	7.5 to 8.4	6.5 to 8.0	5.0 to 6.0
PCE inflation	1.4 to 1.8	1.4 to 2.0	1.6 to 2.0	2.0	1.3 to 2.5	1.4 to 2.3	1.5 to 2.1	2.0
November projection	1.4 to 2.0	1.5 to 2.0	1.5 to 2.0	1.7 to 2.0	1.4 to 2.8	1.4 to 2.5	1.5 to 2.4	1.5 to 2.0
Core PCE inflation ³	1.5 to 1.8	1.5 to 2.0	1.6 to 2.0		1.3 to 2.0	1.4 to 2.0	1.4 to 2.0	
November projection	1.5 to 2.0	1.4 to 1.9	1.5 to 2.0		1.3 to 2.1	1.4 to 2.1	1.4 to 2.2	

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The November projections were made in conjunction with the meeting of the Federal Open Market Committee on November 1–2, 2011.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.

2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

3. Longer-run projections for core PCE inflation are not collected.

Participants generally anticipated only a small decline in the unemployment rate this year.

In 2013 and 2014, the pace of the expansion was projected to exceed participants' estimates of the longer-run sustainable rate of increase in real GDP by enough to result in a gradual further decline in the unemployment rate.

However, at the end of 2014, participants generally expected that the unemployment rate would still be well above their estimates of the longer-run normal unemployment rate that they currently view as consistent with the FOMC's statutory mandate for promoting maximum employment and price stability.

Participants viewed the upward pressures on inflation in 2011 from factors such as supply chain disruptions and rising commodity prices as having waned, and they anticipated that inflation would fall back in 2012.

Over the projection period, most participants expected inflation, as measured by the annual change in the price index for personal consumption expenditures (PCE), to be at or below the FOMC's objective of 2 percent that was expressed in the Committee's statement of longer-run goals and policy strategy.

Core inflation was projected to run at about the same rate as overall inflation.

As indicated in table 1, relative to their previous projections in November 2011, participants made small downward revisions to their expectations for the rate of increase in real GDP in 2012 and 2013, but they did not materially alter their projections for a noticeably stronger pace of expansion by 2014.

With the unemployment rate having declined in recent months by more than participants had anticipated in the previous Summary of Economic Projections (SEP), they generally lowered their forecasts for the level of the unemployment rate over the next two years.

Participants' expectations for both the longer-run rate of increase in real GDP and the longer-run unemployment rate were little changed from November.

They did not significantly alter their forecasts for the rate of inflation over the next three years.

However, **in light of the 2 percent inflation that is the objective included in the statement of longer-run goals and policy strategy adopted at the January meeting, the range and central tendency of their projections of longer-run inflation were all equal to 2 percent.**

As shown in figure 2, most participants judged that highly accommodative monetary policy was likely to be warranted over coming years to promote a stronger economic expansion in the context of price stability.

In particular, with the unemployment rate projected to remain elevated over the projection period and inflation expected to be subdued, **six** participants anticipated that, under appropriate monetary policy, **the first increase in the target federal funds rate would occur after 2014, and five expected policy firming to commence during 2014 (the upper panel).**

The **remaining six** participants judged that raising the federal funds rate sooner would be required to forestall inflationary pressures or avoid distortions in the financial system.

As indicated in the lower panel, all of the individual assessments of the appropriate target federal funds rate over the next several years were below the longer-run level of the federal funds rate, and 11 participants placed the target federal funds rate at 1 percent or lower at the end of 2014.

Most participants indicated that **they expected that the normalization of the Federal Reserve's balance sheet should occur in a way consistent with the principles agreed on at the June 2011 meeting of the FOMC, with the timing of adjustments dependent on the expected date of the first policy tightening.**

A few participants judged that, given their current assessments of the economic outlook, appropriate policy would include additional asset purchases in 2012, and one assumed an early ending of the maturity extension program.

A sizable majority of participants **continued to judge the level of uncertainty** associated with their projections for real activity and the unemployment rate as unusually high relative to historical norms.

Many also attached a greater-than-normal level of uncertainty to their forecasts for inflation, but, compared with the November SEP, two additional participants viewed uncertainty as broadly similar to longer-run norms.

As in November, many participants saw downside risks attending their forecasts of real GDP growth and upside risks to their forecasts of the unemployment rate; most participants viewed the risks to their inflation projections as broadly balanced.

The Outlook for Economic Activity

The central tendency of participants' forecasts for the change in real GDP in 2012 was **2.2 to 2.7 percent**.

This forecast for 2012, while slightly lower than the projection prepared in November, would represent a pickup in output growth from 2011 to a rate close to its longer-run trend.

Participants stated that the economic information received since November showed continued gradual improvement in the pace of economic activity during the second half of 2011, as the influence of the temporary factors that damped activity in the first half of the year subsided.

Consumer spending increased at a moderate rate, exports expanded solidly, and business investment rose further.

Recently, **consumers and businesses appeared to become somewhat more optimistic about the outlook**.

Financial conditions for domestic nonfinancial businesses were generally favorable, and conditions in consumer credit markets showed signs of improvement.

However, a number of factors suggested that the pace of the expansion would continue to be restrained.

Although some indicators of activity in the housing sector improved slightly at the end of 2011, new homebuilding and sales remained at depressed levels, house prices were still falling, and mortgage credit remained tight.

Households' real disposable income rose only modestly through late 2011.

In addition, federal spending contracted toward year-end, and the restraining effects of fiscal consolidation appeared likely to be greater this year than anticipated at the time of the November projections.

Participants also read the information on economic activity abroad, particularly in Europe, as pointing to weaker demand for U.S. exports in coming quarters than had seemed likely when they prepared their forecasts in November.

Participants anticipated that the pace of the economic expansion would strengthen over the 2013–14 period, reaching rates of increase in real GDP above their estimates of the longer-run rates of output growth.

The central tendencies of participants' forecasts for the change in real GDP were 2.8 to 3.2 percent in 2013 and 3.3 to 4.0 percent in 2014.

Among the considerations supporting their forecasts, participants cited their expectation that the expansion would be supported by monetary policy accommodation, ongoing improvements in credit conditions, rising household and business confidence, and strengthening household balance sheets.

Many participants judged that U.S. fiscal policy would still be a drag on economic activity in 2013, but many anticipated that progress would be made in resolving the fiscal situation in Europe and that the foreign economic outlook would be more positive.

Over time and in the absence of shocks, participants expected that the rate of increase of real GDP would converge to their estimates of its longer-run rate, with a central tendency of 2.3 to 2.6 percent, little changed from their estimates in November.

The unemployment rate improved more in late 2011 than most participants had anticipated when they prepared their November projections, falling from 9.1 to 8.7 percent between the third and fourth quarters.

As a result, most participants adjusted down their projections for the unemployment rate this year.

Nonetheless, with real GDP expected to increase at a modest rate in 2012, the unemployment rate was projected to decline only a little this year, with the central tendency of participants' forecasts at 8.2 to 8.5 percent at year-end.

Thereafter, participants expected that the pickup in the pace of the expansion in 2013 and 2014 would be accompanied by a further gradual improvement in labor market conditions.

The central tendency of participants' forecasts for the unemployment rate at the end of 2013 was 7.4 to 8.1 percent, and it was 6.7 to 7.6 percent at the end of 2014.

The central tendency of participants' estimates of the longer-run normal rate of unemployment that would prevail in the absence of further shocks was 5.2 to 6.0 percent.

Most participants indicated that they anticipated that five or six years would be required to close the gap between the current unemployment rate and their estimates of the longer-run rate, although some noted that more time would likely be needed.

Figures 3.A and 3.B provide details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate over the next three years and over the longer run.

The dispersion in these projections reflected differences in participants' assessments of many factors, including appropriate monetary policy and its effects on economic activity, the underlying momentum in economic activity, the effects of the European situation, the prospective path for U.S. fiscal policy, the likely evolution of credit and financial market conditions, and the extent of structural dislocations in the labor market.

Compared with their November projections, the range of participants' forecasts for the change in real GDP in 2012 narrowed somewhat and shifted slightly lower, as some participants reassessed the outlook for global economic growth and for U.S. fiscal policy.

Many, however, made no material change to their forecasts for growth of real GDP this year.

The dispersion of participants' forecasts for output growth in 2013 and 2014 remained relatively wide.

Having incorporated the data showing a lower rate of unemployment at the end of 2011 than previously expected, the distribution of participants' projections for the end of 2012 shifted noticeably down relative to the November forecasts.

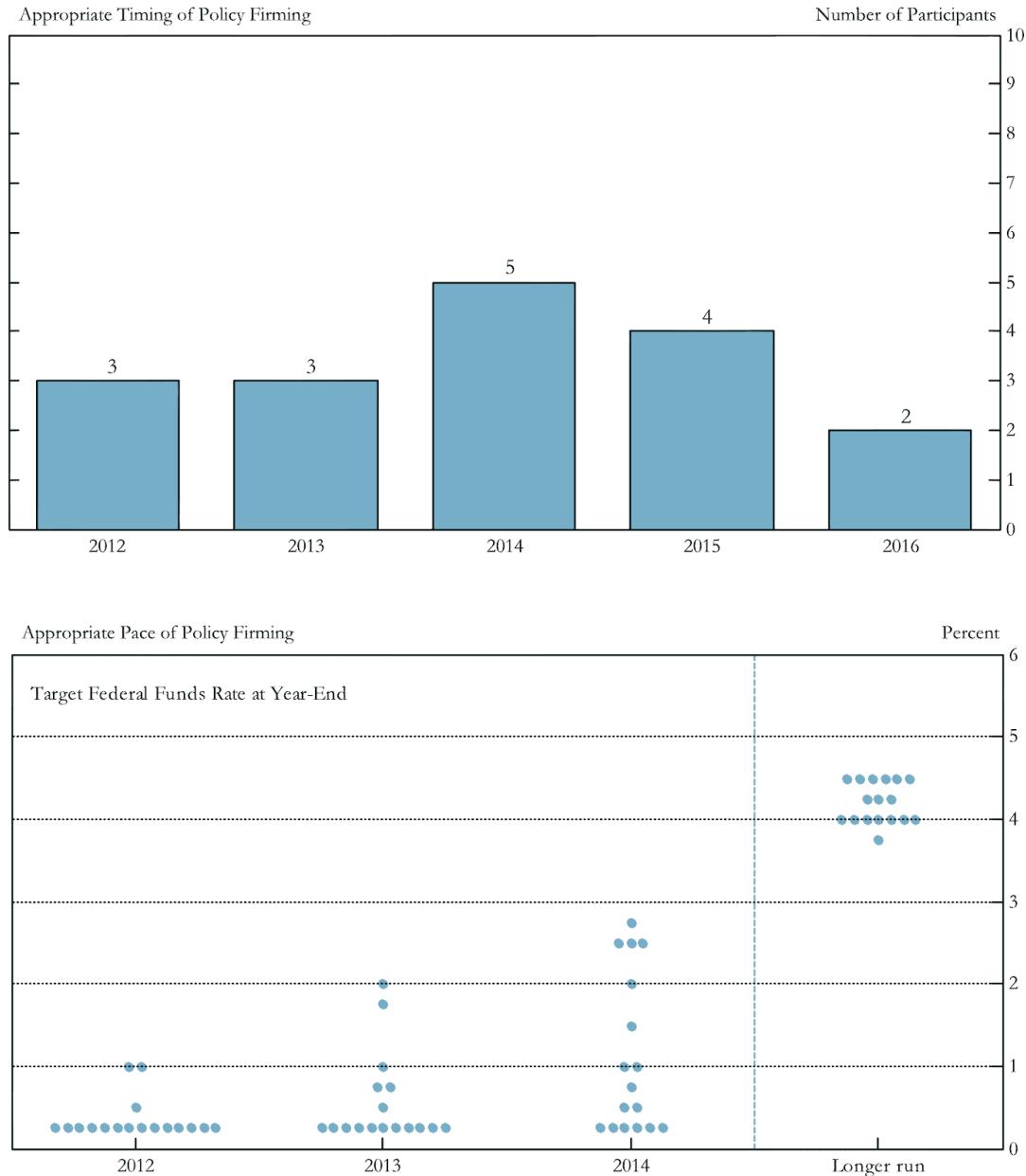
The ranges for the unemployment rate in 2013 and 2014 showed less pronounced shifts toward lower rates and, as was the case with the ranges for output growth, remained wide.

Participants made only modest adjustments to their projections of the rates of output growth and unemployment over the longer run, and, on net, the dispersions of their projections for both were little changed from those reported in November.

The dispersion of estimates for the longer-run rate of output growth is narrow, with only one participant's estimate outside of a range of 2.2 to 2.7 percent.

By comparison, participants' views about the level to which the unemployment rate would converge in the long run are more diverse, reflecting, among other things, different views on the outlook for labor supply and on the extent of structural impediments in the labor market.

Figure 2. Overview of FOMC participants' assessments of appropriate monetary policy



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Figure 3.A. Distribution of participants' projections for the change in real GDP, 2012–14 and over the longer run



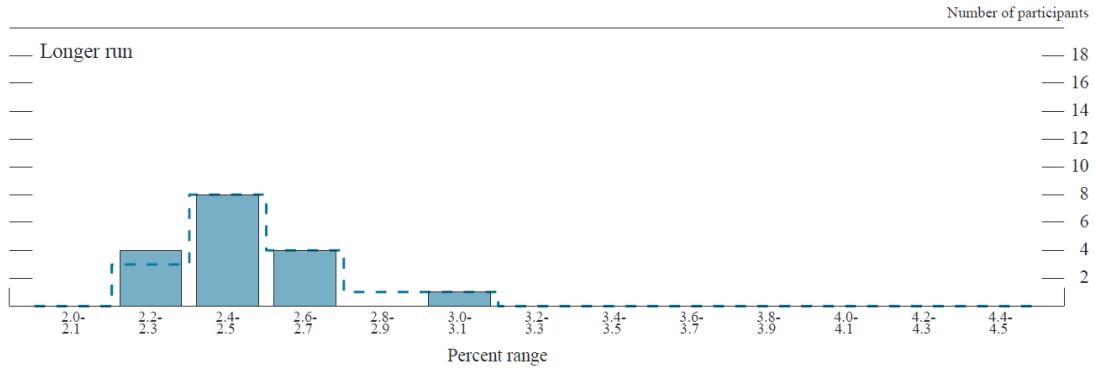
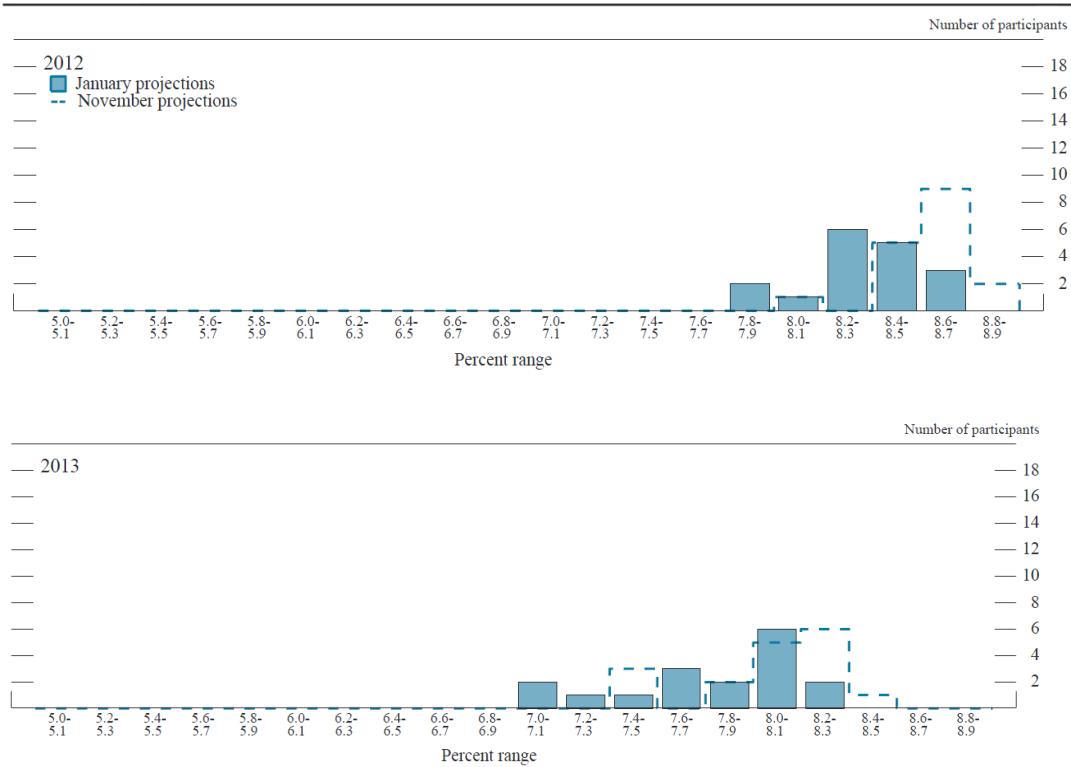
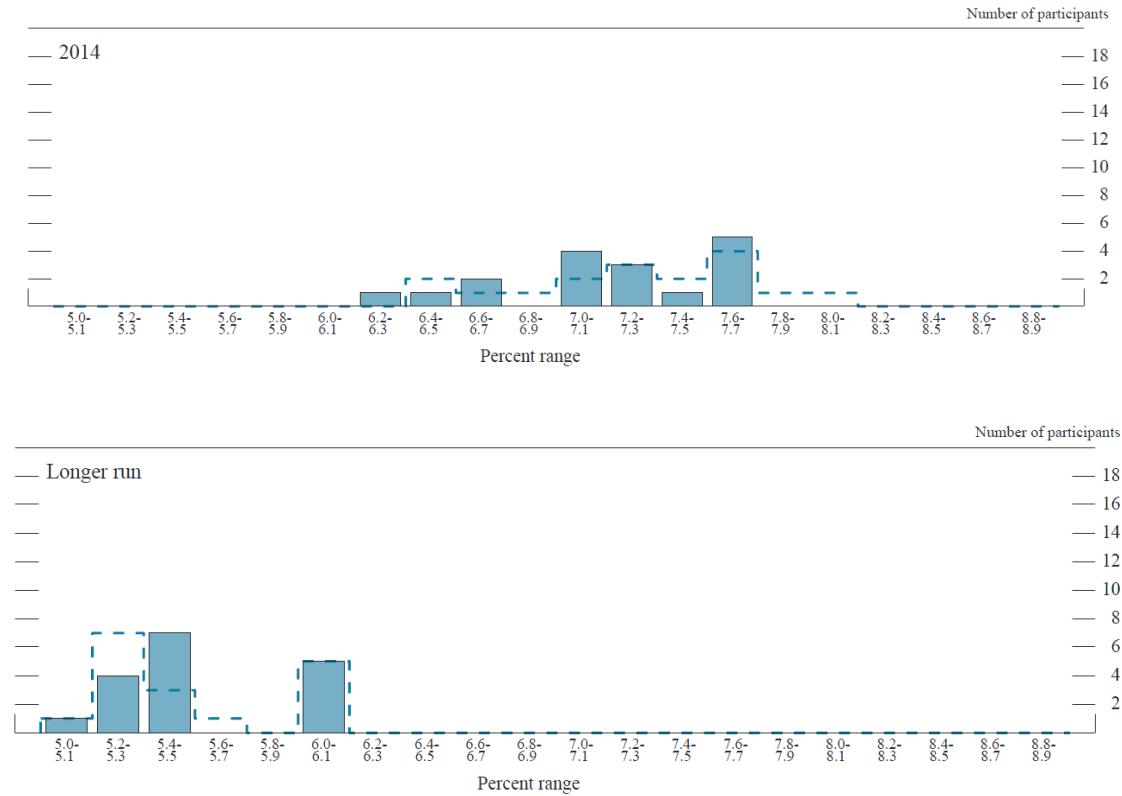


Figure 3.B. Distribution of participants' projections for the unemployment rate, 2012–14 and over the longer run







BANK FOR INTERNATIONAL SETTLEMENTS

BIS Quarterly Review, March 2012 International banking and financial market developments

European bank funding and deleveraging

Asset prices broadly recovered some of their previous losses between early December and the end of February, as the severity of the euro area sovereign and banking crises eased somewhat.

Equity prices rose by almost 10% on average in developed countries and by a little more in emerging markets.

Bank equity prices increased particularly sharply.

Gains in credit markets reflected the same pattern.

Central to these developments was an easing of fears that funding strains and other pressures on European banks to deleverage could lead to forced asset sales, contractions in credit and weaker economic activity.

This article focuses on developments in European bank funding conditions and deleveraging, documenting their impact to date on financial markets and the global economy.

Funding conditions at European banks improved following special policy measures introduced by central banks around the beginning of December.

Before that time, many banks had been unable to raise unsecured funds in bond markets and the cost of short-term funding had risen to levels only previously exceeded during the 2008 banking crisis.

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Dollar funding had become especially expensive.

The ECB then announced that it would **lend euros to banks for three years against a wider set of collateral**.

Furthermore, the cost of swapping euros into dollars fell around the same time, as central banks reduced the price of their international swap lines.

Short-term borrowing costs then declined and unsecured bond issuance revived.

At their peak, bank funding strains exacerbated fears of forced asset sales, credit cuts and weaker economic activity.

New regulatory requirements for major European banks to **raise their capital ratios by mid-2012** added to these fears.

European banks did sell certain assets and cut some types of lending, notably those denominated in dollars and those attracting higher risk weights, in late 2011 and early 2012.

However, there was little evidence that actual or prospective sales lowered asset prices, and overall financing volumes held up for most types of credit.

This was largely because **other banks, asset managers and bond market investors took over** the business of European banks, thus reducing the impact on economic activity.

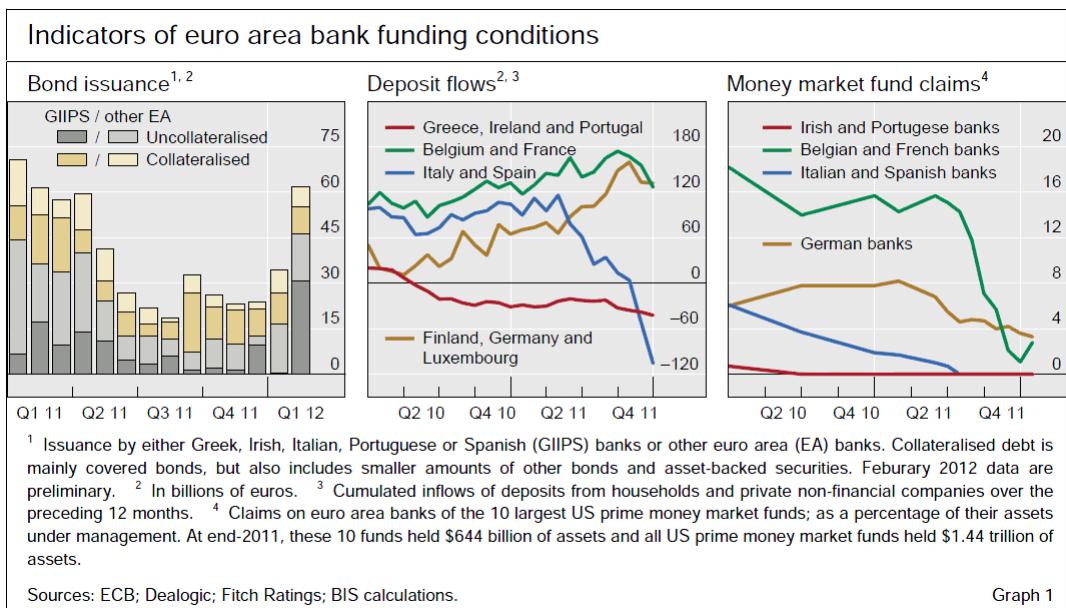
Bank funding pressures and policy responses

European bank funding conditions deteriorated towards the end of 2011, as faltering prospects for economic growth and fiscal sustainability undermined the value of sovereign and other assets.

Bond issuance by euro area banks in the second half of the year, for example, was just a fraction of its first half value (Graph 1, left-hand panel).

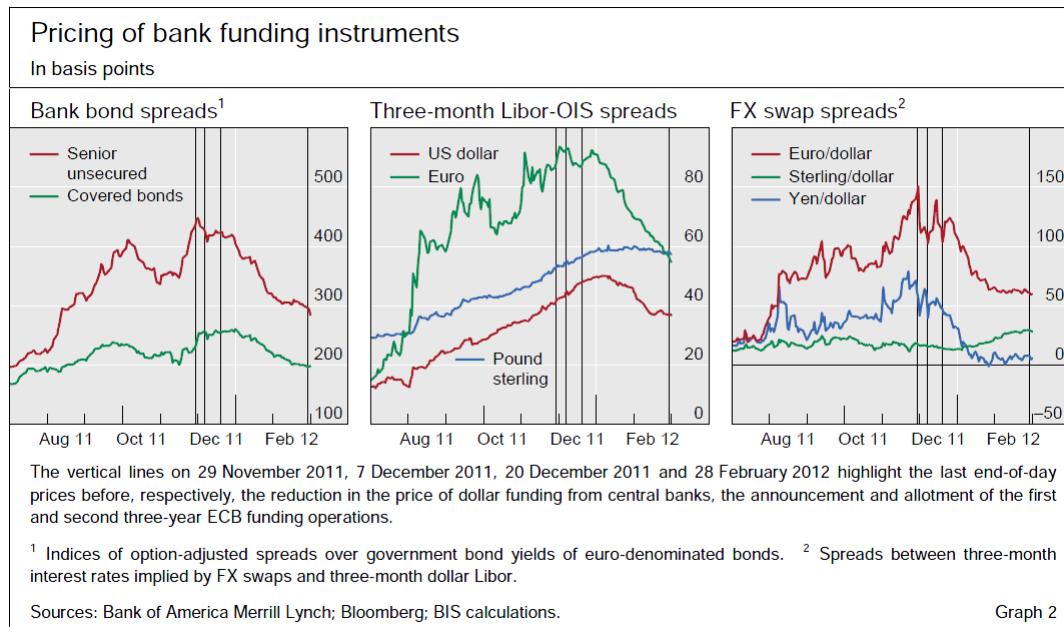
Until December, uncollateralised issuance by banks in countries facing significant fiscal challenges was especially weak.

Deposits also flowed out of banks in these countries, with withdrawals from Italy and Spain accelerating in the final quarter of the year (Graph 1, centre panel).



At this time, US money market funds significantly reduced their claims on French banks, having already eliminated their exposures to Greek, Irish, Italian, Portuguese and Spanish institutions (Graph 1, right-hand panel).

The pricing of long- and short-term euro-denominated bank funding instruments also deteriorated, both in absolute terms and relative to that of non-euro instruments, as did the cost of swapping euros into dollars (Graph 2).



The policy response

Around early December, central banks announced further measures to help tackle these funding strains.

On 8 December, the ECB said that it would supply banks in the euro area with as much three-year euro-denominated funding as they bid for in two special longer-term refinancing operations (LTROs) on 21 December 2011 and 29 February 2012.

At the same time, it announced that Eurosystem central banks would accept a wider range of collateral assets than previously.

The ECB also said that it would halve its reserve ratio from 18 January, reducing the amount that banks must hold in the Eurosystem by around €100 billion.

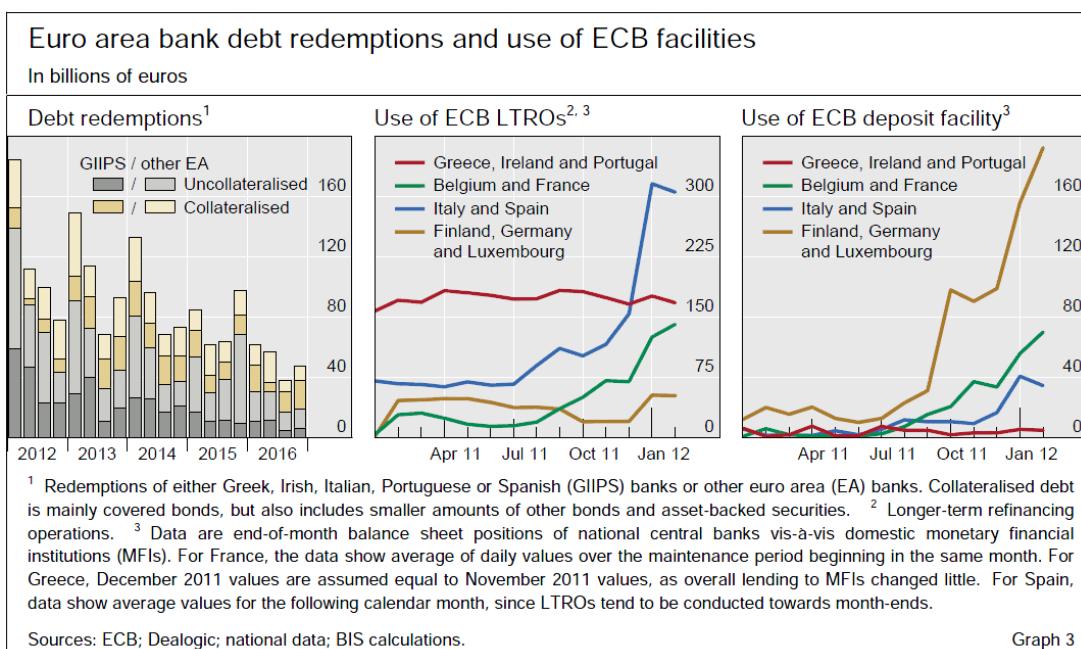
A few days earlier, six major central banks, including the ECB, the Bank of England and the Swiss National Bank, had announced a 50 basis point cut to the cost of dollar funds offered to banks outside the United States.

They also extended the availability of this funding by six months to February 2013.

Euro area banks raised large amounts of funding via the ECB's three-year LTROs, covering much of their potential funding needs from maturing bonds over the next few years.

Across both operations, they bid for slightly more than €1 trillion.

This was equivalent to around 80% of their 2012–14 debt redemption, more than covering their uncollateralised redemptions (Graph 3, left-hand panel).



Banks in Italy and Spain made bids for a large proportion of the funds allocated at the first three-year LTRO (**Graph 3, centre panel**), while the funding situation of banks in other regions improved indirectly.

Banks in Germany, Luxembourg and Finland, for example, did not take much additional funding at the first LTRO.

However, some of the allotted funds, perhaps after a number of transactions, ended up as deposits with these banks, boosting the liquidity of their balance sheets.

In turn, they significantly increased their Eurosystem deposits (**Graph 3, right-hand panel**).

There was also **little change in the LTRO balance at the Greek, Irish and Portuguese central banks**.

However, banks in these jurisdictions had already borrowed a combined €165 billion before December and may have been short of collateral to use at the first LTRO.

Bank funding conditions improved following these central bank measures.

Investors returned to long-term bank debt markets, buying more uncollateralised bonds in January and February 2012 than in the previous five months (**Graph 1, left-hand panel**).

US money market funds also increased their exposure to some euro area banks in January (**Graph 1, right-hand panel**).

Indicators of the cost of long- and short-term euro-denominated bank funding instruments also turned, as did the foreign exchange swap spread for converting euros into dollars (**Graph 2**).

The nexus between sovereign and bank funding conditions

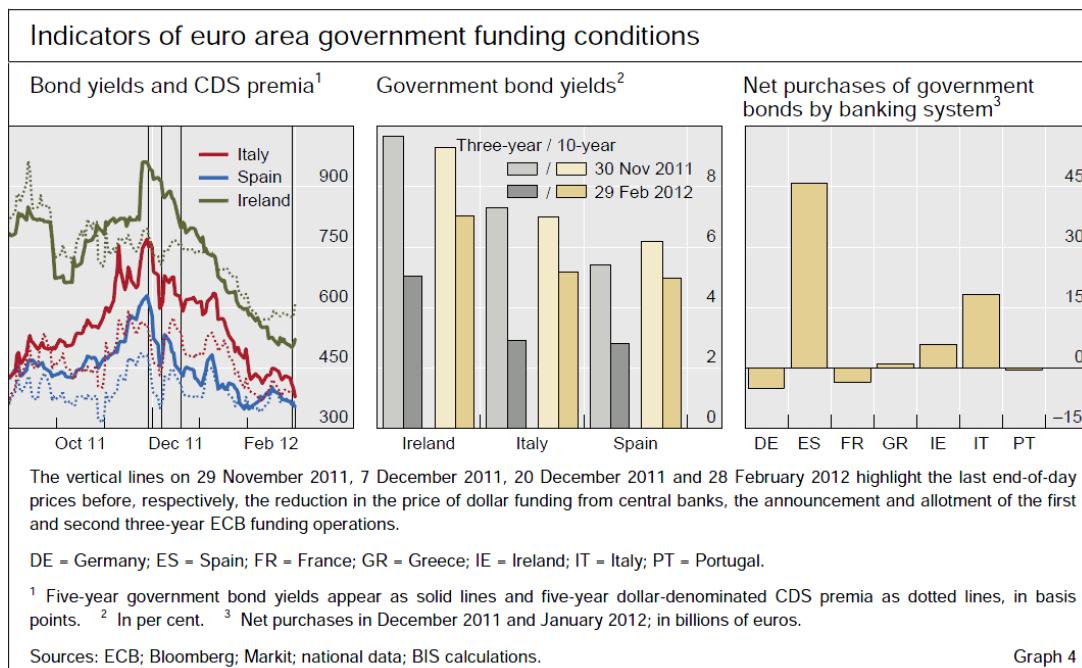
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Funding conditions for euro area sovereigns improved in parallel to those of banks in December 2011 and early 2012.

Secondary market yields on Irish, Italian and Spanish government bonds, for example, declined steadily during this period ([Graph 4, left-hand panel](#)).

Yields on bonds with maturities of up to three years fell by more than those of longer-dated bonds ([Graph 4, centre panel](#)).



At this time, these governments also paid lower yields at a series of auctions, despite heavy volumes of issuance.

One notable exception to this trend was the continued rise in yields on Greek government bonds.

This reflected **country-specific** factors, including the revised terms of a private sector debt exchange and tough new conditions for continued official sector lending.

Part of the decline in government bond yields appeared to reflect diminished perceptions of sovereign credit risk.

This was consistent with declines in sovereign CDS premia.

In turn, part of the reduction in sovereign credit risk probably reflected improvements in bank funding conditions.

This could have worked via two channels.

First, any reduction in the likelihood of banks failing because of funding shortages would have cut the probability of government support for these banks.

Second, any easing of pressure on banks to shed assets would have boosted the outlook for economic activity and, hence, public finances.

In addition, **some of the improvements in perceptions of sovereign credit risk during this period probably reflected announcements made at the 8–9 December EU summit.**

These outlined arrangements to strengthen fiscal discipline in the union and to bring forward the launch of the European Stability Mechanism.

A further part of the decline in yields on government bonds appeared to reflect the additional cash in the financial system available to finance transactions in these and other securities.

This was consistent with government bond yields declining by more than CDS premia.

Banks in Italy and Spain, for example, used new funds to significantly boost their holdings of government bonds (**Graph 4, right-hand panel**).

While other euro area banks were less active in this respect, they may have committed new funds to help finance positions in government bonds for other investors.

Or they may have purchased other assets and the sellers of those assets may have invested the resulting funds in government bonds.

These improvements in funding terms for euro area sovereigns fed back into bank funding conditions.

In particular, higher market values of sovereign bonds enhanced the perceived solvency of banks, which made them more attractive in funding markets. However, this link earlier worked in reverse and could potentially do so again.

Deleveraging prospects and consequences

The sharp rise in funding costs and growing concerns over adequate capitalisation toward the end of 2011 added to existing market pressures on European banks to deleverage.

Deleveraging is part of a necessary post-crisis adjustment to remove excess capacity and restructure balance sheets, thus restoring the conditions for a sound banking sector.

That said, the confluence of funding strains and sovereign risk led to fears of a precipitous deleveraging process that could hurt financial markets and the wider economy via asset sales and contractions in credit.

The extension of central bank liquidity and the European Banking Authority's (EBA) recommendation on bank recapitalisation, however, played important parts in paving the way toward a more gradual deleveraging process.

Deleveraging prospects: capital-raising and asset-shedding

The European bank recapitalisation plan announced in October 2011 brought fears of deleveraging to the forefront of financial market concerns.

It required 65 major banks to attain a 9% ratio of core Tier 1 capital to risk-weighted assets (RWA) by the end of June 2012, and the authorities identified a combined capital shortfall of €84.7 billion at 31 major banks as of end-September 2011.

Banks can deleverage either by recapitalising or by reducing RWA, with different economic consequences.

In order to safeguard the flow of credit to the EU economy, supervisory authorities explicitly discouraged banks from shedding assets. Banks thus planned to meet their shortfalls predominantly through capital measures, and some made progress in spite of unfavourable market conditions.

Low share prices, as at present, cause a strong dilution effect, drawing resistance from incumbent shareholders and management.

The experience of UniCredit, whose deeply discounted €7.5 billion rights issue led to a 45% (albeit transient) plunge in its share price, deterred other banks from following suit.

Capital can also be built through retained earnings, debt-to-equity conversion or redemption below par.

Some banks opted to convert outstanding bonds, notably Santander for €6.83 billion. Overall, banks plan to rely substantially on additions to capital and retained earnings to reach the 9% target ratio.

The actions and plans of EBA banks thus helped to ease market fears over potential shedding of assets among banks with capital shortfalls (see below).

The extent of asset-shedding observed in markets reflects a broader trend among European banks towards deleveraging over the medium term.

French and Spanish banks, for instance, sold dollar-funded assets and divested foreign operations partly to focus their business models on core activities.

Major UK banks, similarly, continued to shrink their balance sheets, although none had to meet any EBA capital shortfall.

In view of recurring funding pressures and changing business models, many banks, with or without EBA capital shortfalls plan to extend the ongoing trend of shedding assets.

Industry estimates of overall asset disposals by European banks over the coming years thus range from €0.5 trillion to as much as €3 trillion.

The extension of central bank liquidity eased the pace of asset-shedding observed in late 2011, but did not turn the underlying trend.

If the banks in the EBA sample, for instance, failed to roll over their senior unsecured debt maturing over a two-year horizon, which amounts to more than €1,100 billion (€600 billion among banks with a capital shortfall), they would have to shed funded assets in equal measure.

By covering these funding needs, the LTROs and dollar swap lines helped avert an accelerated deleveraging process.

But many banks continued to divest assets in anticipation of the eventual expiration of these facilities.

Banks are also mindful that a sustained increase in their capitalisation would facilitate both regulatory compliance and future access to the senior unsecured debt market.

Limited asset-shedding among banks under the European recapitalisation plan

The **European Banking Authority (EBA)** published its recommendation relating to the European bank recapitalisation plan on 8 December 2011.

This forms part of a broader set of EU measures agreed in October 2011 to restore confidence in the banking sector.

By the end of June 2012, 65 banks must reach a 9% ratio of core Tier 1 capital to risk-weighted assets (RWA).

Capital will be assessed net of valuation losses on EEA sovereign exposures incurred by end-September 2011 (“sovereign buffer”).

The 31 banks located in the shaded area below the regulatory line (capital = 0.09 RWA) in Graph A (left-hand panel) were below the 9% target ratio, as of end-September 2011, by an aggregate shortfall of €84.7 billion.

The aggregate shortfall among all 71 banks in the EBA sample reaches €114.7 billion when six Greek banks are included with an estimated shortfall of €30 billion against the (stricter) capital targets under the EU/IMF financial assistance programme.

The plans banks submitted to regulators in January 2012 suggest that the shedding of bank assets will play a small part in reaching the target ratio.

As the example of bank B in the left-hand panel illustrates, banks can deleverage either by recapitalising (moving upward) or by reducing RWA (moving leftward).

The EBA's first assessment shows that banks intend to cover 96% of their original shortfalls by direct capital measures, although the proposed measures also surpass the original capital shortfall by 26%.

Planned capital measures thus account for 77% of the overall effort, and comprise new capital and reserves (26%), conversion of hybrids and issuance of convertible bonds (28%), and retained earnings (16%), while the remaining 23% rely on RWA reductions, notably on internal model changes pre-agreed with regulators (9%) and on the shedding of assets (10%), comprising planned RWA cuts of €39 billion in loan portfolios and some €73 billion through asset sales.

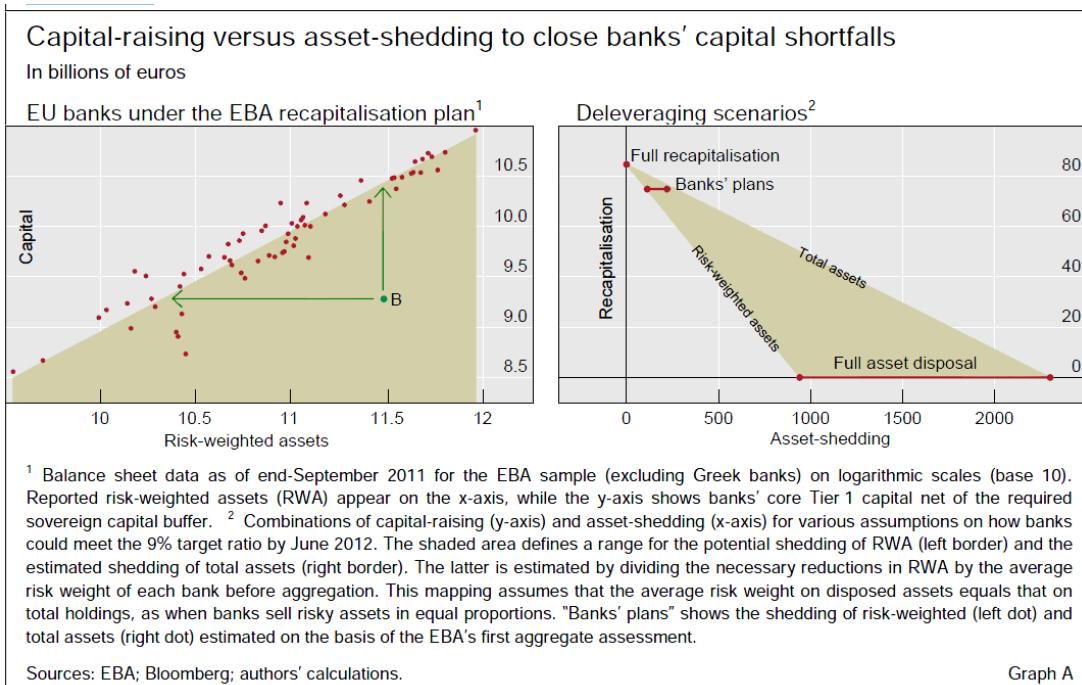
In this regard, the European bank recapitalisation plan reduced, but did not eliminate, the need for banks with capital shortfalls to shed assets (**Graph A, right-hand panel**).

The likely scale of asset-shedding cannot be inferred reliably from RWA reductions.

However, assuming a 75% average risk weight on loans and that the average risk weight on disposed assets equals that on holdings (43%, from average RWA as a share of total assets, using Bloomberg data), the planned RWA cuts of €112 billion relating to lending cuts and asset sales (= €39 + €73 billion) translate into an estimated €221 billion reduction in total assets.

Some of the lending cuts are an inevitable part of restructuring under state aid rules.

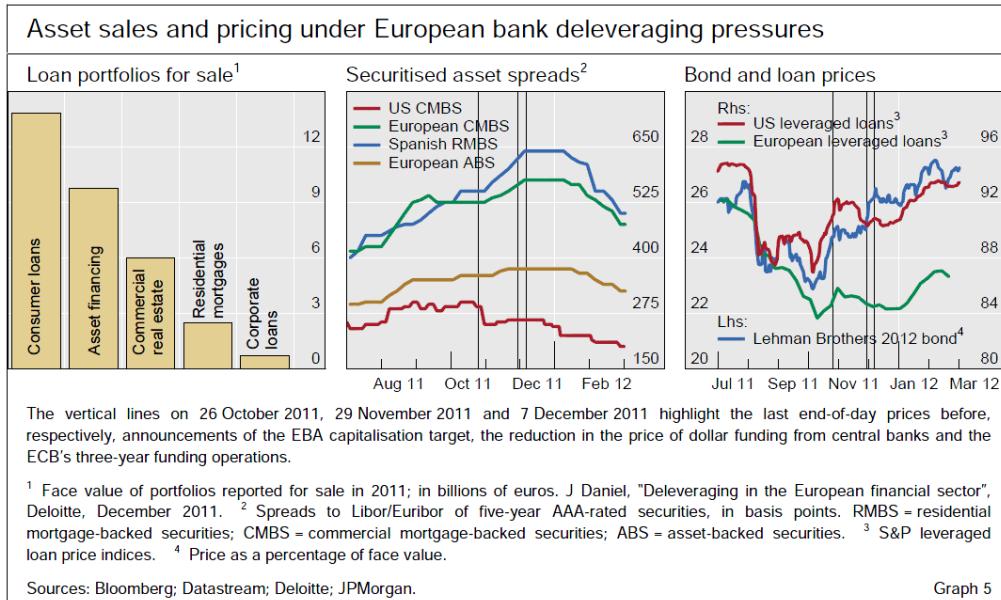
While these amounts are sizeable, they are an order of magnitude smaller than if banks had sought to reach the target ratio without significant additions to their capital.



Evidence of asset sales and price falls

As deleveraging pressures grew towards the end of 2011, European banks offered for sale a significant volume of assets, notably those with high risk weights or market prices close to holding values (Graph 5, left-hand panel).

Offerings with high risk weights included low-rated securitised assets, distressed bonds and commercial property and other risky loans.



Although some such transactions were completed, others did not go through because the offered prices were below banks' holding values.

Selling at these prices would have generated losses, thus reducing capital and preventing the banks from achieving the intended deleveraging.

In contrast, other offerings included aircraft and shipping leases and other assets with steady cash flows and collateral backing, since these often fetched face values and thus avoided losses.

Moreover, as dollar funding remained more expensive than homecurrency funding for many European banks, dollar-denominated assets were in especially strong supply.

Despite this, there is little evidence that actual or expected future sales significantly affected asset prices.

Graph 5 (centre and right-hand panels) shows time series of price quotes for selected high-spread securitised assets, distressed bonds and leveraged loans.

True, the price of US leveraged loans fell and spreads on some securitised assets rose after the EBA capital target announcement, consistent with the deleveraging implications of this news.

And the price of distressed Lehman Brothers bonds increased after the reduction in the cost of dollar financing from central banks.

But these changes were not unusually large compared with past price movements.

Furthermore, some of the other price reactions shown in the graph were in directions opposite to those implied by the deleveraging news.

That said, banks also offered for sale some assets that do not have regular price quotes, including parts of their loan portfolios.

Market participants reported gaps between the best bid and offered prices for some of these assets, with low bid prices sometimes attributed to prospective supplies of similar assets from other banks.

Conclusion

Pressures on European banks to deleverage increased towards the end of 2011 as funding strains intensified and regulators imposed new capitalisation targets.

Many of these banks shed assets, both through sales and by cutting lending.

However, this did not appear to weigh heavily on asset prices, nor did overall financing fall for most types of credit.

This was because other banks, asset managers and bond market investors took over the business of European banks.

An open question is whether other financial institutions will be able to substitute for European banks as the latter continue to deleverage.

The reduction in deleveraging pressures in late 2011 and early 2012, after measures by central banks mitigated bank funding strains, means at least that this process may run more gradually.

This should reduce any impact on financial markets and economic activity.

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**From Chairman Ben S. Bernanke
At the Independent Community Bankers of America National
Convention and Techworld, Nashville, Tennessee (via prerecorded video)
March 14, 2012**

Community Banking

I'm glad to have the chance to speak again to the Independent Community Bankers of America, even if it's by way of prerecorded remarks.

This will be the first time in quite a few years that I haven't been with you in person, but, as you may know, the Federal Open Market Committee met just yesterday in Washington, so I am unable to join you in Nashville.

I have very much enjoyed attending these annual ICBA get-togethers, especially since I get the chance to hear directly from you about what's happening in your local economies and in community banking more generally.

It's a tradition I hope to reestablish in the future.

The Role of Community Banks in a Challenging Economy

Community banks remain a critical component of our financial system and our economy.

They help keep their local economies vibrant and growing by taking on and managing the risks of local lending, which larger banks may be unwilling or unable to do.

They often respond with greater agility to lending requests than their national competitors because of their detailed knowledge of the needs of their customers and their close ties to the communities they serve.

As you well know, however, community banks are also facing difficult challenges. Their close ties to local economies are, on balance, a source of strength, but a drawback of those ties is that the fortunes of communities and their banks tend to rise and fall together.

Another concern for community banks is the narrowing of the range of their profitable lending activities: Because larger banks have used their scale to gain a pricing advantage in volume-driven businesses such as consumer lending, community banks have tended to specialize in other areas, such as loans secured by commercial real estate.

That said, I know that community banks are continuing to look for ways to prudently diversify their revenue sources.

Like larger banks, community banks are also being affected by the state of the national economy.

Despite some recent signs of improvement, the recovery has been frustratingly slow, constraining opportunities for profitable lending.

And, as I will discuss momentarily, actual and prospective changes in the regulatory landscape have also raised concerns among community bankers.

The good news is that, for the most part, community banks appear to be meeting their challenges.

Profits of smaller banks were considerably higher in 2011 than in the previous year, nonperforming assets were lower, provisions for loan losses fell appreciably, and capital ratios improved.

Outreach and Communication with Community Banks

As I noted, together with economic conditions, regulation and supervision are among the top concerns for community banks.

In that regard, I think we would all agree that two-way communication between regulators and community banks is critical.

Banks need to understand supervisors' policies and expectations, but supervisors must also listen to and understand banks' concerns.

At the Federal Reserve, we pursue our dialogue with community bankers through many channels.

One important channel is the recently established **Community Depository Institutions Advisory Council (CDIAC)**.

The council's membership is drawn from smaller banks, credit unions, and savings associations.

Each of the 12 Reserve Banks around the country has a local advisory council, and one representative from each local council serves on the national council that meets with the Board in Washington twice a year.

At a recent meeting, for example, one of our CDIAC members asked us to be clearer about whether particular rules and guidance apply to community banks.

Having heard from this banker as well as others, we are now working to more explicitly indicate which banks will be affected when we issue new regulatory proposals, final rules, or regulatory guidance.

Although this change seems relatively simple, we hope it will help banks avoid allocating precious resources to poring over supervisory guidance that does not apply to them.

In addition to the advisory council, the Board last year established a **supervision subcommittee on smaller regional and community banking**.

Because of their professional backgrounds in community banking and bank supervision, I asked Governors Elizabeth Duke and Sarah Bloom Raskin to serve on this subcommittee.

Its primary role is to improve our understanding of community and regional banking conditions and to review policy proposals for their potential effect on the safety and soundness of, and the regulatory costs imposed on, community and regional institutions.

Governors Duke and Raskin are also keenly interested in how our policies could affect the availability of credit to sound borrowers.

We have other contacts with community banks that have proved valuable. For quite a few years, the Reserve Banks have maintained local training and outreach programs for banks.

More recently, several of these programs have been expanded nationally. For example, the Federal Reserve Bank of St. Louis organizes national "Ask the Fed" calls to provide bankers with an opportunity to hear Federal Reserve staff discuss recent policy initiatives and issues that examiners are encountering in the field.

In addition, the Federal Reserve Bank of San Francisco hosts consumer compliance webinars, and the Federal Reserve Bank of Philadelphia publishes a quarterly overview of consumer compliance issues that allows Federal Reserve staff to address questions from banks.

We are exploring options for building on these initiatives. It is critical to keep the communications channels open if supervisors and banks are to work together constructively.

The Regulation and Supervision of Community Banks

Bank supervision requires a delicate balance--particularly now.

The weak economy, together with loose lending standards in the past, has put pressure on the entire banking industry, including community banks.

To protect banks from new problems down the road, and to safeguard the Deposit Insurance Fund, supervisors must insist on high standards for lending, risk management, and governance.

At the same time, it is important for banks, for their communities, and for the national economy that banks lend to creditworthy borrowers.

Lending to creditworthy borrowers, after all, is how banks earn profits.

We also know that supervision imposes costs on institutions, and we recognize that new regulations and supervisory requirements may impose disproportionate costs on community banks.

Thus, we take quite seriously the importance of evaluating the costs and benefits of new rules.

Supervision is conducted through the Federal Reserve's decentralized structure of 12 regional Reserve Banks, which helps us tailor our

examinations and supervision to the size, complexity, risk profile, and business model of each institution.

Community bankers tell us repeatedly that they are concerned about the changing regulatory environment.

One particular worry is the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

It is important to emphasize that **the Congress enacted the Dodd-Frank Act largely in response to the "too big to fail" problem, and that most of its provisions--regarding, for example, capital, liquidity, and risk management--apply only, or principally, to the largest, most complex, and internationally active banks.**

These new standards are not meant to apply to, and clearly would not be appropriate for, community banks.

We will work to maintain a clear distinction between community banks and larger institutions in the application of new regulations.

Conclusion

To conclude, I would like to reemphasize the importance that my colleagues on the Board and I place on the Federal Reserve's relationship with community banks.

The Fed is committed to fair, consistent, and informed examinations that take into account the size, complexity, and individual circumstances of each bank we oversee.

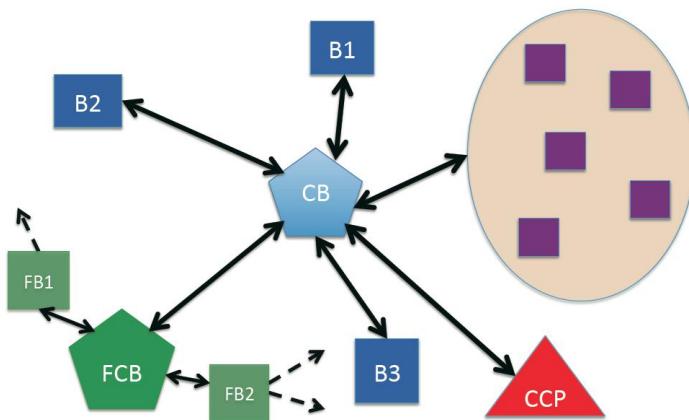
We will do all we can to support the banks' safety and soundness and eliminate unnecessary costs. Despite economic uncertainties, the condition of community banks is improving.

That's good news not only for banks, but for their communities and the national economy as well. Thanks, and enjoy the rest of your meetings.

Interesting!

The paper starts with the phrase: “Weaknesses in the “plumbing” of the financial system that came to light during the financial crisis of 2007-2009...”

The paper has the title: *Replumbing Our Financial System: Uneven Progress* (Preliminary, Darrell Duffie, Stanford University, March 17, 2012). This paper is for a conference of the Board of Governors of the Federal Reserve System, “Central Banking: Before, During and After the Crisis” March 23-24, 2012, Washington D.C.



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Abstract

The financial crisis of 2007-2009 has spurred significant ongoing changes in the “pipes and valves” through which cash and risk flow through the center of our financial system.

These include **adjustments to the forms of lender-of-last-resort financing** from the central bank and changes the infrastructure for the wholesale overnight financing of major dealer banks.

Significant changes in the **regulation** of money market funds are under consideration.

The **Dodd-Frank Act** mandates the central clearing of standardized over-the-counter derivatives, although a pending exemption of foreign-exchange derivatives remains to be decided.

The **vulnerability of major dealers** to runs by prime brokerage clients is also an issue to be addressed.

I focus on U.S. financial plumbing and on areas where financial stability remains a concern.

Introduction

Weaknesses in the “**plumbing**” of the financial system that came to light during the financial crisis of 2007-2009 have prompted reforms that are ongoing.

On the path toward greater financial stability, progress has been uneven.

My objective here is to **focus on some weaknesses that remain**.

“**Plumbing**” is a common metaphor for institutional elements of the financial system that are [fixed in the short run and enable flows of credit, capital, and financial risk](#).

This institutional structure includes some big “**valves and pipes**” that connect central banks, dealer banks, money market funds, major institutional investors, repo clearing banks, over-the-counter (OTC) derivatives central clearing parties, and exchanges.

The connectors include **lending facilities** offered by central banks to each other and to dealer banks, **tri-party repo and clearing agreements**, OTC derivatives master swap agreements, prime-brokerage agreements, and settlement systems arranged through FedWire, CLS Bank, DTC, and other major custodians and settlement systems.

The institutional framework depends on regulations. Largely because of changes in financial regulation, we are heading toward a safer financial system.

Of primary importance in this progress are **improvements in capital and liquidity requirements for regulated banks**, although these are not my main focus here.

Improvements in the plumbing of the financial system, however, have in some areas been **partial or halting**.

Just as the wider economy depends on an effective financial system for transferring credit, capital, and risk among ultimate economic actors, the internal effectiveness of the financial system depends on the proper functioning of financial infrastructure.

At the onset of a financial crisis, institutional arrangements that are fixed in the short run determine the scope for discretionary action, of both harmful and risk-reducing types.

Some of these arrangements, such as central-bank emergency liquidity facilities, are **only activated during a crisis**.

Plumbing elements should not only be resilient to stresses such as the defaults of interacting entities, they should also be placed and designed so as to permit the sorts of transfers that may be needed in a crisis.

Typical approaches to **financial risk management** that balance failure risk against away-from-failure operating efficiency should, in my view, be

fully re-calibrated for applications to certain key financial market infrastructure.

Although regulators are working toward a world that can more easily tolerate the failure of large financial institutions, **I doubt that we should view some of the key financial infrastructure in the same way.**

Obviously there should be effective failure-management plans for repo clearing facilities and OTC derivatives central clearing parties (CCPs), but the public interest suggests that these kinds of utilities should be designed, regulated, and managed with the objective that it is extremely difficult for them to fail catastrophically.

The expected **spillover costs** of the failure of large financial utilities such as these are significant relative to the costs of safer designs.

Moreover, **the threat of their potential failure can lead financial market participants to react defensively in ways that destabilize markets.**

Considering as well the narrow scope for moral hazard associated with dedicated financial market utilities, my view is that we can afford to design and regulate some of these utilities as though they are “too important to fail”.

If that is the case, the operations and capital structure of these utilities should not be entangled with those of larger and more complex financial institutions, especially if there is an intention to let those financial institutions fail whenever they cannot meet their obligations.

In the course of this overview, I will focus on the following policy issues:

1. The emergency plumbing available to the Fed has changed.

We are now in an environment in which the importance of emergency access to a secured lender of last resort is widely recognized, but is

available for a systemically important non-bank financial institution under a limited and potentially shrinking set of circumstances.

Events could some day arise in which it would be difficult for the central bank to provide effective emergency liquidity.

2. Given the systemic importance of tri-party clearing agents, and given their high fixed costs and additional economies of scale, tri-party repo clearing services for U.S. dealers and cash investors should probably operate through a dedicated regulated utility.

Although this would likely **increase operating costs** for market participants, it would **enable investment in more advanced clearing technology and financial expertise**, allowing greater resilience of the tri-party repo market in the face of financial shocks such as the default of a major dealer.

The moral hazard associated with lending of last resort to a dedicated utility is much reduced relative to the case of a financial institution with a wide scope of risk-taking activities.

3. Large institutional investors in money market funds are prone to run in the face of losses.

Systemically important borrowers such as dealer banks remain **dependent on short-term financing from money market funds, particularly through tri-party repos.**

The **Securities and Exchange Commission (SEC)** is considering new regulatory requirements for money market funds, such as capital buffers and redemption gates, with the goal of lowering the risk of runs by money market fund investors.

Further reform of money market funds is indeed necessary for financial stability.

The **unintended consequences** of the reform of money market funds, however, may include a **shift to other forms of run-prone wholesale short-term lending to critical borrowers.**

Close principles-based supervision of systemically important short-term wholesale financing will also be needed.

4. Central clearing parties for OTC derivatives are proliferating.

This risks a significant and unnecessary rise in counterparty exposures as well as the dilution of regulatory oversight across many CCPs.

Competition among CCPs could involve reduced membership requirements for collateral.

Fewer CCPs, each closely supervised, should be a goal.

To this end, arrangements should be made for the **cross-jurisdictional** regulatory supervision of CCPs wherever possible, with clear assignment of regulatory responsibilities and lines of access to central-bank liquidity support.

Regulatory minimum margin standards should be strong and harmonized.

Effective plans for dealing with the failure of a CCP are yet to be established, to my knowledge.

5. If it is agreed that the **central clearing of standardized OTC derivatives is an important source** of financial stability, there is every reason to include foreign exchange (FX) derivatives in the requirement for central clearing, or some effective substitute.

It is currently proposed that FX derivatives should be exempted from clearing and all other major new regulations of the swap market, which include collateral standards for uncleared positions, trade execution in

swap execution facilities, trade recording in swap data repositories, and post-trade transaction reporting.

Regulators abroad are likely to follow the lead of the United States in this area.

6. Prime brokerage was revealed to be an important weak link in the financial system immediately after the failure of Lehman Brothers in 2008.

Rule 15-c-3 of the U.S. Securities Exchange Act of 1934 had appeared to safely limit the dependence of a U.S. dealer for liquidity on its prime-brokerage business. It did not.

The United Kingdom had almost no regulatory standards on this dimension.

Morgan Stanley suffered a loss of liquidity due to a sudden run by its prime brokerage hedge-fund clients in both the United States and the United Kingdom after the failure of Lehman Brothers.

An in-depth forensic analysis of the mechanics of this run is warranted.

The lessons learned should be published and used to revise Rule 15-c-3 and to improve the regulatory treatment of prime brokerage in London and emerging global financial centers.

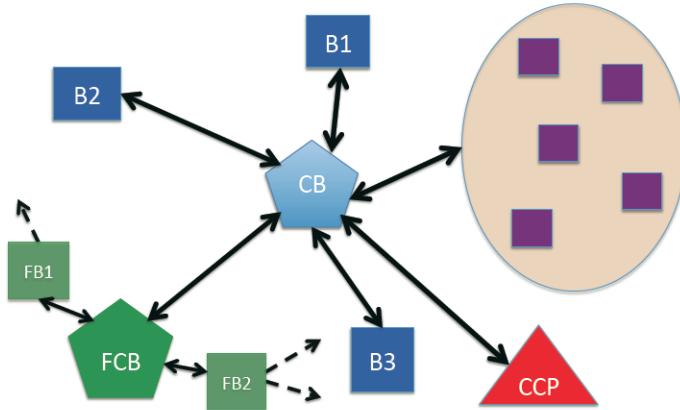


Figure 1: Lines of emergency liquidity provision by a central bank, through the discount window to domestic banks, indirectly to foreign banks through central-bank currency swap lines, through a “program or facility with broad-based eligibility” such as the Primary Dealer Credit Facility, and to a financial market utility under Title VIII of the Dodd-Frank Act.

2 Changes in Central Bank Plumbing

Before the financial crisis of 2007-2009, **central bank liquidity** was provided to financial markets mainly through normal monetary operations conducted through primary dealers, and through limited forms of lender-of-last-resort financing.

The latter included secured lending through the discount window to regulated banks as well as the potential emergency secured lending to essentially any market participant under Section 13(3) of the Federal Reserve Act.

The Dodd-Frank Act now restricts 13(3) emergency financing to a program or facility with broad-based eligibility.

Thus, individual non-bank firms can no longer obtain emergency financing directly from the central bank.

Because of the extreme stresses of the financial crisis, **the Federal Reserve set up a range of broad lender-of-last-resort programs and facilities, such**

as the Primary Dealer Credit Facility (PDCF), the Term Auction Facility (TAF), the Money Market Investor Funding Facility (MMIFF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility (CPFF), and the Term Asset-Backed Securities Loan Facility (TALF).

These programs would presumably have met the statutory criterion, had it applied at the time, of “broad-based eligibility.”

They played a crucial role in mitigating the severity of the financial crisis of 2007-2009. Versions of these facilities could be resurrected in a future crisis.

In addition, as illustrated in Figure 1, in 2007 the Fed set up “currency swap lines” that provided dollar liquidity to foreign central banks.

These currency swap lines enable a foreign central bank to provide lender-of-last-resort financing in dollars to banks within its own jurisdiction, and in principle allowed the Fed to give U.S. banks access to foreign currencies.

Because of the “reserve-currency” status of the U.S. dollar, global financial stability depends on global access to emergency secured loans of last resort in dollars.

With the innovation of these currency central-bank swap lines, the U.S. central bank has improved financial stability while allowing foreign central banks to monitor and absorb the credit risk of the banks to which the dollars ultimately flow.

That these currency swap lines have been a useful addition to the plumbing of the financial system was demonstrated during the 2007-2009 crisis and more recently during the Eurozone debt crisis.

Title VIII of the Dodd-Frank Act allows the central bank to provide liquidity support to financial market utilities such as central clearing parties.

The ability to take advantage of this emergency secured lending to stabilize a financial market utility (FMU) depends in part on the default management plan of the FMU. Because of the nature of its balance sheet, a CCP may have a limited sets of assets to post as collateral to the central bank by the time of its near failure or failure.

As opposed to the case of a large bank, there would be no large class of unsecured creditors to absorb losses.

The counterparties of a CCP are typically systemically important themselves.

Because of these concerns, Duffe and Skeel (2012) point to the potential importance of a short stay on the OTC derivatives of a CCP at its bankruptcy, or at its resolution under Title II of the Dodd-Frank Act.

The ability of the Federal Reserve to provide indirect liquidity to affiliates of regulated banks, such as broker-dealers, is limited by section 23A of the Federal Reserve Act, which **restricts transactions between a bank and its affiliates.**

Argues that during the financial crisis of 2007-2009 section 23A included sufficient exemptive power for the Fed to provide substantial emergency liquidity.

The Dodd-Frank Act, however, has placed significant additional restrictions on “23A transactions.”

Section 23A and section 23B still provide some scope for exemptive liquidity provision, subject however to a finding by the Federal Deposit Insurance Corporation that the exemption does not place the Deposit Insurance Fund at risk, among other requirements.

In summary, if a systemically important non-bank market participant is threatened by a liquidity crisis, lender-of-last-resort secured financing from the Fed can now be obtained only under broad programs or indirectly via the new version of section 23A, which is generally more restrictive.

Even assuming that a broad program could be arranged quickly enough in an emergency situation, the design of such a program places a central bank under some stress.

Depending on the breath of eligibility of such a program, the central bank could be accused of exceeding its mandate.

If the program is aimed broadly but few borrowers ultimately participate, the same concerns could be raised, whether or not they are legitimate.

Some of the targeted market participants might hold back in the face of concerns over stigma regarding their need for funding or over the potential for expectations by the public or some public officials of quid-pro-quo behavior by the borrower.

Among other implications, the new and more limited scope for lender-of-last-resort financing to non-banks merits attention given the potential for new regulations such as the Volcker Rule to incite the emergence of large broker-dealers that are not affiliates of bank holding companies.

If that were to occur, significant quantities of collateral would be placed further from access to lender-of-last resort financing.

These assets may include, for example, over-the-counter derivatives and foreign assets held on the balance sheets of U.S. banks and bank subsidiaries. Section 23A provides an exception for derivatives.

Of the five major U.S. bank holding companies operating OTC derivatives dealers, J.P. Morgan, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley, all but Morgan Stanley keep most of their OTC derivatives on the balance sheets of the respective regulated banks.

The Edge Act allows classes of foreign assets to be held by subsidiaries U.S. banks, where 23A restrictions are less onerous.

For a broker-dealer unaffiliated with a bank, access to a lender of last resort through transactions allowed under Section 23A (and its exemptions) is irrelevant, and only broad programmatic emergency lending would be available. This issue also elevates the importance of strong capital and liquidity standards for non-bank financial firms, which do not fall under the scope of the Basel III process.

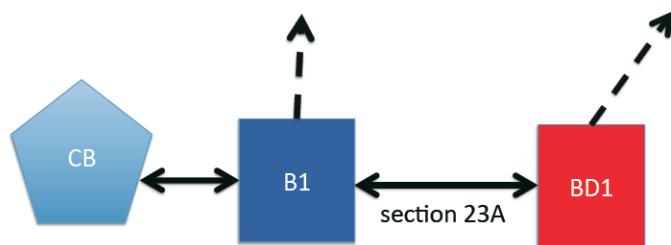


Figure 2: A schematic of access of a bank affiliate, such as a broker dealer, to indirect lender-of-last-resort secured financing through its bank affiliate, as limited by sections 23A and 23B of the Federal Reserve Act.

To read the paper (you must read the paper is what I mean):
<http://www.federalreserve.gov/newsevents/conferences/Duffie.pdf>



PRESS RELEASE

22 March 2012 - Meeting of the European Systemic Risk Board

The General Board of the European Systemic Risk Board (ESRB) held its fifth regular meeting.

The current situation

Since the last meeting of the General Board in December 2011, the ESRB has observed signs of stabilisation in the EU economy and an improvement in the situation of financial markets, notably in response to the measures adopted by central banks, the agreement on the fiscal compact, and the progress made in fiscal consolidation and economic reforms in many countries.

At the same time, an environment of uncertainty and fragility in segments of the EU financial system persists.

The key systemic risk remains the mutual negative feedback loops between three main risks, namely:

- (i) Persistent uncertainties on sovereign debt;
- (ii) Pressures on bank funding and excessive and/or disorderly bank deleveraging in some countries; and
- (iii) Subdued growth prospects.

It is therefore crucial that:

1. Countries make further progress towards restoring sound fiscal positions and implementing the structural reform agenda in order to

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strengthen their growth potential, increase employment and enhance competitiveness;

2. Banks strengthen their resilience further – the soundness of banks' balance sheets is a key factor in exiting from current dependence on central bank support measures and facilitating an appropriate provision of credit to the economy.

Market conditions continue to be characterised by difficulties in financial intermediation across EU borders (including within the euro area).

The ESRB calls on all public and private institutions to undertake efforts to preserve the integrity of the European financial system.

In this respect, the ESRB supports efforts by international and European institutions to reduce – through the so-called “*Vienna 2.0 Initiative*” – risks of financial fragmentation in some economies from central, eastern and south-eastern Europe, both within and outside the EU.

Looking ahead

The main issue is how to ensure the provision of credit to the economy in the current environment.

The ESRB has identified the following areas that might warrant macro-prudential policy measures.

1. Since summer 2011, banks have started a deleveraging process.

The ongoing deleveraging can also be seen as an overdue correction of excessive leverage accumulated over the past – albeit at different speeds across countries.

At the present time such readjustment could be achieved without risks to a smooth provision of credit to the economy.

2. Towards the end of 2011, banks faced severe strains in funding markets, both domestically and internationally.

Central bank measures, such as the recent LTROs, have alleviated such pressures.

The full extent of their impact on the credit supply will become clear over time.

The ESRB will monitor lending conditions in the EU and stands ready to draw attention to the need for corrective actions in case clear signs of a credit crunch materialise.

3. Investors have shown uncertainty over banks' resilience.

By providing ample liquidity and requiring banks to achieve stronger capital positions, authorities are putting banks in a position to improve their financial conditions.

There are first signs of **banks returning to market funding**, namely by **issuing secured and unsecured liabilities**.

Banks should use this window of opportunity to further strengthen their capital base (e.g. by retaining earnings) and to implement business models that rely on private funding.

4. In a weak economy banks are exposed to a materialisation of credit risk; they should make adequate provision for this.

Banks should manage their loan portfolios through the cycle by taking into account the medium-term creditworthiness of their borrowers without perpetuating non-viable credit positions.

The ESRB intends to work – in cooperation with the EBA and national supervisory authorities – on the lack of qualitative and quantitative information on forbearance.

5. In the past, ample liquidity conditions have been associated with the emergence of imbalances in different segments of financial markets.

While markets are still recovering their pre-crisis values, there are signs of a decrease in risk aversion in some selected financial market segments.

6. Finally, it is central that governments continue with fiscal consolidation and structural reforms, the provision of credible firewalls against contagion risk, and implementation of the fiscal compact.

This would contain the impact of further adverse shocks and limit negative spillover.

Activity of the ESRB

Work is also continuing on structural issues, such as developing a sound basis for macro-prudential policy and instruments in the EU and at the national level.

At the EU level, the ESRB is monitoring developments regarding relevant legislative initiatives in the EU, such as the implementation of the Basel III agreement in a revised Capital Requirements Directive and a new Regulation for banks and other credit institutions (the so-called “CRD4”).

The ESRB welcomes recent progress in the legislative process.

In this respect, the ESRB has brought to the attention of competent European institutions the fact that relevant national authorities need to be equipped with the tools necessary for taking early action at the local level – either on their own initiative or on the recommendation of the ESRB, taking into account reciprocity – to stem build-ups of systemic risk associated with banks.

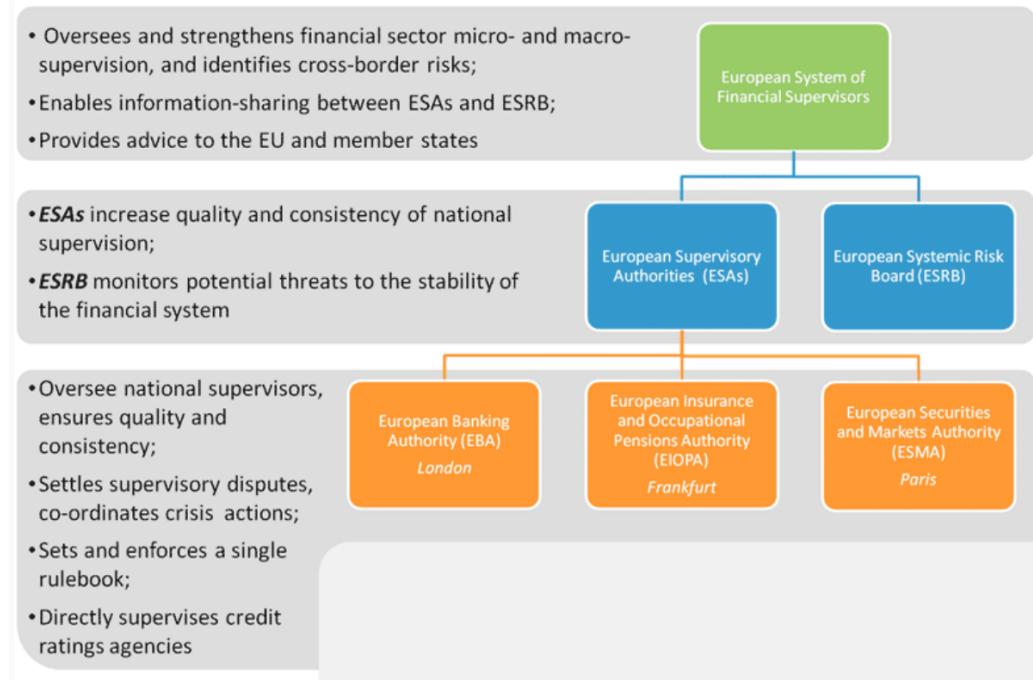
This should occur within the framework of an EU system of safeguards of the Single Market, to which the ESRB is ready to contribute.

The ESRB decided today to send a letter to the EU legislative bodies putting forward its macro-prudential views on certain aspects of the CRD4, taking into account recent developments in the legislative process.

In its letter, the ESRB has identified a number of areas in which it considers further strengthening and development of the proposals to be critical.

Such areas relate to: the scope for macro-prudential policies, the flexibility for authorities to conduct effective macro-prudential policies, and the governance arrangements for the use of macro-prudential instruments.

This letter will be published on the ESRB's website once it has been communicated to the recipients.



Cayman Islands – An Overview

The **three Cayman Islands**, Grand Cayman, Cayman Brac and Little Cayman, are located in the western Caribbean about 150 miles south of Cuba, 460 miles south of Miami, Florida, and 167 miles northwest of Jamaica.

George Town, the capital, is on the western shore of Grand Cayman.

Grand Cayman, the largest of the three islands, has an area of about 76 square miles and is approximately 22 miles long with an average width of four miles.



Its most striking feature is the shallow, reef-protected lagoon, the North Sound, which has an area of about 35 square miles. The island is low-lying, with the **highest point about 60 feet above sea level**.

Cayman Brac lies about 89 miles northeast of Grand Cayman. It is about 12 miles long with an average width of 1.25 miles and has an area of about 15 square miles.

Its terrain is the most spectacular of the three islands.

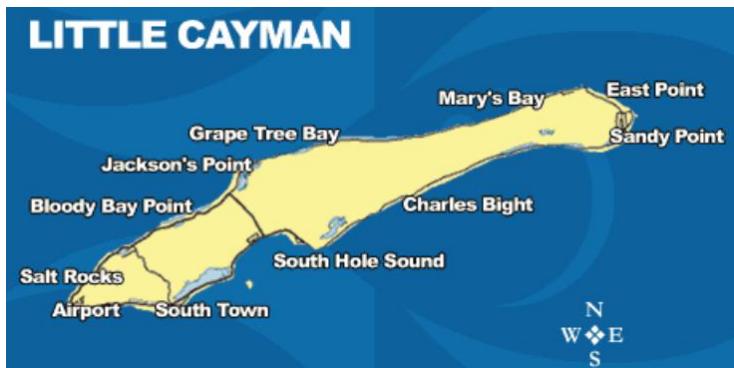
The Bluff, a massive central limestone outcrop, rises steadily along the length of the island up to 140 ft. above the sea at the eastern end.



Little Cayman lies five miles west of Cayman Brac and is approximately ten miles long with an average width of just over a mile.

It has an area of about 11 square miles. The island is low-lying with a few areas on the north shore rising to 40 ft. above sea level.

There are no rivers on any of the islands. The coasts are largely protected by offshore reefs and in some places by a mangrove fringe that sometimes extends into inland swamps.



Geographically, the Cayman Islands is part of the Cayman Ridge, which extends westward from Cuba. **The Cayman Trench**, the deepest part of the Caribbean at a depth of over four miles, separates the three small islands from Jamaica.

The islands are also located on the plate boundary between the North American and Caribbean tectonic plates.

The tectonic plates in Cayman's region are in continuous lateral movement against each other.

This movement, with the Caribbean plate travelling in an eastward direction and the North American plate moving west, limits the size of earthquakes and there has never been an event recorded of more than magnitude 7.

It is not unusual for minor tremors to be recorded. Many residents don't even notice them. However in December 2004 a quake of 6.8 magnitude rocked Grand Cayman and everyone noticed. The earthquake, short in duration, opened some small sinkholes but otherwise didn't cause any damage.

Christopher Columbus first sighted Cayman Brac and Little Cayman on 10 May 1503. On his fourth trip to the New World, Columbus was en route to Hispaniola when his ship was thrust westward toward "two very small and low islands, full of tortoises, as was all the sea all about, insomuch that they looked like little rocks, for which reason these islands were called Las Tortugas."

A 1523 map show all three Islands with the name Lagartos, meaning alligators or large lizards, but by 1530 the name **Caymanas** was being used. It is derived from the Carib Indian word for the **marine crocodile**, which is now known to have lived in the Islands.

Sir Francis Drake, on his 1585-86 voyage, reported seeing "great serpents called **Caymanas**, like large lizards, which are edible."

It was the Islands' ample supply of **turtle**, however, that made them a popular calling place for ships sailing the Caribbean and in need of meat for their crews. This began a trend that eventually denuded local waters of the turtle, compelling local turtle fishermen to go further afield to Cuba and the Miskito Cays in search of their catch.

The first recorded settlements were located on Little Cayman and Cayman Brac during 1661-71.

Because of the depredations of Spanish privateers, the governor of Jamaica called the settlers back to Jamaica, though by this time Spain had recognised British possession of the Islands in the 1670 Treaty of Madrid.

Often in breach of the treaty, British privateers roamed the area taking their prizes, probably using the Cayman Islands to replenish stocks of food and water and careen their vessels.

The first royal grant of land in Grand Cayman was made by the governor of Jamaica in 1734.

It covered 3,000 acres in the area between Prospect and North Sound. Others followed up to 1742, developing an existing settlement, which included the use of slaves.

On 8 February 1794, an event occurred which grew into one of Cayman's favourite legends -- The Wreck of the Ten Sail.

A convoy of more than 58 merchantmen sailing from Jamaica to England found itself dangerously close to the reef on the east end of Grand Cayman.

Ten of the ships, including HMS Convert, the navy vessel providing protection, foundered on the reef. With the aid of Caymanians, the crews and passengers mostly survived, although some eight lives were lost.

The first census of the Islands was taken in 1802, showing a population on Grand Cayman of 933, of whom 545 were slaves. Before slavery was abolished in 1834, there were over 950 slaves owned by 116 families.

Though Cayman was regarded as a dependency of Jamaica, the reins of government by that colony were loosely held in the early years, and a tradition grew of self-government, with matters of public concern decided at meetings of all free males. In 1831 a legislative assembly was established.

The constitutional relationship between Cayman and Jamaica remained ambiguous until 1863 when an act of the British parliament formally made the Cayman Islands a dependency of Jamaica.

When Jamaica achieved independence in 1962, the Islands opted to remain under the British Crown, and an administrator appointed from London assumed the responsibilities previously held by the governor of Jamaica

The constitution currently provides for a Crown-appointed Governor, a Legislative Assembly and a Cabinet.

Unless there are exceptional reasons, the Governor accepts the advice of the Cabinet, which comprises three appointed official members and five ministers elected from the 15 elected members of the Assembly.

The Governor has responsibility for the police, civil service, defence and external affairs but handed over the presidency of the Legislative Assembly to the Speaker in 1991.



Cayman Islands, Banking Statistics

Overview

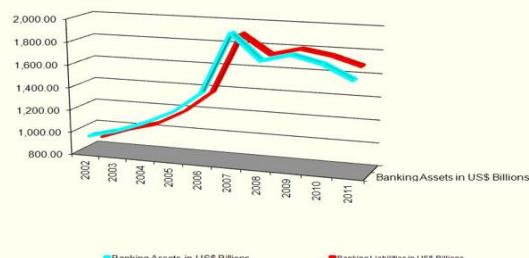
There were a total of **234 banks** under the supervision of the Banking Supervision Division at the end of December 2011.

The fundamentals of the banking sector remain sound and the industry in general has been relatively resilient in a very challenging market environment.

Banks continue to consolidate and restructure in search of cost efficiencies, and improvements in operational risk management and governance.

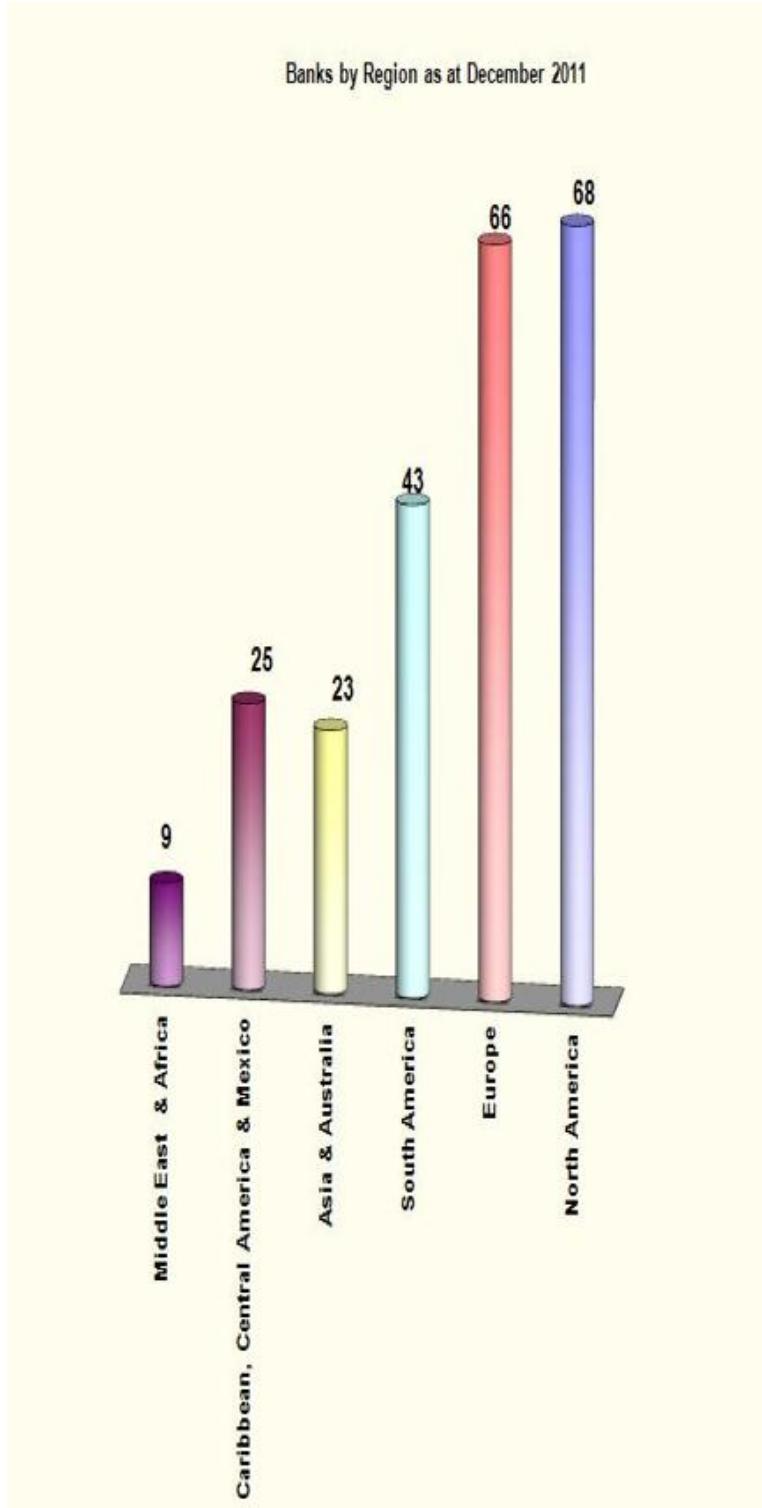
As of September 2011, total assets were reported at US\$1.607 trillion down from the same period of the previous year where total assets stood at US\$1.725 trillion.

International Claims and Liabilities



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The Cayman Islands is recognised as one of the top 10 international financial centres in the world, with over 40 of the top 50 banks holding licences here.

Over 80 percent of more than US\$1 trillion on deposit and booked through the Cayman Islands, represents **inter-bank bookings** between onshore banks and their Cayman Islands branches or subsidiaries.

These institutions present a very low risk profile for money laundering.

Basel II

The **Cayman Island Monetary Authority (CIMA)** is implementing the Basel II Framework.

The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that seeks to improve on the existing Basel I rules by aligning regulatory capital requirements more closely to the underlying risks that banks face.

The Framework is intended to promote a more forward looking approach to capital supervision that **encourages banks to identify risks and to develop or improve their ability to manage those risks.**

As a result, it is intended to be more flexible and better able to evolve with advances in markets and risk management practices.

A key objective of the revised Framework is to promote the adoption of stronger risk management practices by the banking industry.

Banks to Which Basel II Applies

The Basel II Framework applies to **banks that are locally incorporated in the Cayman Islands (Category A and B banks), all home regulated banks and host regulated banks (subsidiaries of foreign banks), with or without a physical presence.**

Branches of foreign banks operating the Cayman Islands, will **not be**

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required to maintain a separate capital requirement, and as such will be excluded from the local Basel II requirements.

However, these foreign banks including the operations of the Cayman Islands branches **must maintain the minimum capital adequacy requirements as stipulated by their home jurisdictions.**

Implementation Phases

CIMA proposes to apply the Basel II Framework in **two phases** leveraging a practical measured approach.

First Phase

The first phase of the implementation was completed on December 31, 2010 and comprised the following Pillar 1 approaches:

- Credit Risk – Standardized
- Market Risk – Standardized
- Operational Risk – Basic Indicator Approach and The Standardized Approach

The first phase of the Basel II implementation includes Pillar 2 – Supervisory Review Process and Pillar 3 - Market Discipline.

Second Phase

The second phase of the CIMA Basel II implementation will be considered for implementation **after 2012.**

It will include considering the implementation of advanced approaches, specifically Pillar 1 – Credit Risk – Advanced Approaches (IRB), Operations Risk – Advanced Measurement Approaches (AMA) and Market Risk – Internal Risk Management Models.

Industry Input

Since the majority of banks impacted by the application of the Basel II Framework are **members of the Cayman Island Bankers Association**

(CIBA), CIMA has established a joint CIMA/CIBA Basel II Working Committee.

The primary objective of the working committee is to provide banks and CIMA a forum for consultation, discussion and agreement on Basel II related issues. CIMA proposes to obtain the majority of feedback on Basel II related issues from the CIBA/CIMA Basel II Working Committee.

CIMA also proposes to **communicate directly** with those banks that are not members of CIBA or those banks that have principal agents that are not members of CIBA.

However, these banks will not have the benefit of consultation or participation in discussions on Basel II issues with the majority of impacted banks.

Banks wishing to participate in the CIBA consultations and discussions should contact CIBA directly.

Basel iii

This is the next step, but we have no timeline yet.

According to Reina Ebanks, Head of Banking Supervision, Cayman Islands Monetary Authority at the Opening of the FSI & CGBS Seminar - Regional Seminar on Capital Adequacy & Basel III George Town, Grand Cayman, Cayman Islands February 22-24, 2011:

“It is good that so many of our colleagues from regulatory bodies in the Caribbean region have seen the value of this seminar and have seized this opportunity to participate.

I also appreciate the involvement of our local industry partners who will serve as presenters.

We all have experiences to share, and by sharing those experiences we will learn from each other.

The Cayman Islands Monetary Authority believes strongly in the necessity and benefits of professional training.

We have always sought to ensure that our own staff members have every opportunity to enhance the skills that are necessary for the Authority to effectively carry out its role.

The regulatory reform package of the Basel Committee addresses identified weaknesses of the pre-crisis banking sector and outlines several measures to promote a more resilient banking sector.

The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spill over from the financial sector to the real economy.

The new global standards referred to a “Basel III” cover both firm-specific and broader, systematic risks. At this 3 day seminar our presenters who are experts in their field are expected to cover specific aspects of Basel III.

One of the things you learn quickly as a regulator is how rapidly changes occur within today's financial systems and how interconnected and interdependent they are.

The international financial crisis underscored this forcefully, but it is not going to change it.

Products will continue to evolve; markets will continue to change; ways of doing business will continue to be constantly challenged by new innovations despite the new regulations and standards put in place as a result of the crisis.

However, one of the strong lessons which it has taught us as regulators is that, in order to stay ahead of the curve, **we must expand our knowledge** of the markets and products we are charged with regulating and the role of the different jurisdictions, large and small, that are part of the global marketplace.

We must apply that knowledge efficiently in our day-to-day operations.

We must cooperate as regulators at the organizational level.

We must engage in dialogue and we must take joint action.

This is necessary if we are to regulate effectively without stifling legitimate business and economic growth.”



CAYMAN ISLANDS MONETARY AUTHORITY

$$\text{Minimum Capital Adequacy Ratio} = \frac{\text{Eligible Regulatory Capital}}{\text{Credit RWA} + \text{Market RWA} + \text{Operational RWA}}$$

Paragraph 72	Area of National Discretion	CIMA's Comment
49 (xiii)	Employ a third tier of capital (Tier 3), consisting of short term subordinated debt for the sole purpose of meeting a proportion of the capital requirements for market risks.	CIMA proposes to exercise this option subject to the conditions listed in paragraph 49(xiii) of the Framework
49(xiii)	Limit the eligibility of Tier 2 and Tier 3 capital i.e. the sum total of Tier 2 plus Tier 3 capital should not exceed total Tier 1.	CIMA proposes to exercise this option.
49 (xviii)	Apply a policy of deduction either for <ol style="list-style-type: none"> 1. all holding of other bank's capital 2. holdings that exceed material limits in relation to the holding bank's capital or the issuing bank's capital; or 3. on a case by case basis. 	CIMA proposes to deduct holdings that exceed material limits ⁷³ in relation to the holding bank's capital or the issuing bank's capital.

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The Basel iii Compliance Professionals Association (BiiiCPA) is the largest association of Basel iii Professionals in the world. It is a business unit of the Basel ii Compliance Professionals Association (BCPA), which is also the largest association of Basel ii Professionals in the world.

Basel III Speakers Bureau

The Basel iii Compliance Professionals Association (BiiiCPA) has established the Basel III Speakers Bureau for firms and organizations that want to [access the Basel iii expertise](#) of Certified Basel iii Professionals (CBiiiPros).

The BiiiCPA will be [the liaison](#) between our certified professionals and these organizations, [at no cost](#). We strongly believe that [this can be a great opportunity](#) for both, our certified professionals and the organizers.

To learn more:

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Basel 3 News May 2012



Dear Member,

Crying is not a sign of weakness. You may let out your tears!

Assuming full implementation of the Basel III requirements as of 30 June 2011, including changes to the definition of capital and risk-weighted assets, and ignoring phase-in arrangements, Group 1 banks would have an overall shortfall of €38.8 billion for the CET1 minimum capital requirement of 4.5%, which rises to €485.6 billion for a CET1 target level of 7.0% (ie including the capital conservation buffer); the latter shortfall already includes the G-SIB surcharge where applicable.

As a point of reference, the sum of profits after tax prior to distributions across the same sample of Group 1 banks in the second half of 2010 and the first half of 2011 was €356.6 billion.

Under the same assumptions, the capital shortfall for Group 2 banks included in the Basel III monitoring sample is estimated at €8.6 billion for the CET1 minimum of 4.5% and €32.4 billion for a CET1 target level of 7.0%.

The sum of Group 2 bank *profits after tax* prior to distributions in the second half of 2010 and the first half of 2011 was €35.6 billion.

Quantitative impact study results published by the Basel Committee, 12 April 2012

The Basel Committee published the results of its **Basel III monitoring exercise**.

The study is based on rigorous reporting processes set up by the Committee to periodically review the implications of the Basel III standards for financial markets.

A total of 212 banks participated in the study, including 103 Group 1 banks (ie those that have Tier 1 capital in excess of €3 billion and are internationally active) and 109 Group 2 banks (ie all other banks).



While the Basel III framework sets out transitional arrangements to implement the new standards, the monitoring exercise results assume full implementation of the final Basel III package based on data as of 30 June 2011 (ie they do not take account of the transitional arrangements such as the phase in of deductions).

No assumptions were made about bank profitability or behavioural responses, such as changes in bank capital or balance sheet composition.

For that reason the results of the study are not comparable to industry estimates.

Based on data as of **30 June 2011** and applying the changes to the definition of capital and risk-weighted assets, **the average common equity Tier 1 capital ratio (CET1) of Group 1 banks was 7.1%**, as compared with the Basel III minimum requirement of 4.5%.

In order for all Group 1 banks to reach the 4.5% minimum, an increase of €38.8 billion CET1 would be required.

The overall shortfall increases to €485.6 billion to achieve a CET1 target level of 7.0% (ie including the capital conservation buffer); this amount includes the surcharge for global systemically important banks where applicable.

As a point of reference, the sum of profits after tax and prior to distributions across the same sample of Group 1 banks in the second half of 2010 and the first half of 2011 was €356.6 billion.

For **Group 2** banks, the average CET1 ratio stood at 8.3%.

In order for all **Group 2** banks in the sample to meet the new 4.5% CET1 ratio, the additional capital needed is estimated to be **€8.6 billion.**

They would have required an **additional €32.4 billion** to reach a CET1 target 7.0%; the sum of these banks' profits after tax and prior to distributions in the second half of 2010 and the first half of 2011 was **€35.6 billion.**

The Committee also assessed the estimated impact of the **liquidity standards.**

Assuming banks were to make no changes to their liquidity risk profile or funding structure, as of June 2011, the weighted average **Liquidity Coverage Ratio (LCR)** for **Group 1** banks would have been 90% while the weighted average LCR for **Group 2** banks was 83%.

The aggregate **LCR** shortfall is **€1.76 trillion** which represents

approximately 3% of the €58.5 trillion total assets of the aggregate sample.

The weighted average Net Stable Funding Ratio (NSFR) is 94% for both Group 1 and Group 2 banks.

The aggregate shortfall of required stable funding is €2.78 trillion.

Banks have until 2015 to meet the LCR standard and until 2018 to meet the NSFR standard, which will reflect any revisions following each standard's observation period.

As noted in a January 2012 press statement issued by the Group of Governors and Heads of Supervision, the Basel Committee's oversight body, **modifications to a few key aspects of the LCR are currently under investigation but will not materially change the framework's underlying approach.**

The Committee will finalise and subsequently publish its recommendations in these areas by the end of 2012.

Banks that are below the 100% required minimum thresholds can meet these standards by, for example, lengthening the term of their funding or restructuring business models which are most vulnerable to liquidity risk in periods of stress.

It should be noted that the shortfalls in the LCR and the NSFR are **not additive**, as reducing the shortfall in one standard may also reduce the shortfall in the other standard.

Results of the Basel III monitoring exercise as of 30 June 2011 April 2012

Executive summary

In 2010, the Basel Committee on Banking Supervision conducted a comprehensive quantitative impact study (C-QIS) using data as of 31 December 2009 to ascertain the impact on banks of the Basel III framework, published in December 2010.

The Committee **intends to continue monitoring the impact of the Basel III framework in order to gather full evidence on its dynamics.**

To serve this purpose, a **semi-annual** monitoring framework has been set up on the risk-based capital ratio, the leverage ratio and the liquidity metrics using data collected by national supervisors on a representative sample of institutions in each jurisdiction.

This report summarises the aggregate results of the latest Basel III monitoring exercise, using data as of 30 June 2011.

The Committee believes that the information contained in the report will provide the relevant stakeholders with a **useful benchmark for analysis**.

Information for this report was submitted by individual banks to their national supervisors on a voluntary and confidential basis.

A total of 212 banks participated in the study, including 103 Group 1 banks and 109 Group 2 banks.

Members' coverage of their banking sector is very high for Group 1 banks, reaching 100% coverage for some jurisdictions, while coverage is comparatively lower for Group 2 banks and varied across jurisdictions.

The Committee appreciates the significant efforts contributed by both banks and national supervisors to this ongoing data collection exercise.

The report focuses on the following items:

- **Changes to bank capital ratios** under the new requirements, and estimates of any capital deficiencies relative to fully phased-in minimum and target capital requirements (**to include capital charges for global systemically important banks – G-SIBs**);
- **Changes to the definition of capital** that result from the new capital standard, referred to as common equity Tier 1 (CET1), including a reallocation of deductions to CET1, and changes to the eligibility criteria for Additional Tier 1 and Tier 2 capital;
- **Increases in risk-weighted assets** resulting from changes to the definition of capital, securitisation, trading book and counterparty credit risk requirements;
- **The international leverage ratio**; and
- **Two international liquidity standards** – the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

With the exception of the transitional arrangements for non-correlation trading securitisation positions in the trading book, this report does not take into account any transitional arrangements such as phase-in of deductions and grandfathering arrangements.

Rather, the estimates presented assume full implementation of the final Basel III requirements based on data as of 30 June 2011.

No assumptions have been made about banks' profitability or behavioural responses, such as changes in bank capital or balance sheet composition, since this date or in the future.

For this reason the results are not comparable to current industry estimates, which tend to be based on forecasts and consider management actions to mitigate the impact, and incorporate estimates where information is not publicly available.

The results presented in this report are also **not comparable to the prior C-QIS**, which evaluated the impact of policy questions that differ in certain key respects from the finalised Basel III framework.

As one example, the C-QIS did not consider the impact of capital surcharges for global systemically important banks.

Capital shortfalls

Assuming full implementation of the Basel III requirements as of 30 June 2011, including changes to the definition of capital and risk-weighted assets, and ignoring phase-in arrangements, **Group 1** banks would have an overall shortfall of €38.8 billion for the CET1 minimum capital requirement of 4.5%, which rises to €485.6 billion for a CET1 target level of 7.0% (ie including the capital conservation buffer); the latter shortfall already includes the G-SIB surcharge where applicable.

As a point of reference, the sum of profits after tax prior to distributions across the same sample of **Group 1** banks in the second half of 2010 and the first half of 2011 was **€356.6 billion**.

Under the same assumptions, the capital shortfall for **Group 2** banks included in the Basel III monitoring sample is estimated at €8.6 billion for the CET1 minimum of 4.5% and €32.4 billion for a CET1 target level of 7.0%.

The sum of **Group 2** bank profits after tax prior to distributions in the second half of 2010 and the first half of 2011 was €35.6 billion.

Further details on additional capital needs to meet the Basel III requirements are included in Section 2.

Capital ratios

The average CET1 ratio under the Basel III framework would **decline** from 10.2% to 7.1% for **Group 1** banks and **from 10.1% to 8.3%** for **Group 2** banks.

The Tier 1 capital ratios of Group 1 banks would decline, on average from 11.5% to 7.4% and total capital ratios would decline from 14.2% to 8.6%.

As with the CET1 ratios, the decline in other capital ratios is comparatively less pronounced for Group 2 banks; Tier 1 capital ratios would decline on average from 10.9% to 8.6% and total capital ratios would decline on average from 14.3% to 10.6%.

Changes in risk-weighted assets

As compared to current risk-weighted assets, total risk-weighted assets increase on average by 19.4% for Group 1 banks under the Basel III framework.

This increase is driven largely by charges against counterparty credit risk and trading book exposures.

Securitisation exposures, principally those risk-weighted at 1250% under the Basel III framework (which were previously 50/50 deductions under Basel II), are also a significant contributor to the increase.

Banks that have significant exposures in these areas influence the average increase in risk-weighted assets heavily.

As Group 2 banks are less affected by the revised counterparty credit risk and trading book rules, these banks experience a comparatively smaller increase in risk-weighted assets of only 6.3%.

Even within this sample, higher risk-weighted assets are attributed largely to Group 2 banks with counterparty and securitisation exposures (ie those subject to a 1250% risk weighting).

Leverage ratio

The weighted average current Tier 1 leverage ratio for all banks is 4.5%. For Group 1 banks, it is somewhat lower at 4.4% while it is 5.0% for Group 2 banks.

The average Basel III Tier 1 leverage ratio for all banks is 3.5%. The Basel III average for Group 1 banks is 3.4%, and the average for Group 2 banks is 4.2%.

Liquidity standards

Both liquidity standards are currently subject to an observation period which includes a review clause to address any unintended consequences prior to their respective implementation dates of 1 January 2015 for the LCR and 1 January 2018 for the NSFR.

Basel III monitoring results for the end-June 2011 reporting period give an indication of the impact of the calibration of the standards and highlight several key observations:

A total of 103 Group 1 and 102 Group 2 banks participated in the liquidity monitoring exercise for the end-June 2011 reference period.

The weighted average LCR for Group 1 banks is 90% while the weighted average LCR for Group 2 banks is 83%.

The aggregate LCR shortfall is €1.76 trillion which represents approximately 3% of the €58.5 trillion total assets of the aggregate sample.

The weighted average NSFR is 94% for both Group 1 and Group 2 banks.

The aggregate shortfall of required stable funding is €2.78 trillion.

General remarks

At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision (GHOS), the Committee's oversight body, announced a substantial strengthening of existing capital requirements and fully endorsed the agreements it reached on 26 July 2010.

These capital reforms together with the introduction of two international liquidity standards, delivered on the core of the global financial reform agenda presented to the Seoul G20 Leaders summit in November 2010.

Subsequent to the initial comprehensive quantitative impact study published in December 2010, the Committee continues to monitor and evaluate the impact of these capital and liquidity requirements (collectively referred to as “Basel III”) on a semi-annual basis.

This report summarises results of the latest Basel III monitoring exercise using 30 June 2011 data.

Scope of the impact study

All but one of the 27 Committee member jurisdictions participated in Basel III monitoring exercise as of 30 June 2011.

The estimates presented are based on data submitted by the participating banks to national supervisors in reporting questionnaires in accordance with the instructions prepared by the Committee in September 2011.

The questionnaire covered components of eligible capital, the calculation of risk-weighted assets (RWA), the calculation of a leverage

ratio, and components of the liquidity metrics. The results were initially submitted to the Secretariat of the Committee in October 2011.

The purpose of the exercise is to provide the Committee with an ongoing assessment of the impact on participating banks of the capital and liquidity proposals set out in the following documents:

- Revisions to the Basel II market risk framework and Guidelines for computing capital for incremental risk in the trading book;
- Enhancements to the Basel II framework which include the revised risk weights for re-securitisations held in the banking book;
- Basel III: A global framework for more resilient banks and the banking system as well as the Committee's 13 January 2011 press release on loss absorbency at the point of non-viability;
- International framework for liquidity risk measurement, standards and monitoring; and
- Global systemically important banks: Assessment methodology and the additional loss absorbency requirement.

Sample of participating banks

A total of 212 banks participated in the study, including 103 Group 1 banks and 109 Group 2 banks. Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active.

All other banks are considered Group 2 banks.

Banks were asked to provide data as of 30 June 2011 at the consolidated level.

Subsidiaries of other banks are not included in the analyses to avoid double counting.

Table 1 shows the distribution of participation by jurisdiction.

For Group 1 banks members' coverage of their banking sector was very high reaching 100% coverage for some jurisdictions.

Coverage for Group 2 banks was comparatively lower and varied across jurisdictions.

Table 1
Number of banks submitting data for the Basel III monitoring exercise

Jurisdiction	Group 1	Group 2
Australia	4	1
Belgium	1	2
Brazil	2	0
Canada	6	2
China	6	0
France	5	5
Germany	9	25
Hong Kong, SAR	0	7
India	5	5
Indonesia	0	2
Italy	2	11
Japan	13	5
Korea	5	3
Luxembourg	0	1
Mexico	0	5
Netherlands	3	17
Russia	0	1
Saudi Arabia	3	0
Singapore	3	0
South Africa	3	3
Spain	2	6
Sweden	4	0
Switzerland	2	4
Turkey	6	0
United Kingdom	6	4
United States	13	0
Total	103	109

Not all banks provided data relating to all parts of the Basel III framework.

Accordingly, a small number of banks are excluded from individual sections of the Basel III monitoring analysis due to incomplete data.

Methodology

The impact assessment was carried out by comparing banks' capital positions under Basel III to the current regulatory framework implemented by the national supervisor.

With the exception of transitional arrangements for non-correlation trading securitisation positions in the trading book, Basel III results are calculated without considering transitional arrangements pertaining to

the phase-in of deductions and grandfathering arrangements.

Reported average amounts in this document have been calculated by creating a composite bank at a total sample level, which effectively means that the total sample averages are weighted.

For example, **the average common equity Tier 1 capital ratio is the sum of all banks' common equity Tier 1 capital for the total sample divided by the sum of all banks' risk-weighted assets for the total sample.**

To maintain confidentiality, many of the results shown in this report are presented using box plots charts.

These charts show the distribution of results as described by the median values (the thin red horizontal line) and the 75th and 25th percentile values (defined by the blue box).

The upper and lower end points of the thin blue vertical lines show the values which are 1.5 times the range between the 25th and the 75th percentile above the 75th percentile or below the 25th percentile, respectively.

This would correspond to approximately 99.3% coverage if the data were normally distributed.

The red crosses indicate outliers.

To estimate the impact of implementing the Basel III framework on capital, comparisons are made between those elements of Tier 1 capital which are not subject to a limit under the national implementation of Basel I or Basel II, and CET1 under Basel III.

Data quality

For this monitoring exercise, participating banks submitted comprehensive and detailed non-public data on a voluntary and best-efforts basis.

As with the C-QIS, national supervisors worked extensively with banks to **ensure data quality, completeness and consistency with the published reporting instructions.**

Banks are included in the various analyses that follow only to the extent they were able to provide sufficient quality data to complete the analyses.

For the liquidity elements, data quality has improved significantly throughout the iterations of the Basel III monitoring exercise, although it is still the case that some differences in banks' reported liquidity risk positions could be attributed to differing interpretations of the rules,

rather than underlying differences in risk.

Most notably individual banks appear to be using different methodologies to identify operational wholesale deposits and exclusions of liquid assets due to failure to meet the operational requirements.

Interpretation of results

The following caveats apply to the interpretation of results shown in this report:

These results are not comparable to those shown in the C-QIS, which evaluated the impact of policy questions that differ in certain key respects from the finalised Basel III framework.

As one example, the C-QIS did not consider the impact of capital surcharges for G-SIBs based on the initial list of G-SIBs announced by the Financial Stability Board in November 2011.

One member country, **Switzerland**, has already implemented certain elements of the Basel III framework pertaining to new rules for market risk and enhancements to the treatment of securitisations held in the banking book (often referred to collectively as “Basel 2.5”).

For banks in this country, the results included in this report reflect the impact of adopting the Basel III requirements relative to the Basel II and Basel 2.5 frameworks already in place.

The new rules for **counterparty credit risk are not fully accounted** for in the report, as data for capital charges for **exposures to central counterparties (CCPs)** and **stressed effective expected positive exposure (EEPE)** could not be collected.

The actual impact of the new requirements will likely be lower than shown in this report given the phased-in implementation of the rules and interim adjustments made by the banking sector to changing economic conditions and the regulatory environment.

For example, the results **do not consider bank profitability, changes in capital or portfolio composition, or other management responses to the policy changes since 30 June 2011 or in the future.**

For this reason, the results are not comparable to industry estimates, which tend to be based on forecasts and consider management actions to mitigate the impact, as well as incorporate estimates where information is not publicly available.

The Basel III capital amounts shown in this report **assume that all common equity deductions are fully phased in and all non-qualifying**

capital instruments are fully phased out.

As such, these amounts underestimate the amount of Tier 1 capital and Tier 2 capital held by a bank as they do not give any recognition for non-qualifying instruments that are actually phased out over nine years.

The treatment of deductions and non-qualifying capital instruments also affects figures reported in the leverage ratio section.

The underestimation of Tier 1 capital will become less of an issue as the implementation date of the leverage ratio nears.

In particular, in 2013, the capital amounts based on the capital requirements in place on the Basel III monitoring reporting date will reflect the amount of non-qualifying capital instruments included in capital at that time.

These amounts will therefore be more representative of the capital held by banks at the implementation date of the leverage ratio.

Capital shortfalls and overall changes in regulatory capital ratios

Table 2 shows the aggregate capital ratios under the current and Basel III frameworks and the capital shortfalls if Basel III were fully implemented, both for the definition of capital and the calculation of risk-weighted assets as of 30 June 2011.

Table 2
Aggregate capital ratios and capital shortfalls

	Fully implemented requirement, in percent		Actual capital ratios, in percent		Capital shortfalls, in € billions	
	Minimum	Minimum plus capital conservation buffer	Current	Basel III	Minimum	Minimum plus capital conservation buffer*
Group 1						
CET1	4.5	7.0	10.2	7.1	38.8	485.6
Tier 1	6.0	8.5	11.5	7.4	66.6	221.4
Total	8.0	10.5	14.2	8.6	119.3	223.2
Group 2						
CET1	4.5	7.0	10.1	8.3	8.6	32.4
Tier 1	6.0	8.5	10.9	8.6	7.3	16.6
Total	8.0	10.5	14.3	10.6	5.5	11.6

The shortfall is calculated as the sum across individual banks where a shortfall is observed. The calculation includes all changes to risk-weighted assets (eg definition of capital, counterparty credit risk, trading book and securitisation in the banking book). The Tier 1 and total capital shortfalls are incremental assuming the higher tier capital requirements are fully met. See below for details. * The shortfalls including the capital conservation buffer also include the capital surcharges for 28 initial G-SIBs as applicable.

As compared to current CET1, the average CET1 capital ratio of Group 1 banks would have fallen by nearly one-third from 10.2% to 7.1% (a decline of 3.1 percentage points) when Basel III deductions and risk-weighted assets are taken into account.

The reduction in the CET1 capital ratio of Group 2 banks is smaller (from 10.1% to 8.3%), which indicates that the new framework has greater impact on larger banks.

Results show significant variation across banks as shown in Chart 1.

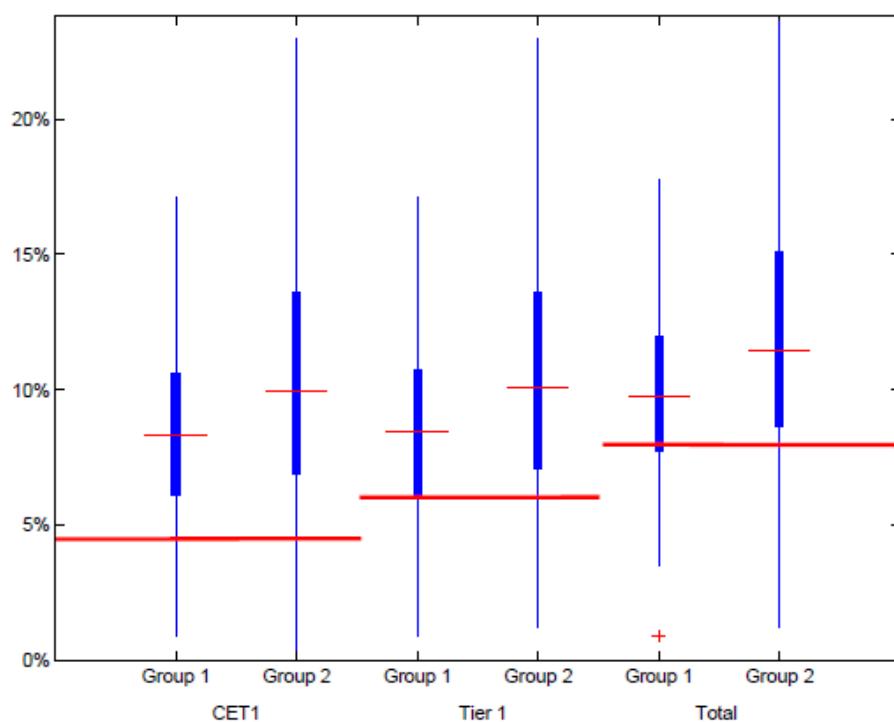
The reduction in CET1 ratios is driven by the new definition of eligible capital, by deductions that were not previously applied at the common equity level of Tier 1 capital in most jurisdictions (numerator) and by increases in risk-weighted assets (denominator).

Banks engaged heavily in trading or counterparty credit activities tend to show the largest denominator effects as these activities attract substantively higher capital charges under the new framework.

Tier 1 capital ratios of Group 1 banks would on average decline 4.1 percentage points from 11.5% to 7.4%, and total capital ratios of this same group would decline on average by 5.6 percentage points from 14.2% to 8.6%.

As with CET1, Group 2 banks show a more moderate decline in Tier 1 capital ratios from 10.9% to 8.6%, and a decline in total capital ratios from 14.3% to 10.6%.

Chart 1
Basel III CET1, Tier 1 and total capital ratios, in percent¹⁷



The Basel III framework includes the following phase-in provisions for capital ratios:

For CET1, the highest form of loss absorbing capital, the minimum requirement will be raised to 4.5% and will be phased-in by 1 January 2015;

For Tier 1 capital, the minimum requirement will be raised to 6.0% and will be phased-in by 1 January 2015;

For total capital, the minimum requirement remains at 8.0%;

Regulatory adjustments (ie possibly stricter sets of deductions that apply under Basel III) will be fully phased-in by 1 January 2018;

An additional 2.5% capital conservation buffer above the regulatory minimum capital ratios, which must be met with CET1, will be phased-in by 1 January 2019; and

The additional loss absorbency requirement for G-SIBs, which ranges from 1.0% to 2.5%, will be phased in by 1 January 2019.

It will be applied as the extension of the capital conservation buffer and must be met with CET1.

The Annex includes a detailed overview of all relevant phase-in arrangements.

Chart 2 and Table 2 provide estimates of the amount of capital that Group 1 and Group 2 banks would need between 30 June 2011 and 1 January 2019 in addition to the capital they already held at the reporting date, in order to meet the target CET1, Tier 1, and total capital ratios under Basel III assuming fully phased-in target requirements and deductions as of 30 June 2011.

Under these assumptions, the CET1 capital shortfall for Group 1 banks with respect to the 4.5% CET1 minimum requirement is €38.8 billion.

The CET1 shortfall with respect to the 4.5% requirement for Group 2 banks, where coverage of the sector is considerably smaller, is estimated at €8.6 billion.

For a CET1 target of 7.0% (ie the 4.5% CET1 minimum plus the 2.5% capital conservation buffer, plus any capital surcharge for G-SIBs as applicable), Group 1 banks' shortfall is €485.6 billion and Group 2 banks' shortfall is €32.4 billion.

The surcharges for G-SIBs are a binding constraint on 24 of the 28 G-SIBs included in this Basel III monitoring exercise.

As a point of reference, the aggregate sum of after-tax profits prior to distributions for Group 1 and Group 2 banks in the same sample was

€356.6 billion and €35.6 billion, respectively in the second half of 2010 and the first half of 2011.

Assuming the 4.5% CET1 minimum capital requirements were fully met (ie, there were no CET1 shortfall), Group 1 banks would need an additional €66.6 billion to meet the minimum Tier 1 capital ratio requirement of 6.0%.

Assuming banks already hold 7.0% CET1 capital, Group 1 banks would need an additional €221.4 billion to meet the Tier 1 capital target ratio of 8.5% (ie the 6.0% Tier 1 minimum plus the 2.5% CET1 capital conservation buffer), respectively.

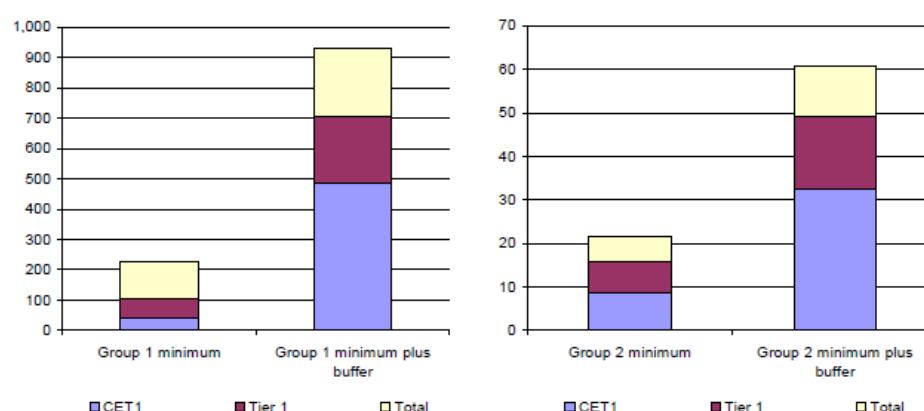
Group 2 banks would need an additional €7.3 billion and an additional €16.6 billion to meet these respective Tier 1 capital minimum and target ratio requirements.

Assuming CET1 and Tier 1 capital requirements were fully met (ie, there were no shortfalls in either CET1 or Tier 1 capital), Group 1 banks would need an additional €119.3 billion to meet the minimum total capital ratio requirement of 8.0% and an additional €223.2 billion to meet the total capital target ratio of 10.5% (ie the 8.0% Tier 1 minimum plus the 2.5% CET1 capital conservation buffer), respectively.

Group 2 banks would need an additional €5.5 billion and an additional €11.6 billion to meet these respective total capital minimum and target ratio requirements.

As indicated above, no assumptions have been made about bank profits or behavioural responses, such as changes balance sheet composition, that will serve to ameliorate the impact of capital shortfalls over time.

Chart 2
Estimated overall capital shortfalls, participating Group 1 and Group 2 banks,
in € billions¹⁸



Impact of the definition of capital on Common Equity Tier 1 capital

As noted above, reductions in capital ratios under the Basel III framework are attributed in part to capital deductions not previously applied at the common equity level of Tier 1 capital in most jurisdictions.

Table 3 shows the impact of various deduction categories on the gross CET1 capital (ie, CET1 before deductions) of Group 1 and Group 2 banks.

In the aggregate, deductions reduce the gross CET1 of Group 1 banks under the Basel III framework by 32.0%.

The largest driver of Group 1 bank deductions is goodwill, followed by combined deferred tax assets (DTAs) deductions, and intangibles other than mortgage servicing rights.

These deductions reduce Group 1 bank gross CET1 by 15.4%, 4.9%, and 3.6%, respectively.

The category described as **other deductions reduces Group 1 bank gross CET1 by 3.0%** and pertain mainly to deductions for provision shortfalls relative to expected credit losses and deductions related to defined benefit pension fund schemes.

Holdings of capital of other financial companies reduce the CET1 of Group 1 banks by 2.9%.

The category “Excess above 15%” refers to the deduction of the amount by which the aggregate of the three items subject to the 10% limit for inclusion in CET1 capital exceeds 15% of a bank’s CET1, calculated after all deductions from CET1.

These 15% threshold bucket deductions reduce Group 1 bank gross CET1 by 2.1%. Deductions for MSRs exceeding the 10% limit have a minor impact on Group 1 CET1.

Deductions reduce the CET1 of Group 2 banks by 26.9%. Goodwill is the largest driver of deductions for Group 2 banks, followed by holdings of the capital of other financial companies, and combined DTAs deductions.

These deductions reduce Group 2 bank CET1 by 10.5%, 4.4%, and 4.3%, respectively.

Other deductions, which are driven significantly by deductions for provision shortfalls relative to expected credit losses, result in a 3.5% reduction in Group 2 bank gross CET1.

Deductions for intangibles other than mortgage servicing rights and deductions for items in excess of the aggregate 15% threshold basket reduce Group 2 bank gross CET1 by 2.5% and 1.8%, respectively.

Deductions for mortgage servicing rights above the 10% limit have no impact on Group 2 banks.

Table 3

CET1 deductions as a percentage of new CET1 capital gross of deductions

	N	Goodwill	Intangibles	DTAs*	Financials	MSRs	DTAs above threshold	Excess above 15%**	Other***	Total
Group 1 banks	103	-15.4	-3.6	-3.2	-2.9	-0.1	-1.7	-2.1	-3.0	-32.0
Group 2 banks	109	-10.5	-2.5	-0.8	-4.4	0.0	-3.5	-1.8	-3.5	-26.9

* DTA is the deferred tax assets that are deducted in full under Basel III (ie it excludes DTAs that are related to temporary differences, which are only deducted when they exceed a threshold).** Excess above 15% pertains to significant investments in the common shares of unconsolidated financial institutions, mortgage servicing rights, and DTAs due to timing differences that do not separately exceed the 10% category thresholds but in the aggregate exceed the 15% basket threshold.*** Other includes deductions related to investment in own shares, shortfall of provisions to expected losses, cash flow hedge reserves, cumulative changes in fair value due to changes in own credit risk, net pension fund assets, securitisation gains on sale and deductions from Additional Tier 1 capital to the extent they exceed a bank's Additional Tier 1 capital.

Changes in risk-weighted assets

Overall results

Reductions in capital ratios under the Basel III framework are also attributed to increases in risk-weighted assets.

Table 4 provides additional detail on the contributors to these increases, to include the following categories:

Definition of capital:

These columns measure the change in risk-weighted assets as a result of proposed changes to the definition of capital.

The column heading “other” includes the effects of lower risk-weighted assets for exposures that are currently included in risk-weighted assets but receive a deduction treatment under Basel III.

The column heading “50/50” measures the increase in risk-weighted assets applied to securitisation exposures currently deducted under the Basel II framework that are risk-weighted at 1250% under Basel III.

The column heading “threshold” measures the increase in risk-weighted assets for exposures that fall below the 10% and 15% limits for CET1 deduction;

Counterparty credit risk (CCR):

This column measures the increased capital charge for counterparty credit risk and the higher capital charge that results from applying a higher asset value correlation parameter against exposures to financial institutions under the IRB approaches to credit risk.

Not included in CCR are risk-weighted asset effects of capital charges for exposures to central counterparties (CCPs) or any impact of incorporating stressed parameters for effective expected positive exposure (EEPE);

Securitisation in the banking book:

This column measures the increase in the capital charges for certain types of securitisations (eg, resecuritisations) in the banking book; and

Trading book:

This column measures the increased capital charges for exposures held in the trading book to include capital requirements against stressed value-at-risk, incremental default risk, and securitisation exposures in the trading book.

Risk-weighted assets for Group 1 banks increase overall by 19.4% for Group 1 banks.

This increase is to a large extent attributed to higher risk-weighted assets for counterparty credit risk exposures, which result in an overall increase in total Group 1 bank risk-weighted assets of 6.6%.

The predominant driver behind this figure is capital charges for counterparty credit risk as the higher asset value correlation parameter results in an increase in overall risk-weighted assets of only 1.0%.

Trading book exposures and securitisation exposures currently subject to deduction under Basel II, also contribute significantly to higher risk-weighted assets at Group 1 banks at 5.2% for each category.

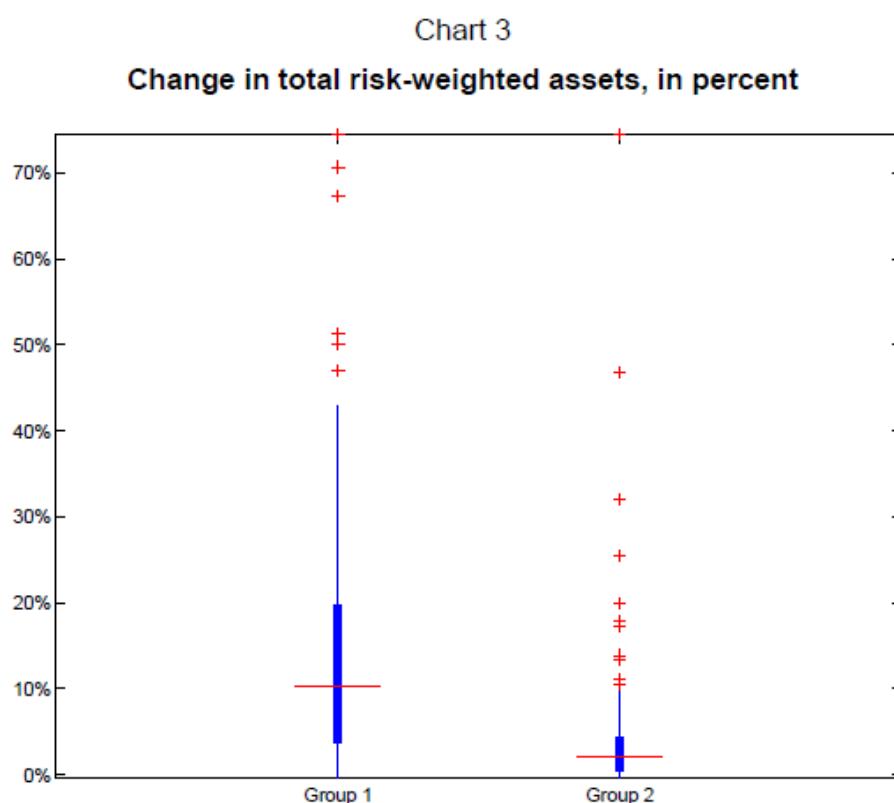
Table 4
Changes in RWA by banking group, in percent

	N	Total	Definition of capital			CCR	Securiti-sation banking book	Trading book
			other	50/50	thre-shold			
Group 1 banks	102	19.4	-1.6	5.2	2.6	6.6	1.5	5.2
Group 2 banks	109	6.3	-0.7	2.3	1.9	2.2	0.1	0.5

Securitisation exposures currently subject to deduction, counterparty credit risk exposures, and exposures that fall below the 10% and 15% CET1 eligibility limits are significant contributors to changes in risk-weighted assets for Group 2 banks.

Changes in risk-weighted assets show significant variation across banks as shown in Chart 3.

Again, these differences are explained in large part by the extent of banks' counterparty credit risk and trading book exposures, which attract significantly higher capital charges under Basel III as compared to current rules.



Impact of the revisions to the Basel II market risk framework

Table 5 shows further detail on the impact of the revised trading book capital charges on overall risk-weighted assets for Group 1 banks.

The sample analysed here is smaller than the one in Table 4 as not all the Group 1 banks provided data on market risk exposures.

For this reduced sample of banks, trading book exposures resulted in a 6.1% increase in total risk-weighted assets.

The main contributors to this increase are stressed value-at-risk (stressed VaR), non-correlation trading securitisation exposures subject the standardised measurement method (column heading "SMM")

non-CTP”), and the incremental risk capital charge (IRC), which contribute 2.2%, 1.7%, and 1.4%.

Less significant contributors to the increase in overall risk-weighted assets are capital charges for correlation trading exposures.

Increases in risk-weighted assets are partially offset by effects related to previous capital charges²⁴ and changes to the **standardised measurement method (SMM)**.

Table 5

Change in trading book-related capital charges relative to overall capital requirements, Group 1 banks, in percent

	N	Total	stressed VaR	SMM*	IRC and securitisation						Other	
					Overall	IRC	SMM non-CTP	Correlation trading		Prev. charge		
								CRM	SMM			
Average	96	6.1	2.2	-0.3	3.6	1.4	1.7	0.7	0.2	-0.6	0.5	

* Includes the elimination of the preferential 4% risk weight for certain equity exposures subject to the standardised measurement method and any other changes in national implementations of the standardised measurement method.

Impact of the rules on counterparty credit risk (CVA only)

Credit valuation adjustment (CVA) risk capital charges lead to a **7.3% increase in total RWA** for the subsample of 77 banks which provided the relevant data (6.6% on the full Group 1 sample).

A larger fraction of the total effect is attributable to the application of the standardised method than to the advanced method.

The impacts on Group 2 banks are smaller but still significant, adding up to an overall 2.9% increase in RWA over a subsample of 63 banks (2.2% for the full Group 2 sample), totally attributable to the standardised method. Further detailed are provided in Table 6.

Table 6

Changes in RWA for credit valuation adjustment (CVA), in percent

	N	CVA vs credit RWA	Of which		CVA vs total RWA	Of which	
			Stand. method	Adv. method		Stand. method	Adv. method
Group 1 banks	77	8.7	5.0	3.7	7.3	4.2	3.1
Group 2 banks	63	3.2	3.2	0.0	2.9	2.9	0.0

Findings regarding the leverage ratio

The results regarding the leverage ratio are provided using two alternative measures of Tier 1 capital in the numerator:

Basel III Tier 1, which is the fully phased-in Basel III definition of Tier 1 capital, and **Current Tier 1**, which is Tier 1 capital eligible under the Basel II agreement (the phase-in period of Basel III begins in 2013).

Total exposures of Group 1 banks according to the definition of the denominator of the leverage ratio were **€59.2 trillion** while total exposures for Group 2 banks were **€5.6 trillion**.

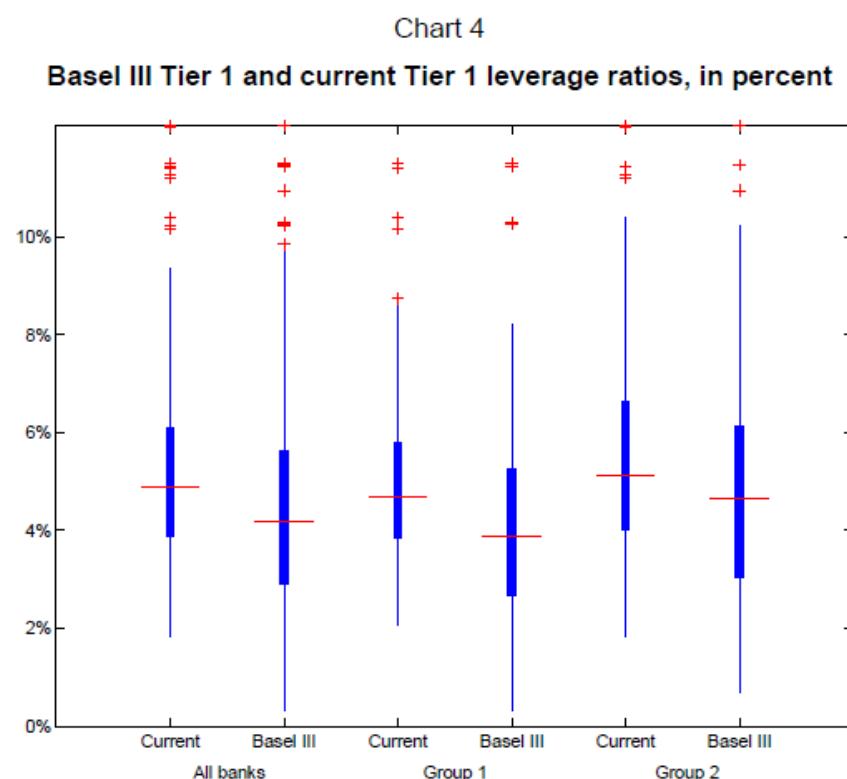
One important element in understanding the results of the leverage ratio section is the terminology used to describe a bank's leverage.

Generally, when a bank is referred to as having more leverage, or being more leveraged, this refers to a multiple (eg 33 times) as opposed to a ratio (eg 3%).

Therefore, a bank with a high level of leverage will have a low leverage ratio.

Chart 4 presents leverage ratios based on Basel III Tier 1 and current Tier 1 capital.

The chart provides this information for all banks, Group 1 banks and Group 2 banks.



The weighted average current Tier 1 leverage ratio for all banks is 4.5%.

For Group 1 banks, it is somewhat lower at 4.4% while it is 5.0% for Group 2 banks.

The average Basel III Tier 1 leverage ratio for all banks is 3.5%. The Basel III average for Group 1 banks is 3.4%, and the average for Group 2 banks is 4.2%.

The analysis shows that Group 2 banks are generally less leveraged than Group 1 banks, and this difference increases under Basel III when the requirements are fully phased in.

It is likely that a portion of this effect is due to the changes in the definition of capital, which, as seen in Section 2, are likely to affect Group 1 banks to a greater extent than Group 2 banks.

Under the current Tier 1 leverage ratio, 17 banks would not meet the 3% Tier 1 leverage ratio level, including six Group 1 banks and 11 Group 2 banks.

Under the Basel III Tier 1 leverage ratio, 63 banks would not meet the 3% Tier 1 leverage ratio level, including 36 Group 1 banks and 27 Group 2 banks.

Liquidity

Liquidity coverage ratio

One of the two standards introduced by the Committee is a 30-day liquidity coverage ratio (LCR) which is intended to promote short-term resilience to potential liquidity disruptions.

The LCR has been designed to require global banks to have sufficient high-quality liquid assets to withstand a stressed 30-day funding scenario specified by supervisors.

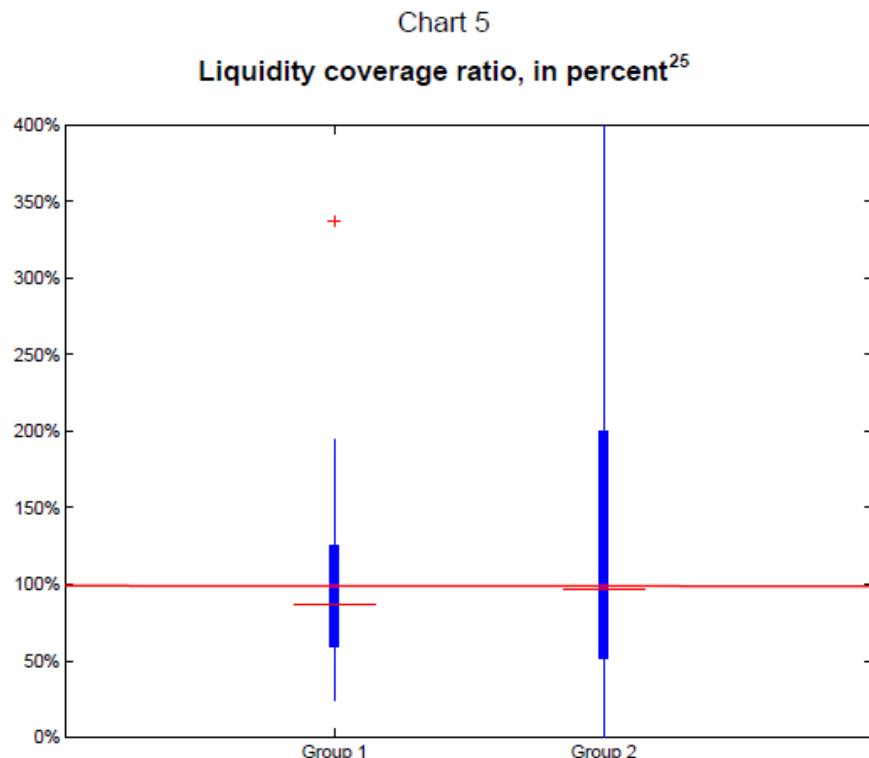
The LCR numerator consists of a stock of unencumbered, high quality liquid assets that must be available to cover any net outflow, while the denominator is comprised of cash outflows less cash inflows (subject to a cap at 75% of outflows) that are expected to occur in a severe stress scenario.

103 Group 1 and 102 Group 2 banks provided sufficient data in the 30 June 2011 Basel III monitoring exercise to calculate the LCR according to the Basel III liquidity framework.

The weighted average LCR was 90% for Group 1 banks and 83% for Group 2 banks. These aggregate numbers do not speak to the range of results across the banks.

Chart 5 below gives an indication of the distribution of bank results; the thick red line indicates the 100% minimum requirement, the thin red horizontal lines indicate the median for the respective bank group.

45% of the banks in the Basel III monitoring sample already meet or exceed the minimum LCR requirement and 60% have LCRs that are at or above 75%.



For the banks in the sample, Basel III monitoring results show a shortfall of liquid assets of €1.76 trillion (which represents approximately 3% of the €58.5 trillion total assets of the aggregate sample) as of 30 June 2011, if banks were to make no changes whatsoever to their liquidity risk profile.

This number is only reflective of the aggregate shortfall for banks that are below the 100% requirement and does not reflect surplus liquid assets at banks above the 100% requirement.

Banks that are below the 100% required minimum have until 2015 to meet the standard by scaling back business activities which are most vulnerable to a significant short-term liquidity shock or by lengthening the term of their funding beyond 30 days.

Banks may also increase their holdings of liquid assets.

The key components of outflows and inflows are shown in Table 7. Group 1 banks show a notably larger percentage of total outflows, when compared to balance sheet liabilities, than Group 2 banks.

This can be explained by the relatively greater contribution of wholesale funding activities and commitments within the Group 1 sample, whereas, for Group 2 banks, retail activities, which attract much lower

stress factors, comprise a greater share of funding activities.

Table 7

LCR outflows and inflows (post-factor) as a percentage of balance sheet liabilities*

Category	Group 1 banks	Group 2 banks
Outflows to...		
Unsecured retail and small business customers	2.1%	2.5%
Unsecured non-financial corporates	4.5%	2.9%
Unsecured sovereign, central bank, public sector entities (PSEs) and other counterparties	1.4%	0.8%
Unsecured financial institutions and other legal entities	5.1%	3.8%
Other unsecured wholesale funding incl. unsecured debt issuance	1.5%	0.7%
Secured funding and collateral swaps	1.8%	1.2%
Collateral, securitisations and own debt	0.8%	0.3%
Credit and liquidity facilities	2.6%	0.7%
Other contractual and contingent cash outflows including derivative payables	1.2%	0.6%
Total outflows**	21.1%	13.6%
Inflows from...		
Financial institutions	2.3%	2.6%
Retail and small business customers, non-financial corporates and other entities	1.7%	1.6%
Secured lending	1.7%	0.7%
Other cash inflows including derivative receivables	0.1%	0.1%
Total inflows***	5.8%	5.0%

* As reported in the net stable funding ratio. ** May contain rounding differences. *** For the purposes of this table, the 75% cap is only applied to the "total inflow" category.

Cap on inflows

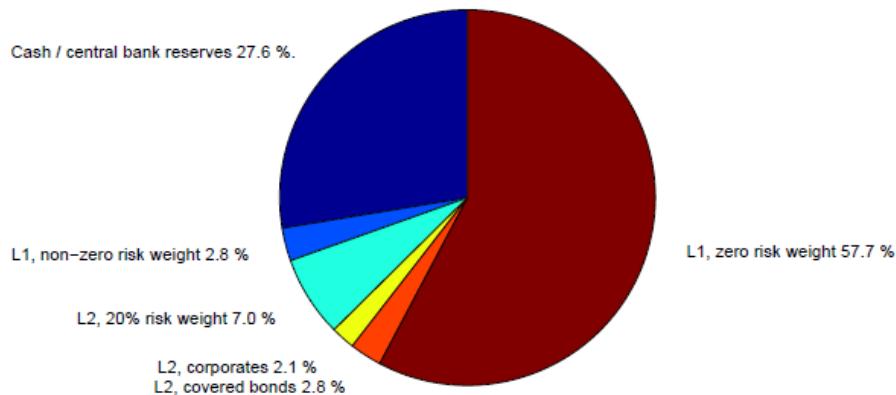
The composition of high quality assets currently held at banks is depicted in Chart 6.

The majority of Group 1 and Group 2 banks' holdings, in aggregate, are comprised of Level 1 assets; however the sample, on whole, shows diversity in their holdings of eligible liquid assets.

Within Level 1 assets, 0% risk-weighted securities issued or guaranteed by sovereigns, central banks and PSEs, and cash and central bank reserves comprising significant portions of the qualifying pool.

Comparatively, within the Level 2 asset class, the majority of holdings is comprised of 20% risk-weighted securities issued or guaranteed by sovereigns, central banks or PSEs, and qualifying covered bonds.

Chart 6
Composition of holdings of all eligible liquid assets (all banks)



Cap on Level 2 assets

€121 billion of Level 2 liquid assets were excluded because reported Level 2 assets were in excess of the 40% cap as currently operationalised.

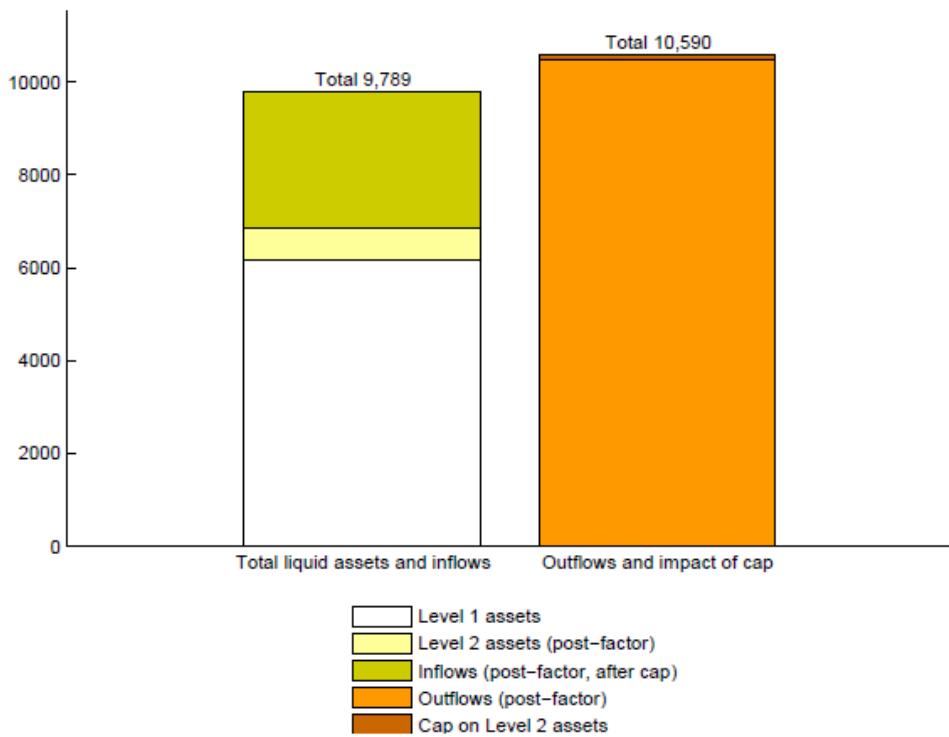
34 banks currently reported assets excluded, of which 24 (11% of the total sample) had LCRs below 100%.

Chart 7 combines the above LCR components by comparing liquidity resources (buffer assets and inflows) to outflows.

Note that the €800 billion difference between the amount of liquid assets and inflows and the amount of outflows and impact of the cap displayed in the chart is smaller than the €1.76 trillion gross shortfall noted above as it is assumed here that surpluses at one bank can offset shortfalls at other banks.

In practice the aggregate shortfall in the industry is likely to lie somewhere between these two numbers depending on how efficiently banks redistribute liquidity around the system.

Chart 7
Comparison of buffer and inflows to outflows and cap (€ billions, all banks)



Net stable funding ratio

The second standard is the net stable funding ratio (NSFR), a longer-term structural ratio to address liquidity mismatches and provide incentives for banks to use stable sources to fund their activities.

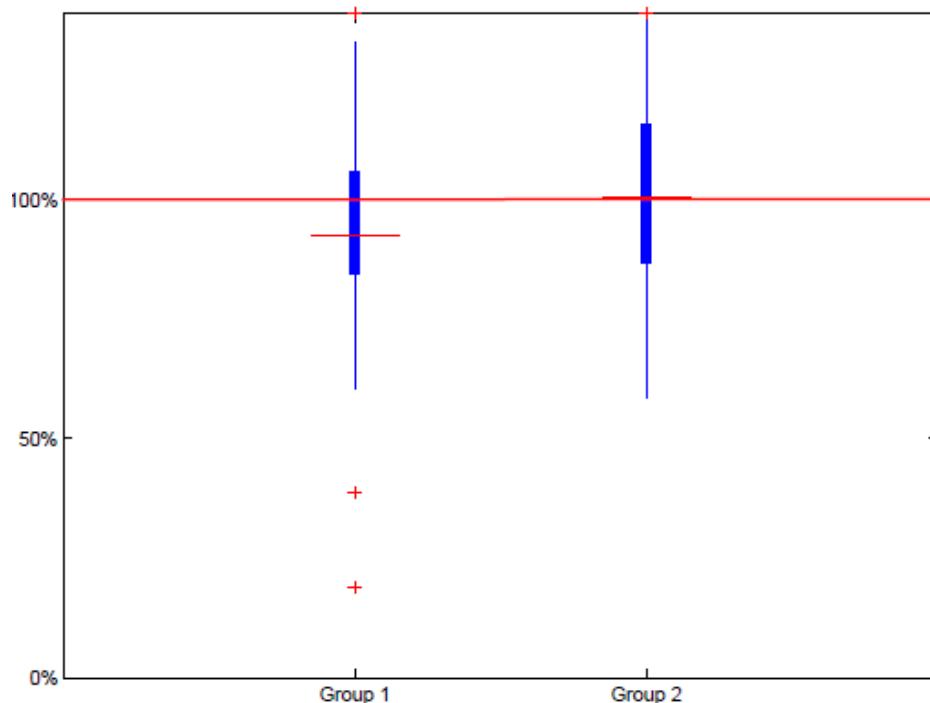
103 Group 1 and 102 Group 2 banks provided sufficient data in the 30 June 2011 Basel III monitoring exercise to calculate the NSFR according to the Basel III liquidity framework.

46% of these banks already meet or exceed the minimum NSFR requirement, with three-quarters at an NSFR of 85% or higher.

The weighted average NSFR for each of the Group 1 bank and Group 2 samples is 94%.

Chart 8 shows the distribution of results for Group 1 and Group 2 banks; the thick red line indicates the 100% minimum requirement, the thin red horizontal lines indicate the median for the respective bank group.

Chart 8
Net stable funding ratio, in percent



The results show that banks in the sample had a shortfall of stable funding of €2.78 trillion at the end of June 2011, if banks were to make no changes whatsoever to their funding structure.

This number is only reflective of the aggregate shortfall for banks that are below the 100% NSFR requirement and does not reflect any surplus stable funding at banks above the 100% requirement.

Banks that are below the 100% required minimum have until 2018 to meet the standard and can take a number of measures to do so, including by lengthening the term of their funding or reducing maturity mismatch.

It should be noted that the shortfalls in the LCR and the NSFR are not necessarily additive, as decreasing the shortfall in one standard may result in a similar decrease in the shortfall of the other standard, depending on the steps taken to decrease the shortfall.

Annex

Phase-in arrangements

(shading indicates transition periods – all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 Jan 2019
Leverage ratio	Supervisory monitoring	Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1		
Minimum CET1 ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer					0.625%	1.25%	1.875%	2.50%	
G-SIB surcharge						Phase-in			1.0%–2.5%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum total capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013							
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins						Introduce minimum standard		



EBA, ESMA and EIOPA publish two reports on Money Laundering

The Joint Committee of the **three European Supervisory Authorities** (EBA, ESMA and EIOPA) has published two reports on the implementation of the **third Money Laundering Directive [2005/60/EC]** (3MLD).

The “**Report on the legal, regulatory and supervisory implementation across EU Member States in relation to the Beneficial Owners Customer Due Diligence requirements**” analyses EU Member States’ current legal, regulatory and supervisory implementation of the anti - money laundering/counter terrorist financing (AML/CFT) frameworks related to the application by different credit and financial institutions of Customer Due Diligence (CDD) measures on their customers’ beneficial owners.

The report sought to identify **differences** in the implementation of the Directive and to determine whether such differences create a gap in the EU AML/CFT regime that could be exploited by criminals for money laundering and terrorist financing purposes.

The “**Report on the legal and regulatory provisions and supervisory expectations across EU Member States of Simplified Due Diligence requirements where the customers are credit and financial institutions**” provides an overview of EU Member States’ legal and regulatory provisions and supervisory expectations in relation to the application of **Simplified Due Diligence (SDD)** requirements of the 3MLD.

The report focuses exclusively on one particular situation of low risk where SDD is applicable, namely where the customer is a credit or financial institution situated in a EU/EEA state or in a country that imposes equivalent AML/CFT requirements.

Both reports come to the conclusion that there are **significant differences** in the implementation across the EU Member States, and that some of these differences could create undesirable effects on the common European Anti Money Laundering Regime.

The reports find that some of these differences are not due to the Directive’s minimum harmonisation approach, but instead appear to stem from different national interpretations of the Directive’s requirements.

Both reports also call on the European Union to consider addressing these problems.

The Joint Committee

The Joint Committee is a forum for cooperation that was established on 1st January 2011, with the goal of strengthening cooperation between the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA), collectively known as the three European Supervisory Authorities (ESAs).

Through the Joint Committee, the three ESAs cooperate regularly and closely and ensure consistency in their practices.

In particular, the Joint Committee works in the areas of supervision of financial conglomerates, accounting and auditing, microprudential analyses of crosssectoral developments, risks and vulnerabilities for financial stability, retail investment products and measures combating money laundering. In addition to being a forum for cooperation, the Joint Committee also plays an important role in the exchange of information with the [European Systemic Risk Board \(ESRB\)](#) and in developing the relationship between the ESRB and the ESAs.

Interesting Abbreviations

AML – Anti Money Laundering

AMLTF – Anti-Money Laundering Task Force of the EBA, ESMA and EIOPA

AML Committee – The Joint Committee of the European Supervisory Authorities' Sub Committee on Anti Money Laundering

CDD - Customer Due Diligence

CPMLTF – EU Committee on the Prevention of Money Laundering and Terrorist Financing

CTF – Counter Terrorist Financing

EBA - European Banking Authority

EC – European Commission

EEA - European Economic Area

EIOPA - European Insurance and Occupational Pensions Authority

EDD – Enhanced Due Diligence

ESMA - European Securities and Markets Authority

EU – European Union

FATF – Financial Action Task Force

ID - Identity

ML – Money Laundering

MS – Member State of the European Union

SDD - Simplified Due Diligence

TF – Terrorist Financing

UBO – Ultimate Beneficial Owner

WG – Working Group

3rd MLD - Third Money Laundering Directive (2005/60/EC)



BIS - Peer review of supervisory authorities' implementation of stress testing principles -April 2012

Stress testing is an important tool used by banks to **identify the potential for unexpected adverse outcomes across a range of risks and scenarios.**

In 2009, the Committee reviewed the performance of stress testing practices during the financial crisis and published recommendations for banks and supervisors entitled Principles for sound stress testing practices and supervision.

As part of its mandate to assess the implementation of standards across countries and to foster the promotion of good supervisory practice, the Committee's Standards Implementation Group (SIG) conducted a peer review during 2011 of supervisory authorities' implementation of the principles.

The review found that stress testing has become a key component of the supervisory assessment process as well as a tool for contingency planning and communication.

Countries are, however, at varying stages of maturity in the implementation of the principles; as a result, more work remains to be done to fully implement the principles in many countries.

Overall, the review found the 2009 stress testing principles to be generally effective.

The Committee, however, will continue to monitor implementation of the principles and determine whether, in the future, additional guidance might be necessary.

Peer review of supervisory authorities' implementation of stress testing principles, April 2012

Executive summary

This report summarises the Basel Committee's peer review on how supervisory authorities have implemented the Committee's 2009 Principles for sound stress testing practices and supervision.

The global financial crisis and the 2009 stress testing principles

Stress testing is an important tool for banks to identify unexpected adverse outcomes across a range of risks. It plays a particularly important role in:

- providing forward-looking assessments of risk;
- overcoming limitations of models and historical data;
- supporting internal and external communication;
- feeding into capital and liquidity planning procedures;
- informing the setting of banks' risk tolerance; and
- facilitating the development of risk mitigation or contingency plans across a range of stressed conditions.

In 2009, the Committee reviewed the performance of stress testing practices during the crisis and found weaknesses in various areas.

Based on the findings, and as part of its efforts to incorporate lessons from the crisis in supervisory practices, the Committee published recommendations for banks and supervisors entitled Principles for sound stress testing practices and supervision.

The guidance sets out a comprehensive set of principles for the sound governance, design and implementation of stress testing programmes at banks.

The principles also established high-level expectations for the role and responsibilities of supervisors in evaluating stress testing practices.

Scope of the review

As part of its mandate to [assess the implementation of standards across countries](#), during 2011 the Committee's Standards Implementation Group undertook a peer review of supervisory authorities' implementation of the principles.

The review was [conducted via an off-site survey of supervisory authorities](#).

All Committee member countries and one non-member country participated in the review.

The review focused primarily on progress in supervisory processes used

to implement the principles.

It was not designed to provide a detailed country-by-country assessment or to assess the adequacy of banks' stress testing programmes.

Increasingly, supervisory stress tests are being used to set minimum capital requirements, determine explicit capital buffers or to limit capital distributions by banks.

This recent development was not extensively considered in the principles and as a result was not a key focus of the review.

Key findings

Progress overview

In the period since the principles were issued, stress testing has become a key component of the supervisory assessment process as well as a tool for contingency planning and communication.

Many of the countries participating in this peer review have been working to implement and refine stress testing frameworks and methodologies at the same time as their economies and banking systems have been affected by a high degree of global economic and financial uncertainty.

Although many supervisory authorities and banks had operational stress testing frameworks in place, existing guidance and rules had to be revised and new expectations put in place to broaden and deepen stress testing capabilities at both banks and supervisory authorities.

The review found that countries are at varying stages of maturity in their implementation of the principles.

Nearly half of the countries were considered to be at an early stage.

These countries showed some progress toward implementing the principles, but they may not have issued or finalised prudential requirements on enterprise-wide stress testing since the principles were published.

They generally had not conducted regular on-site or off-site reviews other than in the context of risk-specific modelling requirements such as for market risk, and had conducted industry-wide stress tests infrequently, or only as part of International Monetary Fund Financial Sector Assessment Program (FSAP) reviews.

In contrast, a few countries were considered to be advanced.

For these countries, the survey responses provided evidence of a rigorous regular review process that included a combination of on-site and off-site assessments, some review and feedback on detailed stress testing models used by banks, evidence of follow-up actions and a well-embedded supervisory stress testing programme that was not limited to externally imposed scenarios.

The remainder of countries were found to fall between the above two groups.

These countries have issued some formal requirements or guidance consistent with the principles, are generally performing regular supervisory stress tests on large banks in their jurisdictions and are reviewing stress testing [in the context of annual internal capital adequacy assessment process \(ICAAP\) reviews and specific risk reviews](#).

These countries have more to do in deepening their stress testing programmes, including issuing updated requirements and conducting more detailed on-site and off-site reviews of banks' stress testing capabilities.

Remaining challenges and examples of good practices

The most common overall supervisory approach was to conduct some review of banks' stress testing as part of regular ICAAP assessments and in the context of specific risks where ongoing supervisory review of exposure modelling is now routine, notably market and liquidity risks.

Conducting more detailed, comprehensive reviews of banks' enterprise-wide stress testing governance and modelling as envisioned in the principles requires expert skills and resourcing at both banks and supervisors, and as a result has not yet become standard practice in many countries.

A significant development in the last several years has been the increased use of supervisory stress tests.

A majority of countries now regularly conduct mandated stress tests with prescribed scenarios across the large banks in their jurisdictions, although for some countries, this is limited to the FSAP stress tests.

A number of countries noted the resource-intensive nature of industry-wide stress tests.

In particular, the more advanced countries note that resourcing at both supervisory authorities and banks to support stress testing is challenging, with a trend towards establishing specially staffed units or internal task forces for stress testing.

Many, however, found that these exercises have been helpful in terms of enhancing the visibility of stress testing and providing a structured basis for dialogue with banks on their capabilities.

It was noted that industry dialogue around mandated stress tests had led to improvements in bank capabilities.

The following types of practices are also associated with relatively more advanced countries:

- plans for, or completed horizontal or thematic reviews of, stress testing either at an enterprise-wide level or for specific portfolios;
- engagement with boards of directors on stress testing scenarios and governance;
- review of detailed evidence of how banks are using stress test outcomes in their decision-making and risk-appetite setting;
- well-articulated plans for improving their stress testing supervision programmes;
- involvement of both generalist and specialist supervision staff; and
- publication of the results and provision of consistent feedback to banks.

While not a primary focus of the peer review, many countries provided views on areas for improvement in stress testing practices at banks.

These responses focused fairly consistently on areas such as governance and the use of stress testing in bank decision-making, data and information technology infrastructure, severity of scenarios and firm-wide modelling challenges.

The review found the principles to be generally effective.

The Committee, however, will continue to monitor implementation of the principles and determine whether, in the future, additional guidance might be necessary.

Introduction

Stress testing is an important tool for banks to identify unexpected adverse outcomes across a range of risks.

The financial crisis highlighted significant weaknesses in banks' stress testing programmes that contributed to failures to identify the nature and magnitude of key risks.

As a result, the Committee engaged with the industry in examining stress testing practices and, in May 2009, the Committee published recommendations for banks and supervisors entitled Principles for sound stress testing practices and supervision.

The guidance set out a comprehensive set of principles for the sound governance, design and implementation of stress testing programmes at banks.

The principles established expectations for the role and responsibilities of supervisors in evaluating stress testing practices. Overall, the guidance includes fifteen principles for banks and six principles for supervisors.

As part of its mandate to assess the implementation of its standards across countries, the **Committee's Standards Implementation Group undertook a peer review of supervisory authorities' implementation of the principles**.

The objectives of this review were to:

- **assess the extent** to which the principles have been implemented in a rigorous and consistent manner across the Committee's member authorities;
- **identify and provide feedback** on factors that are most critical to the effective implementation of the principles; and
- **assess the effectiveness** of the principles themselves.

An important element of the review was the context in which the principles are being implemented.

Many of the countries participating in this peer review have been working to implement and refine stress testing frameworks and methodologies at the same time their economies and banking systems have been affected by a high degree of global economic and financial uncertainty.

Although many supervisory authorities and banks had operational stress testing frameworks in place, existing guidance and rules had to be revised and new expectations put in place to broaden and deepen stress testing capabilities at both banks and supervisors.

This is being done in a stressed environment and is also being conducted at a time when stress testing infrastructure, including the ability to collect appropriate data, develop models and aggregate results, is evolving.

As a result, the current environment has provided a useful early test of how countries are putting the principles into practice.

More broadly, it was evident that countries are implementing stress testing regimes and activities in different ways that may reflect their individual situations and not all will follow the same progression or path in implementing the principles.

The review was intended to deliver feedback on good supervisory practice to help supervisors implement standards more effectively.

Indeed, several countries have reported significant progress subsequent to the completion of the peer review survey, particularly with regard to supervisory stress testing practices.

Methodology

The peer review was conducted through a questionnaire which was distributed to Committee member countries in September 2011.

Analysis of the responses was conducted by a working group of representatives of supervisory authorities with expertise in stress testing.

The questionnaire focused primarily on the implementation activities of supervisors and consisted of both factual multiple choice questions and free-form responses.

The review team used the information provided by each country and, where relevant, source documents demonstrating its implementation of the principles, to assess and compare the progress made across countries.

Given the off-site and high-level nature of the review, it was not intended to produce a definitive assessment of individual countries' implementation of the principles, but, rather, to allow an overall view of progress across countries.

A detailed report was provided to the Standards Implementation Group and to the Committee.

The review focused primarily on the implementation of principles 16-21 for supervisors, as it was not within the scope of the peer review to assess compliance by banks with principles 1-15 on stress testing practices.

However, countries were invited to provide their views on the ease and effectiveness of implementation for each of the principles for banks in their jurisdiction.

In their responses, supervisory authorities were asked to focus on supervision of the largest banks in their jurisdiction, although some also addressed their supervisory expectations for stress testing at smaller banks.

Assessment of principles for supervisors

Overall maturity of implementation

For purposes of assessing and comparing implementation of the principles, participating countries were stratified as being in an early, intermediate or advanced state of implementation.

These assessments were based on indicators of maturity developed for this purpose by the review team, as well as the quality and thoroughness of the questionnaire responses.

Countries in the early category (nearly half of respondents) showed some progress towards implementing the principles; however, they may not have issued or finalised prudential requirements on enterprise-wide stress testing since the principles were published.

These countries generally had not conducted regular on-site or off-site reviews other than in the context of risk-specific modelling requirements such as for market risk, and have conducted industry-wide stress tests infrequently, or only as part of FSAP reviews.

In contrast, a few countries were classified as advanced. For these countries, the review team saw evidence of a rigorous regular review process that included a combination of:

- on-site and off-site assessments;
- some review and feedback on detailed stress testing models used by banks;
- evidence of follow-up actions; and
- a well-embedded supervisory stress testing programme that was not limited to FSAP or regionally-imposed scenarios.

The remainder of countries (approximately half of respondents) fell into the intermediate category.

These countries have issued some formal requirements or guidance consistent with the principles, were generally performing regular supervisory stress tests on their large banks and were reviewing stress testing in the context of annual ICAAP reviews and specific risk reviews.

These countries have more to do in deepening their programmes, including issuing updated requirements and conducting more detailed on-site and off-site reviews of banks' stress testing capabilities.

Notably, several countries have reported significant progress subsequent to the completion of the peer review survey, particularly with regard to supervisory stress testing practices and also in some cases issuance of stress testing requirements or guidance.

Specific areas of supervisory activity in relation to the principles are discussed in more detail below.

Prudential framework

The review found that **all countries have in place prudential requirements relating to stress testing.**

In many cases these requirements were implemented as a component of Basel II, namely the ICAAP requirements, or otherwise pre-date the principles.

In addition, a large majority of the respondents stated that they had issued specific rules or guidance implementing the principles.

However, approximately one-third of respondents has not issued any rules or guidance on stress testing post-2009, and thus would not be considered to have implemented the principles explicitly.

These countries rely on other rules relating to stress testing, particularly under the Basel II credit or market risk requirements.

In terms of future plans, a number of countries across different levels of maturity are in the process of, or are planning to strengthen or finalise guidance or regulations.

In some cases, key elements of the principles have been incorporated into the Pillar 2 requirements and in other cases as (non-mandatory) guidance for banks.

Some countries issued informal guidance based generally on the principles or on other regional guidelines.

A number of countries are still in the early phases of issuing prudential expectations for enterprise-wide stress testing.

At least a few countries have not yet issued requirements relating to Basel II ICAAPs, which was the most common means of implementing the principles.

Other countries have already updated their rules and adapted the principles or other guidelines for their own circumstances.

These would be considered to have a more mature supervision framework for stress testing.

A few other countries have issued their own good practice guidelines which incorporate the principles as well as key findings from supervisory activities and industry dialogue.

Roughly three-quarters of respondents reported that there have not been any impediments to implementing the principles.

However, resourcing and other supervisory priorities were noted as a constraint by a number of other countries.

A number of countries asserted that because their banks or banking systems are not complex, some of the aspects of the principles are not relevant (eg structured products and highly leveraged counterparties).

Further, banks in some jurisdictions generally do not have the infrastructure and skills to be able to comply with sophisticated stress testing requirements.

Supervisory review

Principle 16 recommends that supervisors should make regular and comprehensive assessments of banks' stress testing programmes.

The review found that supervisory authorities use a combination of on-site and off-site reviews to assess banks' stress testing practices.

Most countries indicated that they have conducted some form of on-site review of stress testing at banks.

For specific risk areas (primarily market, liquidity and to some extent credit risk), there are well established supervisory review programmes.

Almost three-quarters of countries indicated that they perform extensive regular review of firm-wide stress testing practices.

The most common approach for assessing firm-wide stress testing is through annual ICAAP reviews, which generally cover capital planning as well as other matters.

Given the scope of ICAAP reviews, it may be difficult to assess all of the principles during a routine ICAAP review.

Indeed, a few countries indicated that they conduct horizontal or thematic reviews specifically on firm-wide stress testing including the principles, which is considered a more advanced practice.

The frequency of on-site reviews of firm-wide stress testing varied across countries.

About one-third of countries conducted less-than-annual reviews (every 2-4 years) while roughly half of responding countries reported that they conduct annual or more frequent on-site reviews of stress testing.

Some supervisors have conducted a one-time review of the principles through self-assessments, questionnaires, or benchmarking studies across a range of banks.

In terms of the scope of supervisory review, supervisory activities regularly covered stress testing for firm-wide risks, general credit risks,

retail mortgages and corporate credit risks, market risk, banking book interest rate risk and liquidity risk.

Authorities reported that areas such as operational risk, overseas operations, as well as specific portfolios such as commercial property and sovereign risks, receive less coverage.

Supervisory authorities in most countries reported conducting annual or more frequent review of board and senior management reporting of stress test results.

Use of stress testing in loan loss provisioning was reviewed regularly by about half of the countries.

The role of stress testing to help set risk appetite and identify risk concentrations were areas that were less commonly reviewed; this is an area where supervisory and bank practice is at a very early stage.

Review of contingency plans for operational risk is the surveyed area least likely to have been assessed by supervisors in the context of stress testing.

Some countries noted different requirements or expectations of stress testing across banks, mainly depending on the banks' systemic importance (including size, complexity and relevance to economy) and risk profile.

Most emphasised that supervisors have proportionately different expectations when conducting stress testing reviews of smaller banks. Several countries (particularly those at the more advanced stages of implementation of the principles) indicated that they are planning to increase the expectations of smaller institutions with respect to stress testing going forward.

Supervisory action

Principle 17 indicates that supervisors should take action on deficiencies in banks' stress testing programmes.

The review found that the two most common areas for supervisory follow-up were improving governance processes for stress testing and use of additional (in particular, more severe) scenarios.

Many countries either regularly or occasionally imposed requirements to improve data or model validation processes.

The least common supervisory follow-up action indicated in the responses was to require the bank to review or change limits or exposures (less than half of the countries reported taking this action regularly).

Principle 19 encourages supervisors to consider the results of stress tests in assessing capital adequacy and in setting prudential buffers for capital and liquidity.

A large majority of countries indicated that they sometimes or regularly impose capital or liquidity requirements as a result of stress testing deficiencies.

In particular, use of stress scenarios for setting liquidity requirements appears to be fairly well established, particularly as countries work toward implementing the Basel III liquidity framework, which is based on stressed cash flows.

Nearly all of the countries indicated regular review of liquidity stress testing.

Use of stress tests for setting minimum capital requirements, determining explicit capital buffers or for limiting capital distributions by banks is a more recent development that was not extensively considered in the principles and as a result was not a key focus of the review.

A small number of countries indicated that stress testing has become a key tool for setting or assessing capital requirements.

Some countries have issued new requirements in the past year or so specifically related to the use of stress tests in assessing capital adequacy.

While use of stress tests to set formal minimum capital requirements is not common, use of standard supervisory stress scenarios as a benchmarking tool is increasingly prevalent.

Other countries took the view that stress test results are just one factor in assessing how much capital is needed to offset the risk of unexpected losses.

In a number of countries, and even those with fairly advanced stress testing supervision programmes, stress testing was seen as one of several tools in assessing capital adequacy and there was a reluctance to place primary reliance on stress test scenario outcomes.

This may reflect the evolving nature of supervisory and bank practices.

Supervisory resourcing

As stress testing is a fairly new and specialised area of supervision, the review found that resourcing and capabilities for stress testing supervision were key challenges for many supervisory authorities.

Only a few countries have established units specifically dedicated to stress testing.

Most countries are primarily relying on separate teams of staff to conduct supervisory stress tests and, in many cases, also to review stress testing practices at banks.

These teams also perform other tasks in addition to reviewing or conducting stress testing.

Typically, a set of specially trained supervisors is responsible for coordinating with banks with respect to the collection of data for stress testing and reviewing and consolidating the stress test information.

Often an inter-departmental team is used to conduct the stress tests.

In general, it was noted that staff with a variety of different backgrounds can be useful in stress testing, including macro-surveillance economists, risk specialists and modelling experts, as well as generalist supervisors who are most familiar with individual institutions or accounting experts.

Similarly, most countries utilise both risk specialists and generalist supervisors in reviewing stress testing practices at banks.

In most countries, generalist supervisors are involved in the review of stress testing practices; however, they are not generally involved in conducting supervisory stress tests.

At the same time, some countries noted that where stress testing is allocated to a separate unit, it can be more difficult to ensure that stress testing is embedded within routine supervision and that stress test outcomes are understood and used by the generalist supervisors.

This was seen as an evolving challenge.

The more advanced countries, in particular, noted a general lack of specialised stress testing resources.

Indeed, some countries found that prioritisation of supervisory work is a major issue as key individuals involved often have other responsibilities.

Most countries indicated they had established some form of training programme on stress testing for supervisors.

In many cases, the training was of a quite general nature and in some cases limited to presentation of the results of supervisory stress tests or high-level discussion in the context of introductory training on Pillar 2 approaches.

A few countries provide quite advanced training programmes, including case studies, and some offer training to other countries' supervisors or to banks in their jurisdiction.

Not surprisingly, several countries noted that stress testing training is an area of focus in their future plans.

Supervisory stress testing

Principle 20 recommends that supervisors should consider implementing stress test exercises based on common scenarios.

It is clear that there has been a significant increase in the use of supervisory stress tests in recent years.

In fact, all countries indicated that they conduct some form of supervisory stress test.

As a result, progress in this area can be considered more advanced generally than some other aspects of the principles.

Portfolio-level stress tests were reported by more than half of the countries.

In recent years, this has included specific stress tests on, for example, housing loan portfolios, consumer debt, sovereign risks and liquidity risk.

Some countries indicated that they conduct very frequent sensitivity testing for specific risks, for example, applying market risk and liquidity shocks on a regular basis.

In terms of firm-wide stress tests based on a common scenario, there was a range of experience.

A few countries have performed FSAP stress tests only.

While these stress tests provide an important basis and experience for designing supervisory stress tests, in many cases they tended to be led by the FSAP mission team and the national central bank, and did not have a supervisory focus.

About one-third of countries were not running stress tests on a firm-wide basis.

In a couple of countries, firm-wide stress tests were conducted by the (non-supervisory) central bank, although with some involvement by the supervisory authority.

Many countries conduct both bank-run and supervisor-run stress tests.

This can involve the supervisory authority running the same scenario using supervisory or public data in order to benchmark banks' results from the bank-run stress test. Some countries run both regional and country-specific stress tests.

Directing banks to run a stress test using a common scenario is considered to be a more advanced practice for supervisors, as it requires

more detailed understanding of bank modelling capabilities and an ability to assess the results.

About half of the countries have conducted bank-run, firm-wide stress tests (outside of the FSAP process), of which about half conduct these on an annual basis.

Supervisory assessment and challenge

The overall assessment and challenge of the reasonableness of banks' stress test scenarios and outputs is a difficult area for supervision.

In many countries, the models, assumptions and approaches used are evolving, and banks are at varying degrees of sophistication.

At a general level, the review found a range of supervisory methods for challenging the scope and results of banks' stress tests and scenarios.

The most widely used method was to compare outputs with historical experience, such as a past severe recession.

However, in countries with little history of financial crisis, this approach may be more difficult.

A number of countries conducted their own parallel stress tests on bank financial data to benchmark results produced by banks or placed high reliance on reasonableness checks based on supervisors' understanding of portfolios.

Peer comparisons were very useful in countries where banks subject to stress testing are comparable in size and scope.

Some countries facilitate this by requiring banks to report the results of their stress tests in a standardised manner.

A number of countries also place moderate to high reliance on banks' own internal model validation reporting.

Independent review by external auditors or consultants can be one element of the assessment and challenge process for some countries.

But more than half of countries indicated they do not rely at all on independent review of stress testing results as part of their supervision activities.

Another supervisory trend is that supervisory authorities are more actively reviewing scenarios chosen by the banks in their internal stress testing and, for example, the banks' ICAAPs.

Monitoring or keeping a systematic inventory of scenarios used by banks is a more advanced practice as it allows better benchmarking of

peer banks' internal view of stressed conditions and possible vulnerabilities.

Several countries maintain a database of scenarios used by their banks, and others have plans to do this.

Over half of the countries periodically review the scenarios used by banks in their internal stress testing.

A few countries in the earlier stages of maturity were not regularly reviewing scenarios used by banks.

Supervisory authorities in several countries indicated that they have performed reverse stress tests, that is, stress tests designed to be sufficiently severe that they challenge the viability of the bank.

However, reverse stress testing has not become a common supervisory practice.

In fact, the supervisory stress tests appear to be the vehicle for assessing the impact of more severe scenarios.

In terms of the choice of scenario for supervisory stress tests, the most common approach was to look to a previous severe recession or input from the central bank.

Also very common was to target the scenario to known vulnerabilities. About half of the countries have used externally prescribed scenarios (for example, from a regional authority or FSAP process).

Dialogue with public and private sectors

Stress testing is increasingly part of the public debate on the strength and transparency of supervision.

Supervisory authorities have regular discussions with banking industry risk officers or hold occasional seminars, workshops or roundtables with banks to exchange experiences on stress testing methodologies and use of results.

In some cases, this has resulted in publication of local industry guidance based on the Committee's principles.

Some supervisors also have a formal process for coordinating with other official organisations within their country.

In some cases, a formal committee of regulators and other authorities (including the central bank) discusses systemic vulnerabilities and provides input into stress testing programmes and the scenarios to be tested.

A number of other supervisors coordinate with their central bank in conducting a quantitative macroeconomic stress test, including consideration of potential systemic issues that may be caused by banks' management reactions to a common stress scenario.

Regional-level coordinating bodies have also become increasingly important.

Effective supervisory approaches

The review highlighted a number of different supervisory approaches that appear to have been more effective and are reflective of more advanced progress.

One of the most effective tools in advancing stress testing practices has been the significantly heightened focus on industry-wide supervisory stress tests.

Many countries found that this process has helped focus on common expectations, provide a structured approach for dialogue on better stress testing practices, and identify gaps in banks' stress testing infrastructure.

By challenging the loss results reported by banks on the prescribed scenarios, supervisors have motivated banks to justify their results and hence improve their internal assessment of key risk areas.

In contrast, there was some evidence that countries that have only conducted supervisory stress tests or supervisory review of stress testing practices without leveraging these two aspects together have not made as much progress in implementing the principles.

In addition, countries that address bank stress testing practices through the ICAAP review process have generally found this to be an effective mechanism, although periodic horizontal or thematic reviews that allow detailed comparison of practices across banks is a more advanced approach that is in use or under consideration in some countries.

A formal self-assessment process conducted in some countries helped banks identify where their practices are consistent with the principles and where gaps exist in stress testing programmes.

Open dialogue with banks was also seen as a key element of an effective supervisory programme.

Annual meetings with banks can include discussions of risk developments and best practices in stress testing that effectively create incentives for banks to strengthen their own practices.

Another approach highlighted by some countries was to engage in dialogue on scenario selection, dynamics of models, reporting templates

and data capabilities, and overall robustness of the stress test at the highest level of bank management.

Several countries have issued publications describing observed good practices arising from benchmarking or initial implementation reviews of the principles.

This type of guidance allows banks to benchmark themselves against their local peers.

Banks, and to some extent regulators, are increasingly using stress testing as a means of communicating their risk profiles to the market.

However, disclosure requirements and practices vary considerably by country.

Many countries now publish aggregate summaries of stress tests results in their regular financial stability reports, and in some cases outcomes for individual banks.

Some banks now routinely provide stress test results as part of their financial results.

Future plans

Most supervisory authorities described future enhancements to their stress testing supervision programmes.

Those countries in the early phases of maturity are planning to issue, finalise or update rules on stress testing and to commence review and assessment of stress testing practices.

Some are also conducting supervisory stress tests for the first time.

Those supervisory authorities in intermediate to advanced stages of maturity plan to focus on deepening their current on-site and off-site review programmes, with the aim of better assessing how stress test outcomes are used in bank decision-making and risk appetite setting.

Stress testing results are expected to have a greater impact on contingency planning including recovery and resolution.

Additional supervisory work is planned for identifying and assessing how banks are integrating stress tests results in the development of risk appetite and overall risk management.

Some supervisors will also use horizontal reviews across multiple banks to assess these areas as well as to benchmark banks' internal stress test scenarios and assumptions.

Greater focus on the use of stress test outputs in assessing capital adequacy and liquidity was evident in a few countries, with some also

planning more explicit consideration of stress test outcomes in setting capital buffers.

Principles for Banks

As the peer review focused on supervisory implementation, an assessment of stress testing practices at banks was not within the scope of this review.

Nevertheless, many countries provided high-level comments on progress of banks in their jurisdictions that were reasonably consistent and may be of broader interest.

In particular, all countries reported significant improvements in stress testing capabilities at banks since publication of the principles.

Authorities noted an overall improvement in the rigor and quality of stress testing and the quality of information presented in ICAAPs.

Risk-specific stress testing, particularly regarding market and liquidity risk, was found to be reasonably well developed.

More recently, banks have focused increasingly on centralised, firm-wide stress testing that encompasses a broader range of risks, but many countries note this area is still evolving.

Banks have strengthened their resourcing, with some banks now having set up dedicated stress testing units.

Banks are using a broader range of scenarios, including those that are more severe and complex.

However, as noted below, many countries indicated that banks' scenarios continue to be less severe than supervisors might find appropriate.

Banks generally are establishing stronger governance frameworks with clear lines of responsibility for stress testing, and some banks are giving more importance to stress test results in their decision making.

Some countries have seen an improvement in data systems and ability to adapt to new vulnerabilities and specific scenarios.

The level of documentation has also improved.

Countries' responses to the review survey highlighted the following common areas of future improvement in bank stress testing practices.

Integrating results into decision-making.

A number of countries pointed to challenges banks have in incorporating stress test results into business and strategic decisions.

Stress testing tools are still immature and some countries felt that in many cases the banks take a compliance-oriented approach in order to meet regulatory requirements.

Governance

There is a sense that banks need to have a better understanding of stress testing limitations, assumptions, and uncertainties by users of stress test results, including senior management and the board of directors.

Severity of scenarios

A number of countries saw a need for firms to deepen the severity of scenarios.

Supervisors in these countries remain concerned that banks' internal stress test scenarios do not plausibly reflect potential severe scenarios and outcomes.

Data and IT infrastructure.

A number of countries noted that data and IT systems remain a key impediment to implementing effective stress testing programmes.

Accumulation of sufficient data for modelling purposes is a challenge for banks in some countries and aggregating information across the bank remains an issue.

Generally, some manual intervention is needed to support the banks' current IT and data infrastructure to run regular stress tests.

Modelling issues

Translating and calibrating scenarios into stress outcomes continues to be an area where banks' capabilities are challenged.

Multiple risk class impacts generally have not been modelled in a sophisticated manner, although some banks attempt to take into account correlations between risks.

Incorporating feedback effects and system-wide interactions remains very difficult.

Another technical area cited is the identification and aggregation of correlated risks and integration between credit, market and liquidity risks.

Conclusions

The current environment has provided a sound test of how countries are putting into practice the Committee's 2009 principles for stress testing supervision.

There is clearly room for further progress among the supervisory community in the supervision of stress testing.

Many countries in the early to intermediate stages of implementation are working to finalise their prudential requirements for stress testing and implement regular review programmes that cover enterprise-wide stress testing governance, capabilities and models.

Even those countries considered to be in the advanced phase of implementation of the principles felt that there are many remaining challenges with respect to their own stress testing programmes.

Authorities are continuing with their efforts to embed the use of stress testing within their supervisory programmes.

In many cases, this requires additional resources and training for both generalist and specialist supervision staff.

Stress testing infrastructure, including the ability to collect appropriate data, develop models and aggregate results, continues to evolve.

Explicit consideration of stress test outcomes in assessing liquidity and market risk capital requirements is well established in supervisory frameworks.

Stress testing has traditionally not featured as prominently in assessment of overall bank capital adequacy but practices are evolving in this area.

The peer review has highlighted that there are different supervisory approaches and it is difficult to state which is most effective.

A combination of supervisory stress tests together with involvement of generalist and specialist supervision staff in reviews of banks' stress testing practices at an enterprise-wide level often characterises the more well developed supervisory programmes.

More advanced countries are encouraging development of more rigorous practices at banks by conducting horizontal and thematic reviews, publishing the results and providing feedback to banks.

Finally, while the review found the principles themselves to be generally effective in setting high-level expectations, the Committee will continue

to monitor implementation of the principles and determine whether, in the future, additional guidance might be necessary.

1	Stress testing should form an integral part of the overall governance and risk management culture of the bank. Stress testing should be actionable, with the results from stress testing analyses impacting business decisions of the board and senior management. Board and senior management involvement in the stress testing programme is essential for its effective operation
2	A bank should operate a stress testing programme that promotes risk identification and control; provides a complementary risk perspective to other risk management tools; improves capital and liquidity management; and enhances internal and external communication.
3	Stress testing programmes should take into account of views from across the organisation and should cover a range of perspectives and techniques.
4	A bank should have written policies and procedures governing the stress testing programme. The operation of the programme should be appropriately documented.
5	A bank should have a suitably robust infrastructure in place, which is sufficiently flexible to accommodate different and possibly challenging stress tests at an appropriate level of granularity.
6	A bank should regularly maintain and update its stress testing framework. The effectiveness of the stress testing programme, as well as the robustness of major individual components, should be assessed regularly and independently.
7	Stress tests should cover a range of risks and business areas, including at the firm-wide level. A bank should be able to integrate effectively, in a meaningful fashion, across the range of its stress testing activities to deliver a complete picture of firm-wide risk.
8	Stress testing programmes should cover a range of scenarios, including forward-looking scenarios, and aim to take into account system-wide interactions and feedback effects.
9	Stress tests should feature a range of severities, including events capable of generating the most damage whether through size of loss or through loss of reputation. A stress testing programme should also determine what scenarios could challenge the viability of the bank (reverse stress tests) and thereby uncover hidden risks and interactions among risks.
10	As part of an overall stress testing programme, a bank should aim to take account of simultaneous pressures in funding and asset markets, and the impact of a reduction in market liquidity on exposure valuation.
11	The effectiveness of risk mitigation techniques should be systematically challenged.

12	The stress testing programme should explicitly cover complex and bespoke products such as securitised exposures. Stress tests for securitised assets should consider the underlying assets, their exposure to systematic market factors, relevant contractual arrangements and embedded triggers, and the impact of leverage, particularly as it relates to the subordination level in the issue structure.
13	The stress testing programme should cover pipeline and warehousing risks. A bank should include such exposures in its stress tests regardless of their probability of being securitised.
14	A bank should enhance its stress testing methodologies to capture the effect of reputational risk. The bank should integrate risks arising from off-balance sheet vehicles and other related entities in its stress testing programme.
15	A bank should enhance its stress testing approaches for highly leveraged counterparties in considering its vulnerability to specific asset categories or market movements and in assessing potential wrong-way risk related to risk mitigation techniques.
16	Supervisors should make regular and comprehensive assessments of a bank's stress testing programme.
17	Supervisors should require management to take corrective action if material deficiencies in the stress testing programme are identified or if the results of stress tests are not adequately taken into consideration in the decision-making process.
18	Supervisors should assess and if necessary challenge the scope and severity of firm-wide scenarios. Supervisors may ask banks to perform sensitivity analysis with respect to specific portfolios or parameters, use specific scenarios or to evaluate scenarios under which their viability is threatened (reverse stress testing scenarios).
19	Under Pillar 2 (supervisory review process) of the Basel II framework, supervisors should examine a bank's stress testing results as part of a supervisory review of both the bank's internal capital assessment and its liquidity risk management. In particular, supervisors should consider the results of forward-looking stress testing for assessing the adequacy of capital and liquidity.
20	Supervisors should consider implementing stress test exercises based on common scenarios.
21	Supervisors should engage in a constructive dialogue with other public authorities and the industry to identify systemic vulnerabilities. Supervisors should also ensure that they have the capacity and skills to assess a bank's stress testing programme.



April 2012

Results of the Basel III monitoring exercise as of 30 June 2011

To assess the **impact of the new capital and liquidity requirements** set out in the consultative documents of June and December 2009, both the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors (CEBS) conducted a so-called comprehensive quantitative impact study (C-QIS) for their member jurisdictions based on data as of 31 December 2009.

The main results of both impact studies have been published in December 2010.

After **finalisation of the regulatory framework (referred to as “Basel III”)** in December 2010, **the impact of this new framework is monitored semi-annually** by both the Basel Committee at a global level and the European Banking Authority (EBA, formerly CEBS) at the European level, using data provided by participating banks on a voluntary and confidential basis.

This report summarises the results of the latest monitoring exercise using consolidated data of European banks as of 30 June 2011. A total of **158 banks submitted data for this exercise, consisting of 48 Group 1 banks and 110 Group 2 banks**.

[Group 1 banks are those with Tier 1 capital in excess of €3 bn and internationally active. All other banks are categorised as Group 2 banks]

Member countries' coverage of their banking system was **very high for Group 1 banks**, reaching 100% coverage for many jurisdictions (aggregate coverage in terms of Basel II risk-weighted assets: 98.5%), while for **Group 2 banks** it was **lower** with a larger variation across jurisdictions (aggregate coverage: 35.8%).

Furthermore, Group 2 bank results are driven by a relatively small number of large but non-internationally active banks, ie the results presented in this report may not be as representative as it is the case for Group 1 banks.

[There are 19 Group 2 banks that have Tier 1 capital in excess of €3 billion. These banks account for 64.3% of total Group 2 RWA.]

Since the new EU directive and regulation are not finalised yet, no EU specific rules are analysed in this report.

Accordingly, this monitoring exercise is carried out assuming full implementation of the Basel III framework, ie transitional arrangements such as phase-in of deductions and grandfathering arrangements are not taken into account.

The results are compared with the respective current national implementation of the **Basel II framework**.

In addition, it is important to note that the monitoring exercise is based on static balance sheet assumptions, ie capital elements are only included if the eligibility criteria have been fulfilled at the reporting date.

Planned management actions to increase capital or decrease risk-weighted assets are not taken into account (“static balance sheet assumption”).

This allows for **identifying effective changes in banks' capital base** instead of identifying changes which are solely based on changes in underlying modelling assumptions.

As a consequence, monitoring results **are not comparable** to industry estimates as the latter usually include assumptions on banks' future profitability, planned capital and/or further management actions that mitigate the impact of Basel III.

In addition, monitoring results are not comparable to C-QIS results, which assessed the impact of policy proposals published in 2009 that differed significantly from the final Basel III framework.

The actual capital and liquidity shortfalls related to the new requirements by the time Basel III is fully implemented will differ from those shown in this report as the banking sector reacts to the changing economic and regulatory environment.

The monitoring exercise provides an impact assessment of the following aspects:

- **Changes to banks' capital ratios** under **Basel III**, and estimates of any capital shortfalls. In addition, estimates of capital surcharges for global systemically important banks (G-SIBs) are included, where applicable;
- **Changes to the definition of capital** that result from the new capital standard, referred to as **common equity Tier 1 (CET1)**, including modified rules on capital deductions, and changes to the eligibility criteria for Tier 1 and total capital;
- **Changes in the calculation of risk-weighted assets (RWA)** resulting from changes to the definition of capital, securitisation, trading book and counterparty credit risk requirements;

- The capital **conservation buffer**;
- The **leverage ratio**; and
- **Two liquidity standards** – the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

Key results - Impact on regulatory capital ratios and estimated capital shortfall

Assuming full implementation of the Basel III framework as of 30 June 2011 (i.e. without taking into account transitional arrangements), the CET1 capital ratios of **Group 1** banks would have declined from an average CET1 ratio of 10.2% (with all country averages above the 7.0% target level) to an average CET1 ratio of 6.5%.

80% of Group 1 banks would be at or above the 4.5% minimum while 44% would be at or above 7.0% target level.

The CET1 capital shortfall for Group 1 banks is **€18 bn** at a minimum requirement of 4.5% and **€242 bn** at a target level of 7.0% (including the G-SIB surcharge).

As a point of reference, the sum of profits after tax prior to distributions across the Group 1 sample in the second half of 2010 and the first half of 2011 was €102 bn.

With respect to the average Tier 1 and total capital ratio, monitoring results show a decline from 11.9% to 6.7% and from 14.4% to 7.8%, respectively.

Capital shortfalls comparing to the minimum ratios (excl. the capital conservation buffer) amount for €51 bn (Tier 1 capital) and €128 bn (total capital).

Taking into account the capital conservation buffer and the surcharge for systemically important banks, the Group 1 banks' capital shortfall rises to €361 bn (Tier 1 capital) and €485 bn (total capital).

For **Group 2** banks, the average CET1 ratio declines from 9.8% to 6.8% under Basel III, where 87% of the banks would be at or above the 4.5% minimum and 72% would be at or above the 7.0% target level.

The respective CET1 shortfall is approx. €11 bn at a minimum requirement of 4.5% and €35 bn at a target level of 7.0%.

The sum of profits after tax prior to distributions across the Group 2 sample in the second half of 2010 and the first half of 2011 was €17 bn.

Main drivers of changes in banks' capital ratios

For Group 1 banks, the overall impact on the CET1 ratio can be attributed in almost equal parts to changes in the definition of capital and to changes related to the calculation of risk-weighted assets: while CET1 declines by 22.7%, RWA increase by 21.2%, on average.

For Group 2 banks, while the change in the definition of capital results in a decline in CET1 of 25.9%, the new rules on RWA affect Group 2 banks far less (+6.9%), which may be explained by the fact that these banks' business models are less reliant on exposures to counterparty and market risks (which are the main drivers of the RWA increase under the new framework).

Reductions in Group 1 and Group 2 banks' CET1 are mainly driven by goodwill (-17.3% and -14.8%, respectively), followed by deductions for holdings of capital of other financial companies (-4.4% and -7.0%, respectively).

As to the denominator of regulatory capital ratios, the main driver is the introduction of CVA capital charges which result in an average RWA increase of 8.0% and of 2.9% for Group 1 and Group 2 banks, respectively.

In addition to CVA capital charges, trading book exposures and the transition from Basel II 50/50 deductions to a 1250% risk weight treatment are the main contributors to the increase in Group 1 banks' RWA.

As Group 2 banks are in general less affected by the revised counterparty credit risk rules, these banks show a much lower increase in overall RWA (+6.9%).

However, even within this group, the RWA increase is driven by CVA capital charges, followed by changes related to the transition from Basel II 50/50 capital deductions to a 1250% risk weight treatment, and to the items that fall below the 10/15% thresholds.

Leverage ratio

Monitoring results indicate a positive correlation between bank size and the level of leverage, since the average LR is significantly lower for Group 1 banks.

Assuming full implementation of Basel III, Group 1 banks show an average Basel III Tier 1 leverage ratio (LR) of 2.7%, while Group 2 banks' leverage ratio is 3.4%.

41% of participating Group 1 and 72% Group 2 banks would meet the 3% target level as of June 2011.

If a hypothetical current leverage ratio was already in place, Group 1 and Group 2 banks' LR would be 4.0% and 4.7%, respectively.

Liquidity standards

A total of 156 Group 1 and Group 2 banks participated in the liquidity monitoring exercise for the end-June 2011 reporting period.

Group 1 banks have reported an average LCR of 71% while the average LCR for Group 2 banks is 70%.

The aggregate Group 1 and Group 2 shortfall of liquid assets is at approx. €1.2 trillion which represents 3.7% of the approx. €31 trillion total assets of the aggregate sample.

Group 1 banks reported an average NSFR of 89% (Group 2 banks: 90%).

To fulfil the minimum standard of 100% on a total basis, banks need stable funding of approx. €1.9 trillion.

Both liquidity standards are currently subject to an observation period which includes a review clause to address any unintended consequences prior to their respective implementation dates.

1. General remarks

In September 2010, the Group of Governors and Heads of Supervision (GHOS), the Basel Committee on Banking Supervision's oversight body, announced a substantial strengthening of existing capital requirements and fully endorsed the agreements reached on 26 July 2010.

Since the beginning of 2011, the impact of the new requirements related to these capital reforms and the introduction of two international liquidity standards is monitored and evaluated by the Basel Committee on Banking Supervision on a semi-annual basis for its member jurisdictions.

At European level, this analysis is conducted by the European Banking Authority (EBA), also based on the Basel III reform package as the CRD IV, the European equivalent to the Basel III framework, has not yet been finalised.

This report presents the results of the latest monitoring exercise based on consolidated data of European banks as of 30 June 2011. The monitoring exercise provides an impact assessment of the following aspects:

- Changes to banks' capital ratios under Basel III, and estimates of any capital shortfalls. In addition, estimates of capital surcharges for global systemically important banks (G-SIBs) are included, where applicable;
- Changes to the definition of capital that result in a new capital standard, referred to as common equity Tier 1 (CET1), a reallocation of regulatory adjustments to CET1 and changes to the eligibility criteria for Tier 1 and total capital,

- Changes in the calculation of risk-weighted assets due to changes to the definition of capital, trading book, securitisation and counterparty credit risk requirements,
- The capital conservation buffer of 2.5%,
- The introduction of a leverage ratio and
- The introduction of two international liquidity standards – the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR)

The [related policy documents](#) are:

- Revisions to the Basel II market risk framework⁹ and Guidelines for computing capital for incremental risk in the trading book;
- Enhancements to the Basel II framework¹¹ which include the revised risk weights for re-securitisations held in the banking book;
- Basel III: A global framework for more resilient banks and the banking system as well as the Committee's 13 January press release on loss absorbency at the point of non-viability;
- International framework for liquidity risk measurement, standards and monitoring; and
- Global systemically important banks: Assessment methodology and the additional loss absorbency requirement.

1.1. Sample of participating banks

The report includes an analysis of data submitted by 48 Group 1 banks from 16 countries and 110 Group 2 banks from 18 countries.

Table 1 shows the distribution of participation by jurisdiction.

Table 1
Number of banks submitting data for the monitoring exercise

	Group 1	Group 2
Austria (AT)	2	1
Belgium (BE)	1	2
Cyprus (CY)	0	2
Denmark (DK)	1	2
Finland (FI)	0	13
France (FR)	5	5
Germany (DE)	9	25
Greece (GR)	3	0
Hungary (HU)	1	2
Ireland (IE)	3	1
Italy (IT)	2	11
Luxembourg (LU)	0	1
Malta (MT)	0	1
Netherlands (NL)	3	17
Norway (NO)	1	7
Poland (PL)	0	5
Portugal (PT)	3	4
Spain (ES)	2	6
Sweden (SE)	4	0
United Kingdom (GB)	8	5
Total	48	110

Coverage of the banking sector is high, reaching 100% of **Group 1** banks in some countries ([aggregate coverage in terms of Basel II risk-weighted assets: 98.5%](#)).

Coverage of **Group 2** banks is lower and varies across countries ([aggregate coverage: 35.8%](#)).

Group 2 results are driven by a relatively small number of banks sufficiently large to be classified as Group 1 banks, but that have been classified as Group 2 banks by their supervisor because they are not internationally active.

1.2. Methodology

“Composite bank” weighting scheme

Average amounts in this document have been calculated by creating a composite bank at a total sample level, which implies that the total sample averages are weighted.

For example, the average common equity Tier 1 capital ratio is the sum of all banks’ common equity Tier 1 capital for the total sample divided by the sum of all banks’ risk-weighted assets for the total sample.

Box plots illustrate the distribution of results

To ensure data confidentiality, most charts show box plots which give an indication of the distribution of the results among participating banks.

The box plots are defined as follows:

- Thick red line: Respective regulatory minimum requirement
- Thin red line: Median value (50% of the observations are below this value, 50% are above this value)
- "x": Mean (weighted average)
- Blue box: 25th and 75th percentile values. A percentile is the value of a variable below which a certain percent of observations fall. For example, the 25th percentile is the value below which 25 percent of the observations are found.
- Black vertical lines ("whiskers"):
The upper end point represents the 95th percentile value, the lower end point the 5th percentile value.

1.3. Interpretation of results

The impact assessment was carried out by comparing banks' capital positions under Basel III to the current regulatory framework.

With the exception of transitional arrangements for non-correlation trading securitisation positions in the trading book, results are calculated assuming full implementation of Basel III ie without considering transitional arrangements related to the phase-in of deductions and grandfathering arrangements.

This implies that the Basel III capital amounts shown in this report assume that all common equity deductions are fully phased in and all non-qualifying capital instruments are fully phased out.

As such, these amounts underestimate the amount of Tier 1 capital and total capital held by a bank as they do not give any recognition for non-qualifying instruments that are actually phased out over a 10 year horizon.

The treatment of deductions and non-qualifying capital instruments under the assumption of full implementation of Basel III also affects figures reported in the leverage ratio section.

The potential underestimation of Tier 1 capital will become less of an issue as the implementation date of the leverage ratio approaches.

In particular, in 2013, the capital amounts based on the capital requirements in place on the Basel III implementation monitoring reporting date will reflect the amount of non-qualifying capital instruments included in capital at that time.

These amounts will therefore be more representative of the capital held by banks at the implementation date of the leverage ratio (for more detail see section 5).

In addition, it is important to note that the monitoring exercise is based on static balance sheet assumptions, ie capital elements are only included if the eligibility criteria have been fulfilled at the reporting date.

Planned bank measures to increase capital or decrease risk-weighted assets are not taken into account.

This allows for identifying effective changes in bank capital instead of identifying changes which are simply based on changes in underlying modelling assumptions.

As a consequence, monitoring results are not comparable to industry estimates as the latter usually **include assumptions on banks' future profitability, planned capital and/or management actions that mitigate the impact of Basel III.**

In addition, monitoring results are not comparable to prior C-QIS results, which assessed the impact of policy proposals published in 2009 that **differed significantly from the final Basel III framework.**

As one example, the C-QIS did not consider the impact of capital surcharges for G-SIBs based on the initial list of G-SIBs announced by the Financial Stability Board in November 2011.

To enable comparisons between the current regulatory regime and Basel III, common equity Tier 1 elements according to the current regulatory framework are defined as those elements of current Tier 1 capital which are not subject to a limit under the respective national implementation of Basel II.

1.4. Data quality

For this monitoring exercise, participating banks submitted comprehensive and detailed non-public data on a voluntary and best-efforts basis.

National supervisors worked extensively with banks to **ensure data quality, completeness and consistency with the published reporting instructions.**

Banks are included in the various analyses that follow only to the extent they were able to provide data of sufficient quality to complete the analyses.

2. Overall impact on regulatory capital ratios and estimated capital shortfall

One of the core intentions of the Basel III framework is to **increase the resilience of the banking sector by strengthening both the quantity and quality of regulatory capital.**

Therefore, higher minimum requirements have to be met and stricter rules for the definition of capital and the calculation of risk weighted assets apply.

As the Basel III monitoring exercise assumes full implementation of Basel III (without taking into account any transitional arrangements), it compares capital ratios under current rules with capital ratios that banks would show if Basel III were already fully in force at the reporting date.

In this context, it is important to elaborate on the implications the assumption of full implementation of Basel III has on the monitoring results.

The Basel III capital amounts reported in this exercise assume that all common equity deductions are fully phased in and all non-qualifying capital instruments are fully phased out.

Thus, these amounts may underestimate the amount of Tier 1 capital and total capital under current rules held by banks as they do not give any recognition for non-qualifying instruments which are actually phased out over a 10 year horizon.

Table 2 shows the overall change in common equity Tier 1 (CET1), Tier 1 and total capital if Basel III were fully implemented, as of 30 June 2011.

	Number of banks	CET1		Tier 1		Total capital	
		Current	Basel III	Curr	Basel III	Curr	Basel III
Group 1	45	10.2	6.5	11.9	6.7	14.4	7.8
Group 2	109	9.8	6.8	10.9	7.4	13.6	9.4

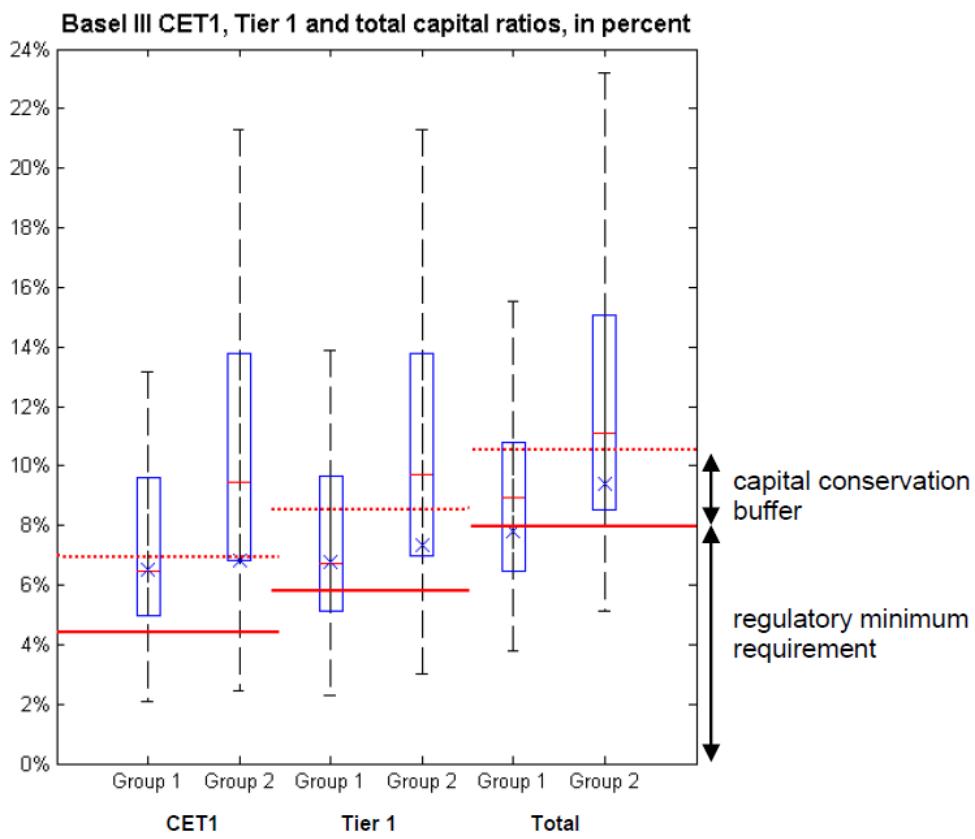
For Group 1 banks, the impact on the average CET1 ratio is a reduction from 10.2% to 6.5% (a decline of 3.7 percentage points) while the average Tier 1 and total capital ratio would decline from 11.9% to 6.7% and from 14.4% to 7.8% respectively.

Contrary to the current framework, for Group 2 banks average capital ratios are higher than for Group 1.

The following chart gives an indication of the distribution of results among participating banks.

It includes the respective regulatory minimum requirement (thick red line), the weighted average (depicted as “x”) and the median (thin red line), ie the value separating the higher half of a sample from the lower half (that means that 50% of all observations are below this value, 50% are above).

Chart 1



80% of **Group 1** banks would be at or above the 4.5% minimum requirement while 44% would be at or above the 7.0% target level, ie it is expected that in the next years banks will put in place several measures to increase high quality capital.

With respect to **Group 2** banks, 87% reported CET1 ratios at or above 4.5% while 72% would be at or above the 7.0% target level.

The reduction in CET1 ratios is driven both by a new definition of capital deductions (numerator) and by increases in risk-weighted assets (denominator).

Banks engaged heavily in trading or in activities subject to counterparty credit risk tend to show the largest denominator effects as these activities attract substantially higher capital charges under the new framework.

For **Group 1** banks, the aggregate impact on the CET1 ratio can be attributed in almost equal parts to changes in the definition of capital and to changes related to the calculation of risk-weighted assets: while CET1 declines by 22.7%, RWA increase by 21.2%, on average.

For **Group 2** banks, while the change in the definition of capital results in a decline in CET1 of 25.9%, the new rules on RWA affect Group 2 banks far less (+6.9%), which may be explained by the fact that these banks' business models are less reliant on exposures subject to counterparty credit risk and market risk (which are the main drivers of

the RWA increase under the new framework).

The Basel III framework includes the following phase-in arrangements for capital ratios:

- For CET1, the highest form of loss absorbing capital, the minimum requirement will be raised to 4.5% and will be phased in by 1 January 2015. Deductions from CET1 will be fully phased in by 1 January 2018;
- For Tier 1 capital, the minimum requirement will be raised to 6.0% and will be phased in by 1 January 2015;
- An additional 2.5% capital conservation buffer above the regulatory minimum capital ratios, which must be met with common equity, after the application of deductions, will be phased in by 1 January 2019; and
- The additional loss absorbency requirement for G-SIBs, which ranges from 1.0% to 2.5% and must be met with common equity, after the application of deductions and as an extension of the capital conservation buffer, will be phased in by 1 January 2019.

Table 3 and Chart 2 provide estimates of the additional amount of capital that Group 1 and Group 2 banks would need between 30 June 2011 and 1 January 2022 to meet the target CET1, Tier 1 and total capital ratios under Basel III assuming fully phased-in target requirements and deductions as of 30 June 2011.

For Group 1 banks, the CET1 capital shortfall is €18 bn at a minimum requirement of 4.5% and €242 bn at a target level of 7.0%.

With respect to the Tier 1 and total capital ratios, the capital shortfall comparing to the minimum ratios amount for €51 bn and €128 bn respectively.

For Group 2 banks, the CET1 capital shortfall is €11 bn at a minimum requirement of 4.5% and €35 bn at a target level of 7.0%.

The Tier 1 and total capital shortfall calculated relative to the 4.5% minimum amount for €18 and €22 bn, respectively.

The surcharges for G-SIBs are a binding constraint for 12 of the 13 G-SIBs included in this monitoring exercise.

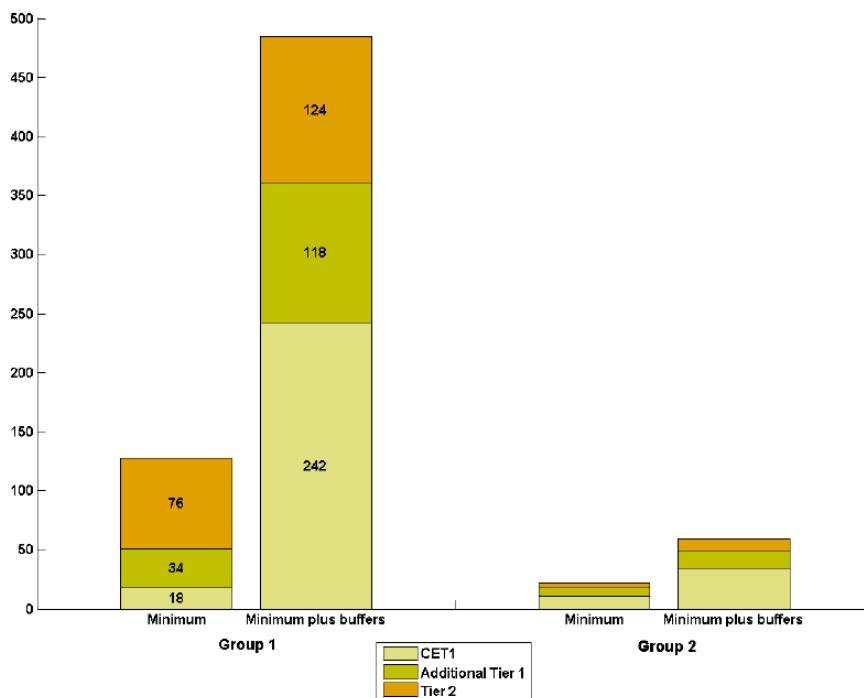
It should be mentioned, that the shortfall figures are not comparable to those of the EBA recapitalisation exercise since the capital definitions and the calculation of the risk-weighted assets differ.

Given these results, a significant effort by banks to fulfil the risk-based capital requirements is expected.

Table 3		
Estimated overall capital shortfall, participating Group 1 and Group 2 banks, in € billion		
	Group 1 banks	Group 2 banks
Number of banks	45	109
Minimum		
CET1 shortfall – 4.5%	17.6	10.6
Tier 1 shortfall – 6.0%	51.2	17.8
Total capital shortfall – 8.0%	128.0	22.2
Minimum plus capital conservation buffer (2019)*		
CET1 shortfall – 7.0%	242.1	34.5
Tier 1 shortfall – 8.5%	360.6	49.6
Total capital shortfall – 10.5%	485.4	58.9

* Including the capital surcharge for global systemically important banks (G-SIBs).

Chart 2
Estimated overall capital shortfall, Group 1 and Group 2 banks, in € billion



3. Impact of the new definition of capital on Common Equity Tier 1

As noted above, reductions in capital ratios under the Basel III framework are attributed in part to capital deductions previously not applied at the common equity level of Tier 1 capital.

Table 4 shows the impact of various deduction categories on the gross CET1 capital (i.e. CET1 before applying deductions) of Group 1 and Group 2 banks.

Table 4 CET1 deductions as a percentage of new CET1 capital gross of deductions										
	N	Goodwill	Intangibles	DTA*	Financials	MRS	DTA above threshold	Excess above 15%**	Other***	Total
Group 1 banks	46	-17.3	-3.9	-3.4	-4.4	0.0	-1.7	-2.3	-4.1	-37.2
Group 2 banks	109	-14.8	-3.0	-0.8	-7.0	0.0	-4.9	-2.6	-4.3	-37.4

* DTA refers to the deferred tax assets that are deducted in full under Basel III (ie it excludes DTAs that are related to temporary timing differences which are only deducted when they exceed a threshold).

** Excess above 15% pertains to significant investments in the common shares of unconsolidated financial institutions, mortgage servicing rights, and DTA due to temporary differences that do not separately exceed the 10% category thresholds but in the aggregate exceed the 15% basket threshold.

*** Other includes deductions related to investment in own shares, shortfall of provisions to expected losses, cash flow hedge reserves, cumulative changes in fair value due to changes in own credit risk, net pension fund assets, securitisation gains on sale and deductions from Additional Tier 1 capital to the extent they exceed a bank's Additional Tier 1 capital.

In the aggregate, deductions reduce gross CET1 of Group 1 banks by 37.2% with goodwill being the most important driver, followed by holdings of capital of other financial companies.

Deductions for defined benefit pension obligations and provisioning shortfalls relative to expected losses tend to be the largest contributors to other deductions across most countries.

For **Group 2** banks, average results are similar: CET1 deductions reduce gross CET1 by 37.4% due in particular to goodwill, and again followed by holdings of capital of other financial companies as the second most important driver.

However, it should be noted that these results are driven by large Group 2 banks (defined as those with Tier1 capital in excess of €3 billion). Without considering these banks, the overall decline of gross CET1 due to deductions would be 22.6%.

Mortgage servicing rights related deductions have no impact, for both groups.

4. Changes in risk-weighted assets

Reductions in capital ratios under Basel III are also attributed to increases in risk-weighted assets as shown in Table 5 for the [following four categories](#):

Definition of capital:

Here we distinguish three effects: The column heading “50/50” measures the increase in risk-weighted assets applied to securitisation exposures currently deducted under the Basel II framework that are risk-weighted at 1250% under Basel III.

The negative sign in column “other” indicates that this effect reduces the RWA. This relief in RWA is mainly technical since it is compensated by deductions from capital.

The column heading “threshold” measures the increase in risk-weighted assets for exposures that fall below the 10% and 15% limits for CET1 deduction;

Counterparty credit risk (CCR):

This column measures the increased capital charge for counterparty credit risk and the higher capital charge that results from applying a higher asset correlation parameter against exposures to financial institutions under the IRB approaches to credit risk.

The effects of capital charges for exposures to central counterparties (CCPs) or any impact of incorporating stressed parameters for effective expected positive exposure (EEPE) are not included;

Securitisation in the banking book:

This column measures the increase in the capital charges for certain types of securitisations (e.g. resecuritisations) in the banking book; and

Trading book:

This column measures the increased capital charges for exposures held in the trading book to include capital requirements against stressed value-at-risk, incremental risk capital charge, and securitisation exposures in the trading book (see section 4.2 for more details).

4.1. Overall results

Risk-weighted assets for Group 1 banks increase overall by 21.2% which can be mainly attributed to higher risk-weighted assets for counterparty credit risk exposures (+8.0%), followed by changes due to the new RWA treatment of current Basel II 50/50 capital deductions (+5.9%) and the new trading book rules (+4.2%).

The main driver behind the capital charges for counterparty credit risk is the charge for **credit valuation adjustments (CVA)** while the higher asset correlation parameter results in an increase in overall risk-weighted assets of only 1.2%.

For **Group 2** banks, aggregate RWA increase overall by 6.9%. The smaller increase relative to Group 1 banks is as expected since Group 2 banks tend to have less exposure to market risk and counterparty exposures.

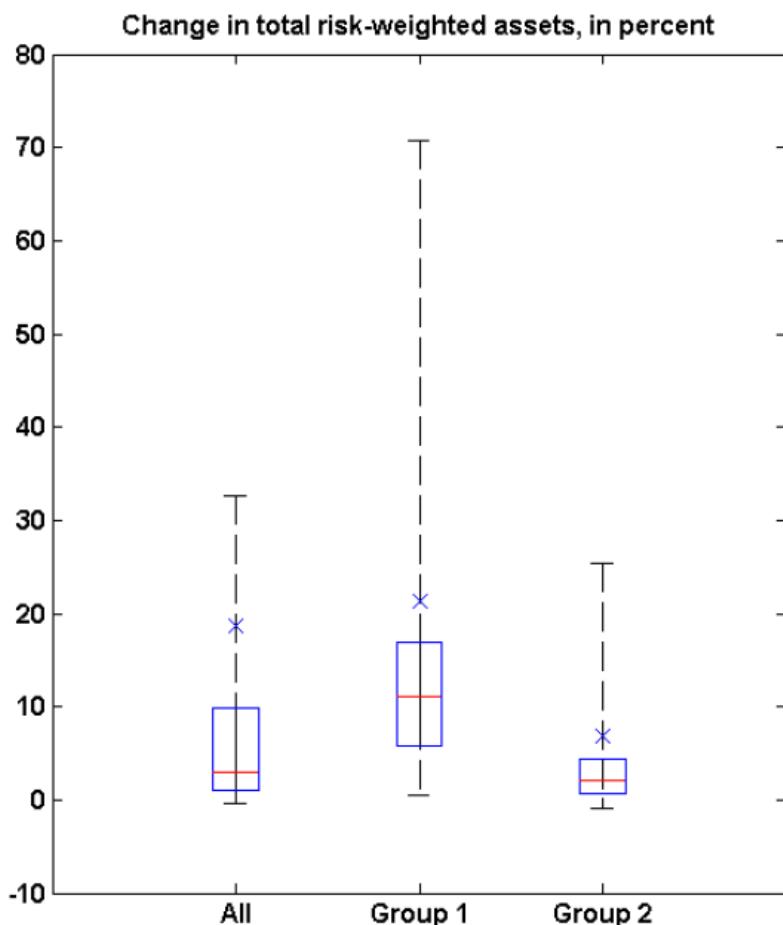
However, even for **Group 2** banks, CCR capital charges (2.9%) are the main contributor to the change in RWA for Group 2 banks.

Moving Basel II 50/50 deductions to a 1250% risk weight treatment and increases in RWA attributable to items that fall below the 10/15% thresholds affect RWA by 2.2% each.

Table 5
Changes in RWA by banking group, in percent

	N	Total	Definition of capital			CCR	Securiti-sation banking book	Trading book
			other	50/50	thres hold			
Group 1 banks	45	21.2	-1.0	5.9	2.9	8.0	1.0	4.2
Group 2 banks	109	6.9	-1.0	2.2	2.2	2.9	0.2	0.4

Chart 3 gives an indication of the distribution of the results across participating banks and illustrates that the dispersion is much higher within the Group 1 bank sample as compared to Group 2 banks.



4.2. Market risk-related capital charges

Table 6 presents details on the impact of the revised trading book capital charges on overall risk-weighted assets for **Group 1** banks.

Group 2 banks are not presented separately because the market risk requirements have a very minor influence on overall Group 2 bank risk-weighted assets. Some of these banks do not have any trading books at all and are therefore not subject to any related capital charges.

Stressed VaR (2.1%), the incremental risk capital charge or “IRC” (1.2%), and the capital charge for non-correlation trading securitisation exposures under the standardised measurement method or “SMM”

“non-CTP” (0.7%) are the three most relevant drivers behind the increase.

Increases in risk-weighted assets are partially offset by effects related to previous capital charges (resulting from the event risk surcharge and previous standardised or VaR-based charges for the specific risk capital requirements of securitisations), and the changes to positions treated with standardised measurement methods (column “SMM”).

Table 6 Increase in market risk capital charges relative to overall capital requirements, Group 1 banks, in percent											
	N	Total	Stressed VaR	SMM*	IRC and securitisation						Other
					Overall	IRC	SMM non-CTP	Correlation trading	CRM	SMM	
Average	45	4.2	2.1	-0.1	2.3	1.2	0.7	0.5	0.2	-0.4	0.0

* Including changes to specific and general market risk as well as commodities and foreign exchange risk.

4.3. Impact of the rules on counterparty credit risk (CVA only)

Credit valuation adjustment (CVA) risk capital charges lead to a 7.8% increase in total RWA for the subsample of 36 banks which provided the relevant data (6.8% for the full Group 1 sample).

A larger fraction of the total effect is attributable to the application of the standardised method than to the advanced method.

The impacts on **Group 2** banks are smaller but still significant, adding up to an overall 3.5% increase in RWA over a subsample of 57 banks (2.3% for the full Group 2 sample), totally attributable to the standardised method.

Further details are provided in Table 7.

Table 7 Changes in RWA for credit valuation adjustment (CVA), in percent							
	N	CVA vs credit RWA	Of which		CVA vs total RWA	Of which	
			Stand. method	Adv. method		Stand. method	Adv. method
Group 1 banks	36	9.1	5.0	4.2	7.8	4.2	3.6
Group 2 banks	57	3.9	3.9	0.0	3.5	3.5	0.0

5. Leverage Ratio

A simple, transparent, non-risk based leverage ratio has been introduced in the Basel III framework in order to act as a credible supplementary measure to the risk based capital requirements.

It is intended to constrain the build-up of leverage in the banking sector and to complement the risk based capital requirements with a non-risk based “backstop” measure.

For the interpretation of the results of the leverage ratio section it is important to understand the terminology used to describe a bank's leverage.

Generally, when a bank is referred to as having more leverage, or being more leveraged, this refers to a multiple of exposures to capital (i.e. 50 times) as opposed to a ratio (i.e. 2.0%).

Therefore, a bank with a high level of leverage will have a low leverage ratio.

155 Group 1 and Group 2 banks provided sufficient data to calculate the leverage ratio according to the Basel III framework.

In total, aggregate Tier 1 capital according to Basel III (numerator of the leverage ratio) is €0.76 trillion for Group 1 banks while the total aggregate exposure according to the definition of the denominator of the leverage ratio is €27.69 trillion.

For Group 2 banks, the corresponding figures are €0.16 trillion (Tier 1 capital) and €4.59 trillion (total exposure).

To illustrate the impact of the new capital framework, a hypothetical current leverage ratio is shown assuming the leverage ratio was already in place.

This hypothetical ratio is based on the current definition of Tier 1 capital.

It is important to recognize that the monitoring results may underestimate the amount of capital that will actually be held by the bank over the next few years.

The reason is as follows. The Basel III capital amounts reported in this monitoring exercise assume that all common equity deductions are fully phased in and all non-qualifying capital instruments are fully phased out.

Thus, these amounts ceteris paribus underestimate the amount of Tier 1 capital and total capital under current rules held by banks as they do not give any recognition for non-qualifying instruments which are actually phased out over a nine year horizon.

In this exercise, Common Equity Tier 1, Tier 1 capital and total capital could be very similar if all (or most) of the banks' Additional Tier 1 and Tier 2 instruments are considered non-qualifying under Basel III.

As the implementation date of the leverage ratio approaches, this will become less of an issue.

With respect to the total sample of banks, the average Basel III Tier 1 leverage ratio is 2.8%.

Group 1 banks' average Basel III LR is 2.7% while for Group 2 banks the leverage ratio is significantly higher at 3.4%.

Assuming full implementation of Basel III at 30 June 2011, 41.3% of Group 1 banks would meet the calibration target of 3% for the leverage ratio while 80% would be at or above the 4.5% minimum requirement for the risk-based CET1 ratio.

Regarding Group 2 banks, 71.6% show a leverage ratio at or above the target level while 87% reported CET1 ratios at or above the CET1 minimum requirement of 4.5%.

Using Tier 1 capital according to current rules in the numerator, the leverage ratio is 4.1% for the total sample.

For Group 1 banks it is 4.0% (Group 2: 4.7%).

Comparing the average results for Group 1 and Group 2 banks, monitoring results indicate a positive correlation between bank size and the level of leverage, since the average LR is significantly lower for Group 1 banks.

Chart 4 gives an indication of the distribution of the results across participating banks.

The thick red lines show the calibration target of 3% while the thin red lines represent the 50th percentile¹⁹ (the “median”), ie the value separating the higher half of a sample from the lower half (it means that 50% of all observations fall below this value, 50% are above this value).

The weighted average is shown as “x”. For further information on the methodology see section 1.2.

Chart 4
Basel III Leverage Ratio and Current Leverage Ratio, in percent

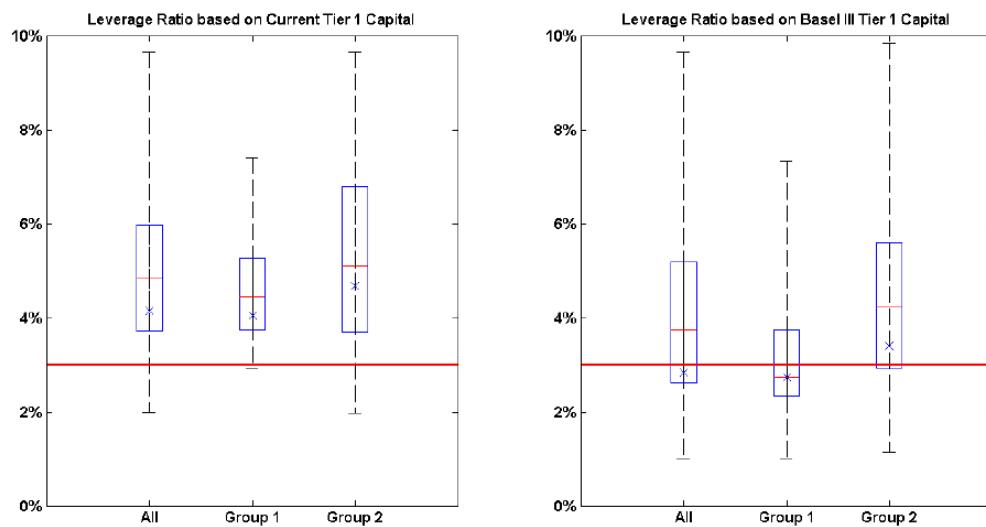


Table 8 shows the average Basel III leverage ratios and the capital shortfall under the assumption that banks already fulfill the risk-based capital requirements for the Tier 1 ratio of 6% and 8.5%, respectively.

The shortfall is the additional amount of Tier 1 capital that banks would need to raise in order to meet the target level of 3% for the leverage ratio (i.e. after the risk-based minimum requirements have been met).

Table 8 Additional shortfall of Tier 1 capital as a result of the leverage ratio					
	Number of banks	Tier 1 solvency ratio of 6%		Tier 1 solvency ratio of 8.5%	
		Leverage Ratio	Shortfall in € bn	Leverage Ratio	Shortfall in € bn
Group 1 banks	45	2.9	95.2	3.6	16.5
Group 2 banks	109	3.8	11.8	4.5	9.5

Assuming that banks with a risk-based Tier 1 ratio below 6% would have raised capital to fulfill the minimum requirement of 6%, 52% of Group 1 banks and 21% of Group 2 banks would not meet the calibration target of 3% for the leverage ratio.

The additional shortfall related to the leverage ratio requirement would be €95 bn (Group 1) and €12 bn (Group 2), respectively.

Assuming that banks with a risk-based Tier 1 ratio below 8.5% would have raised capital to meet the minimum requirement of 8.5%, 17% of both Group 1 and Group 2 banks would show a leverage ratio below the 3% target level.

The additional shortfall would be €17 bn and €10 bn for Group 1 and Group 2 banks, respectively.

6. Liquidity

6.1. Liquidity Coverage Ratio

One of the new minimum standards is a 30-day liquidity coverage ratio (LCR) which is intended to promote short-term resilience to potential liquidity disruptions.

The LCR has been designed to require banks to have sufficient high-quality liquid assets to withstand a stressed 30-day funding scenario specified by supervisors.

The LCR numerator consists of a stock of unencumbered, high quality liquid assets that must be available to cover any net outflow, while the denominator is comprised of cash outflows less cash inflows (subject to a cap at 75% of total outflows) that are expected to occur in a severe stress scenario.

157 Group 1 and Group 2 banks provided sufficient data in the mid-2011 Basel III implementation monitoring exercise to calculate the LCR according to the Basel III liquidity framework.

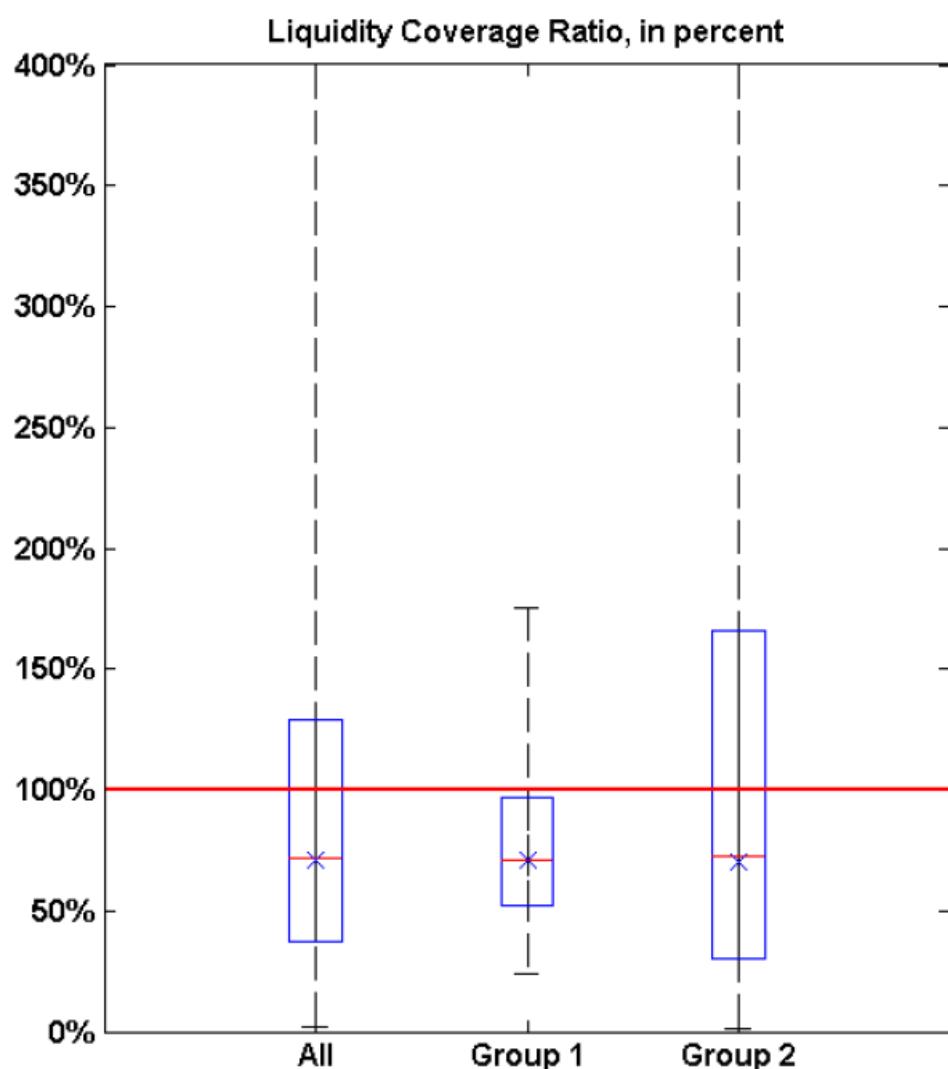
The average LCR is 71% for Group 1 banks and 70% for Group 2 banks.

These aggregate numbers do not speak of the range of results across the banks.

Chart 5 below gives an indication of the distribution of bank results; the thick red line indicates the 100% minimum requirement, the thin red horizontal lines indicate the median for the respective bank group while the mean value is shown as “x”.

34% of the banks in the sample already meet or exceed the minimum LCR requirement and 39% have LCRs that are at or above 85%.

Chart 5²⁰



For the banks in the sample, monitoring results show a [shortfall of liquid assets of €1.15 trillion](#) (which represents 3.7% of the €31 trillion total assets of the aggregate sample) as of 30 June 2011, if banks were to make no changes whatsoever to their liquidity risk profile.

This number is only reflective of the aggregate shortfall for banks that are **below the 100% requirement** and does not reflect surplus liquid assets at banks above the 100% requirement.

Banks that are below the 100% required minimum have until 2015 to meet the minimum standard by scaling back business activities which are most vulnerable to a significant short-term liquidity shock or by lengthening the term of their funding beyond 30 days.

Banks may also increase their holdings of liquid assets.

The key components of outflows and inflows are presented in Table 9.

Group 1 banks show a notably larger percentage of total outflows, when compared to balance sheet liabilities, than **Group 2** banks.

This can be explained by the relatively greater contribution of wholesale funding activities and commitments within the Group 1 sample, whereas, for Group 2 banks, retail activities, which attract much lower stress factors, comprise a greater share of funding activities.

Table 9 LCR outflows and inflows (post-factor) as a percentage of balance sheet liabilities*		
Category	Group 1 banks	Group 2 banks
Outflows to...		
Unsecured retail and small business customers	3.3%	3.1%
Unsecured non-financial corporates	7.1%	3.3%
Unsecured sovereign, central bank, public sector entities (PSEs) and other counterparties	2.2%	1.0%
Unsecured financial institutions and other legal entities	9.9%	5.3%
Other unsecured wholesale funding incl. unsecured debt issuance	4.1%	1.5%
Secured funding and collateral swaps	4.6%	2.2%
Collateral, securitisations and own debt	0.8%	0.4%
Credit and liquidity facilities	4.4%	1.2%
Other contractual and contingent cash outflows including derivative payables	2.3%	0.9%
Total outflows**	38.6%	18.7%
Inflows from...		
Financial institutions	4.6%	3.4%
Retail and small business customers, non-financial corporates and other entities	4.0%	2.3%
Secured lending	3.5%	0.8%
Other cash inflows including derivative receivables	0.1%	0.1%
Total inflows	12.3%	6.6%

* As reported in the net stable funding ratio. ** May contain rounding differences.

Cap on inflows

Two Group 1 and 21 Group 2 banks reported inflows that exceeded the cap. Of these, 7 fail to meet the LCR, so the cap is binding on them.

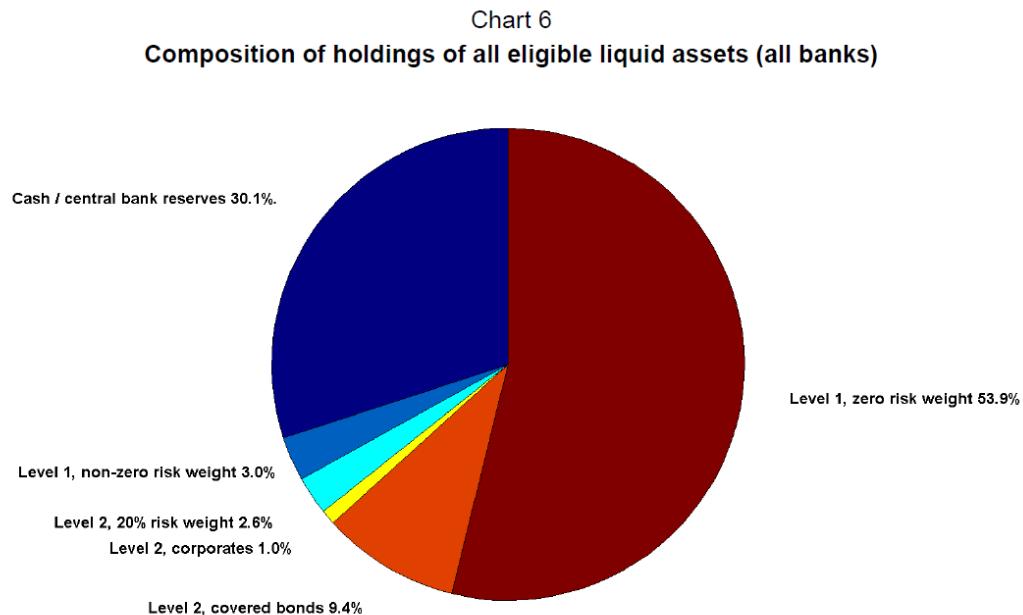
Composition of highly liquid assets

The composition of high quality liquid assets currently held at banks is depicted in Chart 6.

The majority of Group 1 and Group 2 banks' holdings, in aggregate, are comprised of Level 1 assets; however the sample, on the whole, shows diversity in their holdings of eligible liquid assets.

Within Level 1 assets, 0% risk-weighted securities issued or guaranteed by sovereigns, central banks and PSEs, and cash and central bank reserves comprise significant portions of the qualifying pool.

Comparatively, within the Level 2 asset class, the majority of holdings is comprised of 20% risk-weighted securities issued or guaranteed by sovereigns, central banks or PSEs, and qualifying covered bonds.



Cap on Level 2 assets

€53 billion of Level 2 liquid assets were excluded because reported Level 2 assets were in excess of the 40% cap.

40 banks currently reported assets excluded, of which 80.0% (20.4% of the total sample) had LCRs below 100%.

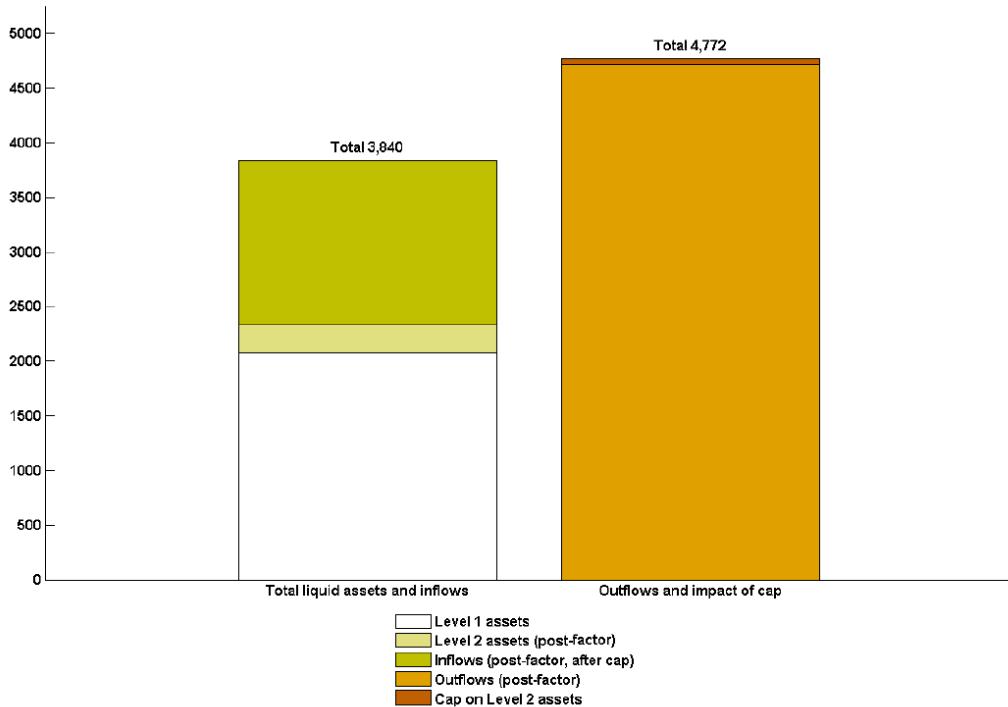
Chart 7 combines the above LCR components by comparing liquidity resources (buffer assets and inflows) to outflows.

Note that *the €900 billion difference between the amount of liquid assets and inflows and the amount of outflows and impact of the cap displayed in the chart is smaller than the €1.15 trillion gross shortfall noted above as it is assumed here that surpluses at one bank can offset shortfalls at other banks.*

In practice the aggregate shortfall in the industry is likely to lie somewhere between these two numbers depending on how efficiently banks redistribute liquidity around the system.

Chart 7

Comparison of buffer and inflows to outflows and cap (€ billions, all banks)



6.2. Net Stable Funding Ratio

The second standard is the net stable funding ratio (NSFR), a longer-term structural ratio to address liquidity mismatches and to provide incentives for banks to use stable sources to fund their activities.

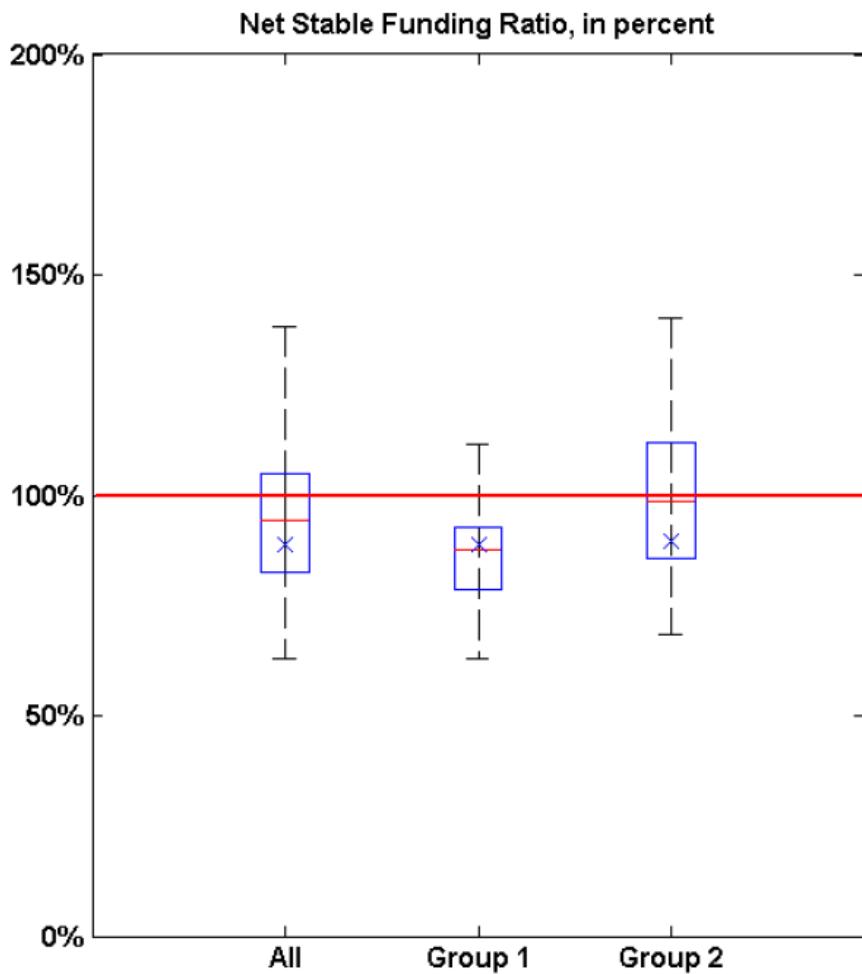
156 Group 1 and Group 2 banks provided sufficient data in the mid-2011 Basel III implementation monitoring exercise to calculate the NSFR according to the Basel III liquidity framework.

37% of these banks already meet or exceed the minimum NSFR requirement, with 70% at an NSFR of 85% or higher.

The average NSFR for each of the Group 1 bank and Group 2 samples is 89% and 90%, respectively.

Chart 8 shows the distribution of results for Group 1 and Group 2 banks; the thick red line indicates the 100% minimum requirement, the thin red horizontal lines indicate the median for the respective bank group.

Chart 8



The results show that banks in the sample had a shortfall of stable funding of €1.93 trillion at the end of June 2011, if banks were to make no changes whatsoever to their funding structure.

[The shortfall in stable funding measures the difference between balance sheet positions after the application of available stable funding factors and the application of required stable funding factors for banks where the former is less than the latter.]

This number is only reflective of the aggregate shortfall for banks that are below the 100% NSFR requirement and does not reflect any surplus stable funding at banks above the 100% requirement.

Banks that are below the 100% required minimum have until 2018 to meet the standard and can take a number of measures to do so, including by lengthening the term of their funding or reducing maturity mismatch.

It should be noted that the shortfalls in the LCR and the NSFR are not necessarily additive, as decreasing the shortfall in one standard may result in a similar decrease in the shortfall of the other standard, depending on the steps taken to decrease the shortfall.

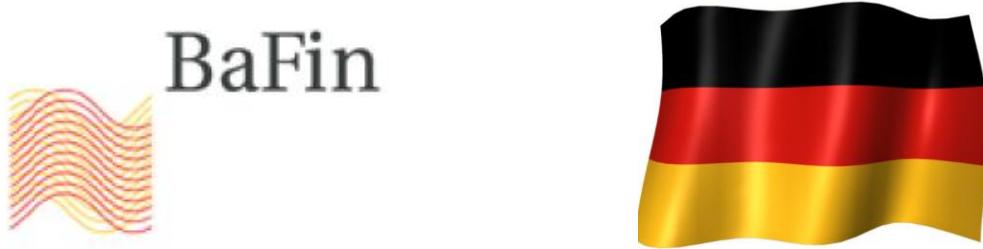
Abbreviations

C-QIS	quantitative impact study
CCPs	central counterparties
CCR	counterparty credit risk
CET1	common equity tier 1
CRD	capital requirements directive
CRM	comprehensive risk model
CTP	correlation trading portfolio
CVA	credit value adjustment
DTA	deffered tax assets
EBA	European Banking Authority
EEPE	effective expected positive exposure
GHOS	Group of Governors and Heads of Supervision
G-SIB	global systemically important banks
ISG	Impact Study Group
IRC	incremental risk charge
LCR	liquidity coverage ratio
LR	leverage ratio
MSR	mortgage servicing rights
NSFR	net stable funding ratio
OBS	off-balance sheet
PFE	potential future exposure
PSE	public sector entities
RWA	risk-weighted assets

SMM	standardised measurement-method
VaR	value at risk

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Learning more about Supervisory Agencies

**BaFin - Bundesanstalt für Finanzdienstleistungsaufsicht
Bundesrepublik Deutschland (Federal Republic of Germany)**

Since it was established in May 2002, the **Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht - known as BaFin for short)** has brought the supervision of banks and financial services providers, insurance undertakings and securities trading under one roof.

BaFin is an independent public-law institution and is subject to the legal and technical oversight of the Federal Ministry of Finance.

It is funded by **fees and contributions from the institutions** and undertakings that it supervises.

It is therefore **independent** of the Federal Budget.

Organisation

Banking Supervision, Insurance Supervision and Securities Supervision/Asset Management are three different organisational units within BaFin – the so-called **Directorates**.

International

The large number of players operating on the global financial markets has been increasing steadily for many years now.

Even though there is no legal framework that is binding internationally, markets are still expanding across borders.

Financial supervision, however, is still largely inward-looking, since sovereign powers usually end at the national border.

Functions

BaFin operates in the public interest. Its primary objective is to **ensure the proper functioning, stability and integrity of the German financial system**.

Bank customers, insurance policyholders and investors ought to be able to trust the financial system.

BaFin has over 1,900 employees working in Bonn and **Frankfurt am Main**.

They supervise around **1,900 banks, 717 financial services institutions, approximately 600 insurance undertakings and 30 pension funds as well as around 6,000 domestic investment funds and 73 asset management companies** (as of March 2011).

Under its solvency supervision, BaFin **ensures the ability** of banks, financial services institutions and insurance undertakings to meet their payment obligations.

Through its market supervision, BaFin also enforces standards of professional conduct which preserve investors' trust in the financial markets.

As part of its investor protection, BaFin also seeks to prevent unauthorised financial business.

Legal basis

BaFin's By-Laws represent a major set of precepts for how it acts.

They contain regulations governing its structure and organisation and its rights and obligations.

They also govern the functions and powers of BaFin's supervisory body, its Administrative Council (Verwaltungsrat), and details of its budget.

BaFin also bases the way in which it carries out its supervisory activities on the Mission Statement it gave itself shortly after it was established. According to this Mission Statement, BaFin's function is to limit risks to the German financial system at both the national and international level and to ensure that Germany as a financial centre continues to function properly and that its integrity is preserved.

As part of the Federal administration, BaFin is subject to the legal and technical oversight of the Federal Ministry of Finance, with the framework of which the legality and fitness for purpose of BaFin's administrative actions are monitored.

BaFin Text Solvency II

Among other things, Solvency II – the project to reform the European legal framework for insurance supervision – harmonises the solvency capital requirements for insurance firms and groups.

Following the adoption of the Solvency II Directive in November 2009, the focus in 2010 was on developing the implementing measures that are

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to be adopted and on performing the fifth quantitative impact study (QIS5).

It is currently planned to make the initial amendments to the Solvency II Directive at the end of 2011 by way of the **Omnibus II Directive**, for which the European Commission presented a proposal on 19 January 2011.

This contains [amendments to two key areas of legislation.](#)

Firstly, it amends directives governing insurance and securities prospectuses to **reflect the new EU rules** on financial market supervision and in particular the new EU financial supervisory authorities that began work on 1 January 2011.

For example, EIOPA is incorporated into the Solvency II Directive as the successor to CEIOPS.

Provision is also made for the binding settlement of disputes by EIOPA.

Secondly, the proposal contains amendments to the Solvency II Directive.

For example, the Directive provides for the implementation of Solvency II to be postponed by two months until 1 January 2013.

The Omnibus II Directive also **enables the European Commission to specify transitional requirements for individual elements of the Framework Directive, with different maximum transition periods being set for each area.**

The Omnibus II Directive is of considerable significance for the continuing evolution of Solvency II.

For technical reasons, the European Commission cannot present the official draft of the Solvency II implementing measures until after the Omnibus II Directive has been adopted.

The Omnibus II Directive will therefore have a significant influence on the ongoing work on the implementing measures.

Implementing measures

The Solvency II Directive gives the European Commission the authority to adopt implementing measures for particular areas.

These are intended to **add detail to the Directive and hence improve the harmonisation and consistency of supervision in Europe.**

In spring 2010, CEIOPS submitted its proposals in this area to the Commission, which at the end of 2010 presented an initial informal full draft of the implementing measures based on the proposals.

In 2011, this draft will be discussed further with the member states, with specific consideration being given to the findings of QIS5.

The official draft of the Solvency II implementing measures will not be presented by the Commission and discussed with the Council and the Parliament until after the Omnibus II Directive has been adopted.

Impact studies

The QIS5 study conducted by the Commission in the year under review is based on the Solvency II Directive and reflects the implementing measures developed up until that time.

The objective was to test the quantitative impact of Solvency II in detail. European insurance firms and groups were asked to take part in the study between July and November 2010.

The results received from solo firms were initially evaluated by the national supervisory authorities, while the data received from groups were analysed by CEIOPS or EIOPA.

All results and findings were incorporated into a European report, which EIOPA presented to the Commission in March 2011.

In addition, BaFin published a national report.

The results of the study will have a major influence on the discussion regarding the Solvency II implementing measures

Guidelines for supervisors

In future, the provisions of the Directive and the implementing measures adopted by the European Council and the European Parliament will be complemented by guidelines for supervisors adopted by EIOPA, with the aim being to further harmonise supervisory practice in Europe.

The four existing CEIOPS and EIOPA working groups began work on these guidelines in the year under review.

In addition, EIOPA will develop binding standards (on the design of the yield curve, for example).

One of the working groups, the **Financial Requirements Expert Group (FinReq)**, has three areas of work: capital requirements (SCR/MCR), the statement of technical provisions and own funds.

Among other things, it has drawn up initial proposals for guidelines related to the procedure to be followed for the approval of undertaking-specific parameters for use in calculating the solvency capital requirement and the recognition of ancillary own funds.

In cooperation with the **Groupe Consultatif**, a forum of European actuarial associations, it is also developing actuarial standards for calculating technical provisions.

The **Internal Governance, Supervisory Review and Reporting Expert Group (IGSRR)** is responsible for the requirements for public disclosure and supervisory reporting by undertakings, capital add-ons and the valuation of assets and liabilities, and is developing guidance for supervisors on what the supervisory process may look like under Solvency II.

In doing so, it is focusing specifically on the **evaluation of the own risk and solvency assessment (ORSA)** and the templates for future reporting to supervisors.

On a closely related topic, consideration is being given to how and which data may in future be exchanged electronically between national supervisory authorities and with EIOPA.

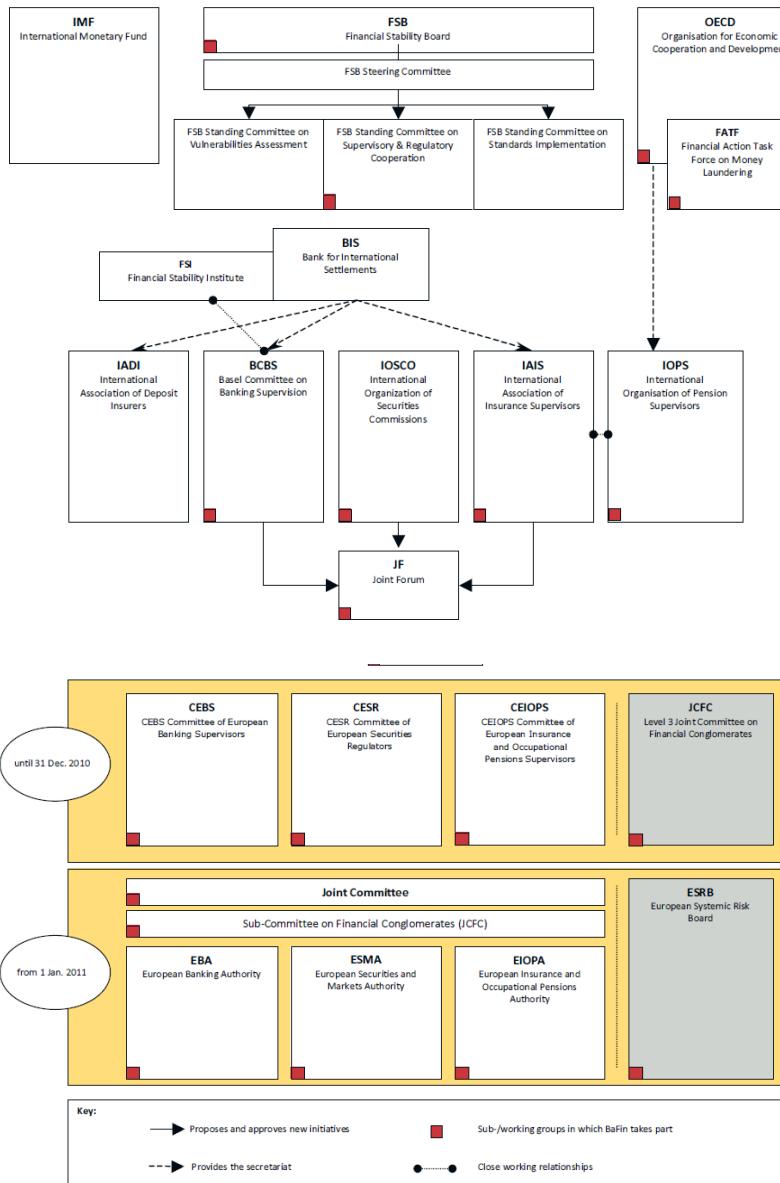
In 2010, the **Internal Models Expert Group (IntMod)** developed guidance on the use test and on calibration, showing supervisors and the insurance industry how they can fulfil the future requirements.

The Group also drew up general guidelines on hitherto less-discussed topics, such as the inclusion of profit and loss attribution in the internal model.

The fourth CEIOPS/EIOPA working group, the **Insurance Groups Supervision Committee (IGSC)**, is drawing up guidance on practical cooperation in the colleges and in coordinating measures.

The working group is also developing harmonised approaches for identifying, reporting and assessing risk concentrations and intragroup transactions.

International institutions and committees



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Thematic review on risk governance Questionnaire for national authorities

The global financial crisis highlighted a number of **corporate governance failures and weaknesses** in financial institutions, including inappropriate Board structures and processes, **weak risk governance systems, and unduly complex or opaque firm organisational structures and activities.**

Many of these shortcomings have been highlighted and documented in various reports that have been issued since 2008.

The October 2011 FSB [Supervisory Intensity and Effectiveness \(SIE\) progress report to the G20](#) notes that much progress has been made in corporate governance at both the supervisory and firm levels, particularly for SIFIs.

However, **effective risk appetite frameworks that are actionable and measurable by both firms and supervisors have not yet been widely adopted.**

The SIE report concludes that **more intense** supervisory oversight is needed to evaluate the effectiveness of improved governance, particularly risk governance that is critical to ensuring a strong risk management culture in firms.

The report recommends that the FSB conduct a **thematic review** on risk governance to assess practices at firms, focusing on the risk committees of executive Boards, as well as the risk management functions (e.g. the Chief Risk Officer organisation) and independent assessment functions (e.g. the Chief Auditor function), and on how supervisors assess their effectiveness.

In light of the recommendation of the SIE report, and the importance and cross-sectoral nature of the topic, the FSB Standing Committee on Standards Implementation (SCSI) agreed, in its conference call on 10 November 2011, to **undertake a peer review on risk governance in early 2012.**

SCSI members also agreed that the peer review would only cover banks and broker-dealers; insurers and other non-bank financial institutions would not be covered.

There is currently no single comprehensive set of principles and standards that fully address and integrate corporate and risk governance requirements.

The review therefore will **not assess compliance** with any specific standard, but will use existing standards and recommendations (as appropriate) in order to **evaluate progress** as well as identify good practices and remaining gaps in firms' risk governance frameworks, and in the assessment of those frameworks by supervisory authorities.

The primary source of information for the peer review will be the responses provided to this questionnaire, and a questionnaire for firms to be developed in March.

The peer review will focus on the roles and interplay between the firm's **Board members that oversee risk management, the enterprise risk management function and relevant aspects of the process for assessing the risk governance framework, processes and practices, either by internal audit or by third parties (e.g. external auditors, consultants).**

In particular, the peer review will focus on:

Board responsibilities and practices

The Board is responsible for **ensuring** that the firm has an **appropriate risk governance framework** given the firm's business model, complexity and size.

How Boards assume such responsibilities varies across jurisdictions and for the purposes of this report, the risk committee refers to a specialised Board committee responsible for advising the Board on the firm's overall current and future risk appetite and strategy, and for overseeing senior management's implementation of that strategy.

Risk management function

The independent risk management function is responsible for the firm's **risk management framework across the entire organisation**, ensuring that the firm's risk meets the desired risk profile as approved by the Board.

The risk management function is responsible for **identifying, measuring, monitoring, recommending strategies to control or mitigate risks, and reporting** on risk exposures.

Independent assessment of the risk governance framework by internal audit and third parties

The independent (e.g. from the business unit and risk management function) assessment of the firm's risk framework plays a crucial role in the ongoing maintenance of a firm's internal control, risk management and risk governance.

It helps a firm accomplish its objectives by bringing a **systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes**.

This may include internal processes, such as internal audit, or external processes such as third party reviews (e.g. external auditors, consultants).

FSB member jurisdictions are requested to provide a consolidated national response to the questionnaire, which should include descriptions of differences where these exist in oversight of risk governance within the jurisdiction (e.g. for banks vs. broker dealers, based on the size, business

model, complexity of the firm), with a particular emphasis on any framework or behavioural changes that have occurred since the crisis.

In order to limit the burden on FSB members and to avoid unnecessary duplication of information collection efforts, authorities can attach links to relevant documents (where available in English).

Feedback should be submitted by 11 May 2012 to fsb@bis.org under the subject heading “FSB Thematic Peer Review on Risk Governance.” Individual submissions will not be made public.

National authorities' approach toward risk governance oversight

Please **describe** your jurisdiction's overall approach to assessing firms' risk governance frameworks (e.g. legislation, regulation or supervisory guidance)?

Please provide links to relevant documents.

Has your jurisdiction evaluated whether such guidance is consistent with the BCBS or OECD principles on corporate governance or other recommendations provided by the industry?

How does your jurisdiction assess alignment or implementation of any legislation, regulation or supervisory guidance in the area of risk governance?

How does your jurisdiction **determine that your significant financial institutions have effective risk governance frameworks, policies and practices?**

Please briefly describe whether firms in your jurisdiction have made changes in response to increased supervisory and regulatory oversight of risk governance.

In addition, please **provide examples** of any material changes in the effectiveness of firms' risk governance practices over the last few years (e.g. decisions regarding whether to reduce/increase certain business activities based on the Board's risk strategy).

During the global financial crisis, were there weaknesses in your oversight of risk governance that became apparent?

Please **summarise any initiatives** planned to strengthen your jurisdiction's oversight of firms' risk governance practices.

Does your jurisdiction **regularly review whether your supervisory, regulatory and enforcement authorities are sufficiently resourced, independent and empowered to deal with risk governance weaknesses that have been identified?**

Does this review include an assessment of inter-agency as well as internal communication and decision-making processes?

Does your jurisdiction have **dedicated teams of qualified personnel** to assess firms' risk governance frameworks, or is oversight of risk governance embedded within other risk oversight functions (e.g. operational, market or credit risk)?

What regulatory and supervisory tools are available in your jurisdiction to incentivise firms to remediate deficiencies within the risk governance framework (e.g. restrictions on activities, capital charges, fines)?

Please **describe any regulatory or supervisory actions taken** to incentivise firms to remediate weaknesses and the firm's responses (if possible in a way that respects national confidentiality rules).

How are **relevant internal control weaknesses** and other significant **internal control deficiencies** factored into the assessment of risk governance frameworks (e.g. a control deficiency that allows significant unauthorised trading activities)?

Please describe any bilateral efforts initiated by supervisors in other jurisdictions regarding the supervision of risk management policies and practices. Please indicate instances where supervisory work plans have been impacted as a result of those meetings.

Board responsibilities and practices

Risk committee refers to a specialised Board committee responsible for advising the Board on the firm's overall current and future risk appetite and strategy, and for overseeing senior management's implementation of that strategy.

Risk committees comprising management members that reside below the Board level (e.g. within business units, management committees) do not fall in this definition.

Do supervisory requirements or expectations exist concerning the role and responsibilities of the Board for risk governance?

If so, how have these requirements or expectations been established (e.g. legislation, regulation, supervisory guidance)?

Do supervisory requirements or expectations exist concerning the role and responsibilities of the risk committee?

If so, how have these requirements or expectations been established (e.g. legislation, regulation, supervisory guidance)?

Do supervisory requirements or expectations exist concerning the governance of the Board's own practices (and where they exist, the practices of any relevant sub-committees)?

If so, how have these requirements or expectations been established (e.g. legislation, regulation, supervisory guidance)?

Do supervisory requirements or expectations exist concerning the information that Boards (or any relevant sub-committees) are supposed to receive, or able to request, from the firm (e.g. CRO, risk management function) and/or third parties (e.g. external auditors, consultants)?

If so, how have these requirements or expectations been established (e.g. legislation, regulation, supervisory guidance)?

How does your jurisdiction assess whether supervisory expectations or requirements concerning the Board's responsibilities and practices (including the Board's use of sub-committees) are achieving desired outcomes?

Risk management function

Does your jurisdiction **require firms to have an independent senior executive** (e.g. a Chief Risk Officer or equivalent) with distinct responsibility for the risk management function and the firm's comprehensive risk management framework across the entire organisation?

How does your jurisdiction assess the **stature, authority and independence of the CRO (or equivalent) and the risk management function?**

Please outline what criteria are considered in your jurisdiction when assessing the stature, authority and independence.

How does your jurisdiction evaluate the qualifications of the CRO and risk management personnel?

How does your jurisdiction evaluate the hiring and performance evaluation process of the CRO?

What is your jurisdiction's approach to regularly assessing firms' overall risk management policies and practices?

How does your jurisdiction assess firms' implementation of effective risk appetite frameworks?

Are **risk measures clearly defined, actionable and effective in enabling the firm to pursue its strategic objectives and maintain the risk profile as set out in the risk appetite framework?**

Is the **risk appetite** assessed globally, or for each type of risk (e.g. credit, market, liquidity, operational)?

How does your jurisdiction regularly assess the adequacy of firms' risk management resources (e.g. number, quality, effectiveness)?

Does your jurisdiction **review the “ownership” and accountability of risk management resources?**

How does your jurisdiction assess the role and effectiveness of firms' risk management process for

- (i) Approval of new products and material modifications to existing ones;
- (ii) Strategic planning;
- (iii) Changes in systems, processes, business models; and
- (iv) Major acquisitions?

What work has been undertaken in your jurisdiction to assess the adequacy, timeliness, and independence of information prepared by risk management and provided to senior management and the Board (or any relevant sub-committee)?

How does your jurisdiction evaluate the type and nature of risk reporting to the Board (or any relevant sub-committee)?

Does it include

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- (i) the manner in which information is compiled;
- (ii) what the decision-making process is for information to be included in the Board reporting; and
- (iii) who/what part of the firm is responsible for compiling this material?

Does your jurisdiction **collect standardised information** from firms on certain risk areas to

- (i) **Compare firms' across risk dimensions;**
- (ii) **Identify the need to initiate possible supervisory reviews; or**
- (iii) **Update supervisory risk management expectations?**

Does your jurisdiction assess the effectiveness of firms' forward-looking stress tests, scenario analysis, contingency arrangements, recovery plans (e.g. raising capital or reducing exposures) and resolution plans (if any).

If so, what criteria are used in this assessment?

How does your jurisdiction **incorporate market and macroeconomic conditions, cross-sectoral developments as well as changes in firms' business and risk profile** into your evaluation of the adequacy of risk management and its ability to respond to changing circumstances?

To what extent are the requirements for the risk management function adapted to firm characteristics, such as size, complexity, business model and systemic importance?

Assessment of the risk governance framework

Does your jurisdiction require internal audit functions at firms to assess the firm's risk governance framework at the enterprise level, legal entity level, and/or for the largest revenue-generating business units?

If so, are the requirements specified in legislation, regulation or supervisory guidance?

What aspects of the risk governance framework are internal auditors or other internal functions (if independent) expected to assess?

Are supervisory requirements and expectations specified in legislation, regulation or supervisory guidance?

Does your jurisdiction allow the use of third parties (e.g. external auditors or other experts) to provide an independent assessment of firms' risk governance frameworks?

If so, does your jurisdiction impose any limitations on certain aspects of internal audit's responsibilities that can be directed toward third parties (e.g. outsourced)?

Are supervisory requirements and expectations specified in legislation, regulation or supervisory guidance?

What aspects of the risk governance framework are external experts expected to assess?

Are supervisory requirements and expectations specified in legislation, regulation or supervisory guidance?

Are internal audit reports, prudential reports, and/or external expert reports monitored as part of the supervision of a firm's risk governance assessment process?

If so, please describe the types of reports and frequency of review.

How does your jurisdiction evaluate the qualifications of the internal auditor and internal audit personnel?

How does it evaluate the hiring and performance evaluation process of the chief auditor (or equivalent)? Where relevant, is this evaluation process also applied to third parties?

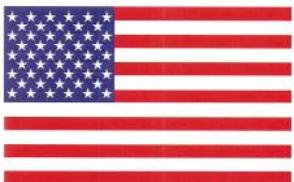
How does your jurisdiction **conduct assessments of the governance of firms' risk management at the enterprise level (e.g. through on-site inspections, off-site monitoring, standard reporting mechanisms, supervisory colleges)?**

Are **escalation processes in place to facilitate the communication of specific situations/behaviours by individuals within a firm to the supervisor (escalation process and/or whistle-blowing)?**

Does your jurisdiction **monitor firms' remediation of weaknesses identified by the independent assessment of risk governance functions?**

If so, is the monitoring embedded in the supervisory process or based on firms' progress reports?

MEMORANDUM OF UNDERSTANDING



*The United States
Securities and Exchange Commission*



*Cayman Islands
Monetary Authority*

The Cayman Islands Monetary Authority (CIMA) and the United States Securities and Exchange Commission (SEC) have entered into a memorandum of understanding (MOU)

The agreement concerns **consultation, cooperation and information exchange** related to the supervision and oversight of regulated entities that operate on a cross-border basis in the USA and the Cayman Islands.

The MOU supplements the **International Organisation of Securities Commissions (IOSCO)** multilateral MOU on cooperation in securities regulation, to which both the SEC and CIMA are signatories and which focuses more on cooperation on enforcement matters between the parties.

The Cayman Islands Premier and Minister responsible for Finance, the Hon. McKeeva Bush, OBE, JP, congratulated CIMA on the agreement.

He commented:

“Through this MOU, CIMA has demonstrated its **commitment to continuing to work with the SEC to fulfill their respective regulatory mandates.**

It shows, too, the commitment of the Cayman Islands to providing the highest quality domicile for financial services.

The signing of this MOU adds to the growing list of international regulatory and supervisory bodies with which the Cayman Islands has entered agreements and is a key endorsement of our financial services regime.

We are convinced that this is not only good for ensuring stability and integrity of the global financial system, but is good for business for this jurisdiction.”

Mrs. Scotland explained that the process of negotiating the latest agreement was enhanced by the solid ties that the two authorities have established over time:

“CIMA and the SEC have had a strong working relationship for many years. This has enabled us to collaborate on several levels.

For example, we have been able to obtain information from, and provide information to, the SEC that has been valuable in both regulators' routine supervisory activities as well as, on occasion, in criminal investigations that have resulted in convictions.

We have conducted joint on-site inspections of Cayman-regulated funds and securities entities, and have worked together to provide training for Cayman and regional regulators.”

The CIMA-SEC MOU is the 23rd cooperation and information exchange agreement that CIMA has effected with overseas regulatory authorities since 1998.

CIMA’s Chairman, Mr. George McCarthy, OBE, JP, said: “the Monetary Authority is committed to collaboration and cooperation with financial services authorities in all the jurisdictions with which Cayman-regulated entities do business.

In addition to the agreements that CIMA already has in place, we actively seek to formalise cooperation with other regulators. This MOU with the SEC is particularly important as Cayman is a major domicile for hedge funds and securities in which US institutions and persons of high net worth invest. It will enable more effective supervision on both sides.”

The MOU details the scope of consultation, cooperation and information exchange between CIMA and the SEC; the procedures for carrying out on-site inspections and for the execution of requests for assistance; the permissible uses of information provided; the confidentiality of information, and the process for onward sharing of information in certain circumstances.



21. **Exchange of Information.** To supplement staff consultations, upon written request, each Authority intends to provide the other Authority with assistance in obtaining information, and interpreting such information, relevant to ensuring compliance with the laws and regulations of the Requesting Authority and that is not otherwise available to the Requesting Authority. The information covered by this paragraph includes, without limitation:
- Information relevant to the financial and operational condition of a Cross-Border Regulated Entity, including, for example, reports of capital reserves, liquidity or other prudential measures, and internal control procedures;
 - Relevant regulatory information and filings that a Cross-Border Regulated Entity is required to submit to an Authority including, for example, interim and annual financial statements and early warning notices; and
 - Regulatory reports prepared by an Authority, including, for example, examination reports, findings, or information drawn from such reports regarding Cross-Border Regulated Entities.

Mario Draghi:

Remarks at the Annual Reception of the Association of German Banks

Speech by Mr Mario Draghi, President of the European Central Bank, at the Annual Reception of the Association of German Banks, Berlin, 26 March 2012

Ladies and Gentlemen,

I would like to take this opportunity to provide you with my assessment of the **current situation in the euro area** and shed light on recent signs of improvements in the overall outlook.

I would particularly like to draw your attention to the **effectiveness of the policy measures implemented by the Eurosystem**, the EU institutions and national authorities.

And to remind you of the **measures that we all must continue to pursue** over the coming months and years with great diligence in order to continue on this path of stabilisation.

The current economic situation

As this audience knows very well, **in November last year, the prospects for the euro area financial sector were very bleak**.

Banks were experiencing a period of heightened stress.

The inter-bank market was closed except to the strongest institutions in the safest countries, and funding markets were impaired.

Unable to raise funds beyond short maturities, many banks were reducing medium term lending to the real economy.



At the same time came the requirement to increase capital ratios to 9%.
 This increased the risks of substantial deleveraging, including the risk of banks cutting back on loans, notably those to small and medium-sized enterprises.

We could see the **intensity of the deleveraging pressures in bank lending surveys and other data.**

In the fourth quarter of 2011, there was a significant tightening of credit standards on loans to both companies and households.

There was no doubt that the euro area was on the brink of a major credit crunch, with potentially adverse consequences for the economy and employment.

At that time, many observers had little confidence in the capacity of the euro area to reverse the situation.

Yet today, **only four months on, the picture looks different.**

There are signs of stabilisation in both financial markets and overall economic activity – albeit still at low levels.

Conditions in bank funding markets have improved.

For example, euro area banks have already issued about 70 billion euro in senior unsecured debt so far this year, which is well above the amount they issued in the whole second half of 2011.

Banks are meeting their new capital requirements. The capital plans submitted to the European Banking Authority (EBA) indicate an intention to exceed the benchmarks by more than 20%.

EBA has also confirmed that **there will be no stress test this year.**

Bank lending is also stabilising. Banks are starting to assess their financial situation more positively and in many cases their willingness to make loans is increasing.

How has the picture changed so clearly in only four months? There are two parts to the answer.

First, the doomsday predictions were always exaggerated. Not because the situation last November was not very serious.

But because the willingness of euro area authorities to take the measures necessary to restore stability was greater than many commentators realised.

Second, euro area authorities have proved their commitment to safeguarding financial stability through a number of important policy measures.

The Eurosystem, the EU institutions and national authorities have all played a role in constructing a comprehensive and coherent response to the economic, financial and fiscal challenges that we face.

Let me now explain the key elements of this response in more detail.

The policy response of the Eurosystem

The primary explanation for the improvement in sentiment over the last few months has been the **measures taken by the Eurosystem** – that is, we at the **European Central Bank (ECB)** and our colleagues at the national central banks of the 17 countries that share the euro.

As you know, since December last year the Eurosystem has launched two **long-term refinancing operations – LTROs** – with a maturity of three years.

While the total liquidity requested by banks in these operations amounted to around 1 trillion euro, the net liquidity injection by the Eurosystem has been around half a trillion euro because the other half has been shifted over from other operations.

Let me be clear about why we implemented the three-year LTROs. It was not to support sovereign debt markets. It was also not to bolster bank profits.

The LTROs were specifically designed to prevent a credit crunch that could compromise the maintenance of price stability in the euro area.

With funding markets closed, banks needed liquidity assurance over the medium term to avoid pre-emptive deleveraging and to continue lending.

To understand why these operations were necessary requires a euro area wide perspective.

It would be misleading to judge the urgency for action – or the necessary responses – based on the situation in any one country or groups of countries.

The Eurosystem acts in the interests of the euro area as a whole with 330 million citizens. This is the perspective that always informs our decisions.

Some observers have raised questions about these operations.

The questions tend to fall into three categories and since they touch on fundamental issues, I would like to spend a moment responding to them.

First, some wonder whether there is really any transmission from the LTROs to the real economy.

The argument goes that banks are simply taking cheap liquidity and setting up carry trades or putting the liquidity back into our deposit facility.

The facts show that this is an incomplete view.

Over 800 banks participated in the February LTRO, compared with around 500 in December. This number included 460 banks from Germany, most of them – literally hundreds – being smaller banks.

I cannot tell you names of the towns and villages in which these banks are located because often they are the only bank in town and could be easily identified. But I can tell you this: **that the money is now closer to small and medium-sized enterprises than it was before.**

We cannot say that this money will **necessarily go** to these smaller enterprises but it is certainly very close to them.

We have this in mind because nearly three quarters of corporate employment in the euro area is in the small and medium-sized business sector.

The banks I am talking about are ones whose main business is lending to the Mittelstand and thereby supporting the real economy.

It is also not accurate to claim that banks are returning the liquidity straight back to the Eurosystem.

We know that banks using the deposit facility are not identical to those borrowing from the Eurosystem.

This implies that even though the bulk of the liquidity is returned eventually, it is being directed within the banking system as intended.

The **second** category of question involves concerns that some have expressed that the Eurosystem is exposing itself to excessive risks.

Critics point in particular to the differentiated collateral framework adopted by some national central banks to allow banks to participate in the three-year LTROs.

Let me underscore that **high haircuts are applied to the additional credit claims so as to ensure risk equivalence between this collateral and the regular framework.**

Moreover, the main elements of the risk management framework applied are common: the eligibility criteria and risk control measures were approved by the Governing Council, and the Council will monitor the effectiveness of the risk control framework on an ongoing basis. Hence, there is **only limited national discretion.**

I should also emphasise that the Eurosystem has a **long experience** in the acceptance of credit claims in its collateral framework.

Moreover, the Eurosystem is being very careful to manage any risks that may ensue from our current operations.

We employ a **conservative risk management framework.**

On the additional collateral presented so far, the average haircut is 53%.

This means that **on a nominal value of 100 euro we provide 47 euro of liquidity.**

This shows you how prudently such collateral is accepted.

If over time the market value or quality of the collateral posted were to decline, counterparties would have to provide additional collateral or return part of the liquidity.

This too serves to **protect the financial soundness of the Eurosystem as a whole.**

The third kind of question comes from some observers who worry that the liquidity created by the LTRO will lead to inflation or asset price distortions.

Here it is important to distinguish between different concepts of liquidity.

We would expect an impact on inflation and asset prices only following a **sustained and strong increase in money and credit** – not following an increase in central bank liquidity per se.

The tentative signs we are seeing of a stabilisation in money and credit growth do not signal increasing inflationary pressures over the medium term.

For example, growth in monetary aggregates remains at low levels, with M3 increasing by 2.5% in January 2012, well below the average growth rate of M3 in monetary union so far, which was 5.9%.

The same is true of the counterparts of M3 – loans to the euro area private sector increased by only 1.5% in January, compared with an average of 6.8% since the start of the euro.

Market indicators of inflation expectations overall show no signs of inflation above our medium-term objective.

Investors overall assume a break-even inflation rate in five years of around 1.7%.

Looking further out at the inflation expectations between five years and ten years also shows that, adjusted for the usual risk premia, market expectations of long-term inflation are fully consistent with our definition of medium-term price stability.

Moreover, **the Eurosystem has a range of tools at its disposal to absorb excess liquidity if that is deemed necessary in the future.**

Available tools include increases in reserve requirements and the conduct of liquidity absorbing operations including not only short-term but **also longer-term deposits.**

Hence, there are tools and the Governing Council can use them as needed.

Moreover, our balance sheet has grown and shrunk in the past without creating inflation – for example, **this was evident over the course of both 2009 and 2010.**

In other words, we are constantly alert to threats to medium-term price stability.

Euro area citizens can be certain that **our objective is delivering price stability over the medium term – and that we have all the necessary tools to achieve it.**

The consistent strong anchoring of inflation expectations confirms that our commitment is credible.

Let me address one final issue, and this concerns the debate in this country about **Target2** balances.

It is important that this debate is framed correctly – in particular, by distinguishing between symptoms and causes.

Target2 is a payment system that reflects the flow of funds within the euro area.

Imbalances within Target2 are a symptom of real and financial imbalances between euro area countries.

Restoring normality within Target2 requires not that we address the symptom – the payment system – but that we address the cause: the underlying imbalances.

This is not the task of monetary policy. **It is the task of the national authorities and EU institutions that are responsible for fiscal, economic and financial policies.**

Important progress has been made in recent months to strengthen the credibility of these policies – and this has been recognised by financial markets.

This is the second explanation for the overall stabilisation we have witnessed since November – and it is something to which I will now turn briefly.

Policy responses at the national and EU level

The signature at the last European Council of the International Treaty, including the fiscal compact, is an important signal of commitment to reducing deficit and debt levels.

Enshrining balanced budget rules in national legislation creates a new “first line of defence” against fiscal imbalances.

Like the Schuldenbremse in this country, this legislation shifts the onus for enforcement away from Brussels and onto national institutions.

Prevention is better than cure – and that is the spirit of the compact.

Member States have also taken important steps to strengthen euro area and global firewalls.

The entry into force of the European Stability Mechanism has been advanced and the paying-in of capital will be accelerated to reach full lending capacity sooner than originally planned.

On top of this, euro area countries have committed to providing an additional 150 billion euro to the IMF.

Seen together, these measures represent a coherent strategy to strengthen euro area economic governance.

The focus is not, as some commentators claim, skewed towards fiscal consolidation.

Stronger fiscal rules are one – albeit essential – element in a larger package that addresses real and financial imbalances and provides a safety net for countries in financial difficulties.

But stronger governance cannot be effective without individual Member States also fulfilling their responsibilities.

Here too we have witnessed a number of positive developments in recent months.

The new governments in Spain and Italy have shown determination to address their twin challenges of fiscal and macroeconomic imbalances.

The government of Spain remains committed to bringing its deficit below 3% by 2013 and taking the necessary measures to ensure a rapid and secure transition to this target from the high deficit in 2011.

The latest review missions confirm that the Irish and Portuguese programmes are on track – with authorities in both countries strongly committed to meeting their targets and with a solid track record.

It is important that observers recognise that these reforms at the national level will take time.

They are addressing deep-rooted obstacles to competitiveness and growth, and the positive effects may not be visible immediately.

But once realised, they will put employment and growth on a new and more sustainable track.

The example of Germany shows the need for patience. The structural reforms passed many years ago did not immediately feed through into higher growth and employment.

But now they have, and Germany is reaping the benefits and leading the way in Europe.

With a new governance framework in place and strong commitments from national governments, there are solid grounds for trusting that reforms will be implemented across the euro area as a whole.

Conclusion

Let me conclude. The turnaround we have witnessed since November is the result of every institution of the euro area fulfilling its responsibilities.

No single institution can carry the burden of addressing a set of challenges that are simultaneously economic, financial and fiscal. Everyone has played their part.

But let me emphasise that the current stabilisation should not make us pause in our responses to these challenges.

Indeed, this is a time for continued action.

The present situation provides a **window of opportunity** for governments to accelerate efforts to consolidate budgets, to boost employment and to enhance competitiveness – and to do so with confidence.

It also creates a benign environment for banks to **strengthen their resilience further** – including by retaining earnings and cutting dividends and bonuses.

Decisive policy measures brought about the stabilisation since last November.

Now, further decisive policy measures are required to strengthen fiscal positions and competitiveness.

These measures will **lay the foundations** for future sustainable and balanced growth in the euro area.

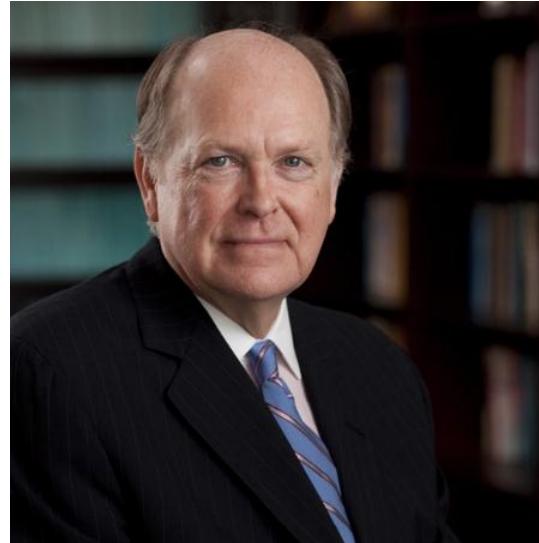
Thank you.

Charles I Plosser: Restoring central banks after the crisis

Speech by Mr Charles I Plosser,
President and Chief Executive Officer
of the Federal Reserve Bank of
Philadelphia, at the conference of the
Global Interdependence Center /
Bank of France, Paris, 26 March 2012.

* * *

The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.



Introduction

I am delighted to be here today in this beautiful city and to have the honor to serve on such a distinguished panel with friends and colleagues.

David Kotok has been the guiding force behind the GIC conferences over the past several years. He and his team at the GIC never fail to gather an interesting and knowledgeable group of people to discuss important topics on truly global issues. So, I want to thank him and the GIC for their efforts and contributions. I also want to thank our hosts, Christian Noyer and the Banque de France.

I am going to take a little different tack on the subject matter of this gathering.

Rather than focus on what new orthodoxy we should take away from the financial crisis, I want to argue that we need to restore some of the old orthodoxy.

David did suggest that he wanted to have a conversation on important issues, so I intend to be somewhat provocative in an effort to stimulate such conversation.

As usual, I want to stress that my views are my own and not necessarily those of my colleagues in the Federal Reserve System.

I will focus my remarks on two related topics that have emerged as a consequence of the crisis.

The first is the relation between monetary policy and fiscal policy.

The second topic involves the role of a central bank's balance sheet as a policy tool.

These are issues that I believe are of fundamental importance to the role of central banks in our economies.

The relationship between monetary and fiscal policies

Let me begin by sharing some thoughts on the appropriate relationship between monetary and fiscal policies.

In the wake of the financial crisis and the ensuing recession, **many countries around the world responded with a significant increase in government spending.**

Some of this increase came about through what economists call automatic stabilizers.

But there has also been a dramatic expansion in budget deficits attributable to deliberate efforts to apply fiscal stimulus to improve economic outcomes.

This expansion in government spending has been very significant in the U.S., but it has also occurred in other countries.

So what does this have to do with monetary policy?

Well, it turns out, a great deal.

It is widely understood that governments can finance expenditures through taxation, debt – that is, future taxes – or printing money.

In this sense, monetary policy and fiscal policy are intertwined through the government budget constraint.

For good reasons, though, societies have converged toward arrangements that provide a fair degree of separation between the functions of central banks and those of their fiscal authorities.

For example, in a world of fiat currency, central banks are generally assigned the responsibility for establishing and maintaining the value or purchasing power of the nation's unit of account.

Yet, that task can be undermined, or completely subverted, if fiscal authorities set their budgets in a manner that ultimately requires the central bank to finance government expenditures with significant amounts of seigniorage in lieu of current or future tax revenue.

The ability of a central bank to maintain price stability can also be undermined when the central bank itself ventures into the realm of fiscal policy.

History teaches us that unless governments are constrained institutionally or constitutionally, they often resort to the printing press to try to escape what appear to be intractable budget problems.

And the budget problems faced by many governments today are, indeed, challenging.

But history also teaches us that resorting to the printing press in lieu of making tough fiscal choices is a recipe for creating substantial inflation and, in some cases, hyperinflation.

Awareness of these long-term consequences of excessive money creation is the reason that over the past 60 years, country after country has moved to establish and maintain independent central banks – that is, central banks that have the ability to make monetary policy decisions free from short-run political interference.

Without the protections afforded by independence, the temptation of governments to exploit the printing press to avoid fiscal discipline is often just too great.

Thus, it is simply good governance and wise economic policy **to maintain a healthy separation between those responsible for tax and spending policy and those responsible for money creation.**

It is equally important for central banks that have been granted independence to be constrained from using their own authority to engage in activities that more appropriately belong to the fiscal authorities or the private sector.

In other words, with independence comes responsibility and accountability.

Central banks that breach their boundaries risk their legitimacy, credibility, and ultimately, their independence.

Given the benefits of central bank independence, that could prove costly to society in the long run.

There are **a number of approaches** to placing limits on independent central banks so that the boundaries between monetary policy and fiscal policy remain clear.

First, the central bank can be given a narrow mandate, such as price stability. In fact, this has been a prominent trend during the last 25 years.

Many major central banks now have price stability as their sole or primary mandate.

Second, the central bank can be restricted as to the type of assets it can hold on its balance sheet.

This limits its ability to engage in credit policies or resource allocations that rightfully belong under the purview of the fiscal authorities or the private marketplace.

And third, the central bank can conduct monetary policy in a systematic or rule-like manner, which limits the scope of discretionary actions that might cross the boundaries between monetary and fiscal policies.

Milton Friedman's famous k-percent money growth rule is one example, as are Taylor-type rules for the setting of the interest rate instrument.

Unfortunately, over the past few years, the combination of a financial crisis and sustained fiscal imbalances has led to a breakdown in the institutional framework and the previously accepted barriers between monetary and fiscal policies.

The pressure has come from both sides. Governments are pushing central banks to exceed their monetary boundaries, and central banks are stepping into areas not previously viewed as appropriate for an independent central bank.

Let me offer a couple of examples to illustrate these pressures.

First, despite the well-known benefits of price stability, there are calls in many countries to abandon this commitment and create higher inflation to devalue outstanding nominal government and private debt.

That is, some suggest that we should attempt to use inflation to solve the debt overhang problem.

Such policies are intended to redistribute losses on nominal debt from the borrowers to the lenders.

Using inflation as a backdoor to such fiscal choices is bad policy, in my view.

Pressure on central banks is also showing up through other channels. In some circles, it has become fashionable to invoke lender-of-last-resort arguments as a rationale for central banks to lend to “insolvent” organizations, either failing businesses or, in some cases, failing governments.

Such arguments go beyond the well-accepted principles established by Walter Bagehot, who wrote in his 1873 classic Lombard Street that central bankers could limit systemic risk in a banking crisis by “lending freely at a penalty rate against good collateral”.

Central bankers have abandoned this basic Bagehot principle in the last few years but have not replaced it with a clear alternative.

Indeed, actions were often confusing and unpredictable and lacked a coherent framework.

I believe that central banks need to think hard about how and when they exercise this important role.

We need to have a well-articulated and systematic approach to such actions.

Otherwise, our actions will exacerbate moral hazard and encourage excessive risk-taking, thus sowing the seeds for the next crisis.

Unfortunately, neither financial reform nor central banks have adequately addressed this dilemma.

Breaching the boundaries is not confined to the fiscal authorities asking central banks to do their heavy lifting.

The Fed and other central banks have undertaken other actions that have blurred the distinction between monetary policy and fiscal policy, such as adopting credit policies that favor some industries or asset classes relative to others.

Such steps were taken with the sincere belief that they were absolutely necessary to address the challenges posed by the financial crisis.

The clearest examples can be seen when the Federal Reserve established credit facilities to support markets for commercial paper and asset-backed securities.

Most notable has been the effort by the Fed to support the housing market through its purchases of mortgage backed securities.

These credit allocations have not only breached the traditional boundaries between fiscal and monetary policy, they have generated pointed public criticisms of the Fed.

Once a central bank ventures into fiscal policy, it is likely to find itself under increasing pressure from the private sector, financial markets, or the government to use its balance sheet to substitute for other fiscal decisions.

Such actions by a central bank can create their own form of moral hazard, as markets and governments come to see central banks as instruments of fiscal policy, thus undermining incentives for fiscal discipline.

This pressure can threaten the central bank's independence in conducting monetary policy and thereby undermine monetary policy's effectiveness in achieving its mandate.

In my view, this blurring of the boundaries between monetary and fiscal policies is fraught with risks.

As I said, these boundaries arose for good reason, and we ignore their breach at our peril. I believe we must seek ways to restore the boundaries.

The central bank's balance-sheet policy

Another related issue facing central banks arises from the degree to which central banks have **expanded their balance sheets**.

There are **two dimensions** to this issue.

One is the composition of the balance sheet.

In the U.S., for example, the balance sheet of the Federal Reserve has **changed** from one made up almost entirely of short-term U.S. Treasury securities to one that is mostly long-term Treasuries, plus significant quantities of long-term mortgage-backed securities.

This concentration of housing-related securities is problematic because it is a form of credit allocation and thus violates the monetary/fiscal policy boundaries I just mentioned.

The second aspect is the overall size of the balance sheet.

Many central banks **expanded their balance sheets in an effort to ease monetary policy after their usual policy instrument – an interest rate – had reached the zero lower bound**.

Do central bankers anticipate that their balance sheets will shrink to more normal levels as they move away from the zero lower bound?

Is it desirable to do so? Or should monetary policy now be seen as having another tool, even in normal times?

Some have suggested that central banks adopt a regime in which the monetary policy rate is the interest rate on reserves rather than a market interest rate, such as the federal funds rate.

This would then permit the central bank to **manage its balance sheet separately** from its monetary instrument, freeing it to respond to liquidity demands of the financial system without altering the stance of monetary policy.

In principle, this would take pressure off central banks to shrink their balance sheets from the current high levels and simply rely on raising the interest rate on reserves to tighten monetary policy.

The alternative is to **return to a more traditional operating regime** in which the central bank sets a target for a market interest rate, such as the federal funds rate in the U.S., above the interest rate on reserves.

Implementing this regime would require a smaller balance sheet.

I am **very skeptical of an operating regime that gives central banks a new tool without boundaries or constraints.**

Without an understanding, or even a theory, as to how the balance sheet should or can be manipulated, we open the door to giving vast new discretionary abilities to our central banks.

This violates the principle of drawing clear boundaries between monetary policy and fiscal policy.

When markets or governments come to believe that a central bank can freely expand its balance sheet without directly impacting the stance of monetary policy, **I believe that various political and private interests will**

come forward with a long list of good causes, or rescues, for which such funds could or should be used.

Economic theory and practice teach us that monetary policy works best when it is clear about its objectives and systematic in its approach to achieving those objectives.

Granting vast amounts of discretion to our central banks in the expectation that they can cure our economic ills or substitute for our lack of fiscal discipline is a dangerous road to follow.

In June, the Federal Reserve's Open Market Committee outlined some principles that would guide its exit from this period of extraordinary monetary accommodation.

In my view, those principles represented an important first step in the FOMC's attempt to restore the boundaries between monetary and fiscal policies.

In particular, the FOMC clearly stated its desire to return to an operating environment in which the federal funds rate is the primary instrument of monetary policy.

To achieve that objective, the Fed will have to shrink its balance sheet to a more normal level.

I interpret this as **saying that our balance sheet should not be viewed as a new independent instrument of monetary policy in normal times.**

The exit principles also indicated the Committee's desire to return the Fed's balance sheet to an all-Treasuries portfolio.

This re-establishes the idea that the Fed should not use its balance sheet to actively engage in credit allocations.

In other speeches, I have outlined a framework that I have termed a “new accord” between the Federal Reserve and the Treasury.

It would enable the central bank to act in emergencies when requested by the Treasury or the fiscal authorities, but it would be clear up front that any non-Treasury assets that accrued on the central bank’s balance sheet would be swapped for government securities within a specified period of time.

This would ensure that fiscal policy decisions remain under the purview of the fiscal authorities, not the central bank.

Summary

To summarize, it is important for governments to maintain independent central banks so that they are better able to achieve their mandates.

It is also sound policy to limit the discretionary ability of central banks to engage in policies that fundamentally belong to fiscal authorities or private markets.

Establishing and maintaining clear boundaries between monetary and fiscal policies protects the independence of the central bank and its ability to carry out its core mandate – maintaining price stability.

Clear boundaries and resisting the use of the balance sheet as a new policy tool would also improve fiscal discipline by making it more difficult for the fiscal authorities to resort to the printing press as a solution to unsustainable budget policies.

Christian Noyer: Re-examining central bank orthodoxy for un-orthodox times

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the conference of the Global Interdependence Center/Bank of France, Paris, 26 March 2012.



The unconventional policies implemented during the crisis have transformed the face of central banking.

But will these changes prove permanent and will “the unconventional become the new normal?”

There is not yet definitive answer to this question.

We may not, as easily as we would like, be able to revert exactly to the status quo ante.

However, I strongly believe we must make sure that the gains from the pre-crisis period, in terms of monetary and price stability, are not compromised in the process.

Prior to the crisis, a description of central banks would have centred on four characteristics:

- They were focused with price stability being their primary or key objective, and no responsibility was sought or given for financial stability;
- They were of limited size with very small balance sheets and interest rates as their only policy instrument;

- They were independent, a condition recognised as necessary to anchor inflation expectations, and embodied in very strong institutional frameworks;
- And they were successful: the “Great moderation”, a period of exceptional low volatility in output and inflation, was widely seen as a product of efficient and wise monetary policies.

There was a happy feeling that, at last, a perennial monetary regime had been found, well-tailored to the characteristics of a modern market economy.

Financial markets were efficient and the zero lower bound and liquidity trap appeared to be no more than historical curiosities.

With hindsight, of course, we can see now that **this “ideal” economy may never have existed.**

The Great Moderation was as much a product of “good luck” (brought by disinflationary effects of globalisation) than good policy.

Monetary stability is a necessary but not a sufficient condition of financial stability, because capital markets are not always and necessarily efficient.

And downward financial spirals may quickly bring our economies to the point where interest rates can no longer be used as effective tools.

Therefore, as the crisis unfolded, **central banks responded by taking unprecedented measures** and, in the process, underwent three major changes

A diversification of their interventions.

In order to both:

- **Unclog financial markets** (both private and public). This involved exceptional liquidity provision to banks as well as temporary purchases of assets, both private and public.
- **Circumvent the zero lower bound and bring down real long-term interest rates** through purchases of government bonds, and/ or interest rate guidance.

As a consequence, central banks' balance sheets expanded by a factor of three, dramatically increasing their role in financial intermediation and sometimes raising concerns, at least in some quarters, about the possible inflationary impact

Together, this diversification and the increase in size have created more complex interactions with fiscal policies.

Specifically, asset purchases are sometimes seen as “quasi fiscal policies” both on the asset side (due to the potential risks attached) and the liability side (when they contribute significantly to meeting the funding needs of the sovereigns).

At the time they were decided, those exceptional interventions were absolutely necessary.

Although it had been forgotten, central banks were initially created to protect the economy from excessive financial disturbances.

This was, historically, their “raison d’être”.

As ultimate and unique providers of liquidity, they cannot escape this responsibility and let the financial system and the economy collapse.

At the same time, by doing so, central banks have exposed themselves to a number of risks

First, there are risks linked to balance sheet expansion. They cannot be ignored, although all central banks have been extremely careful in valuing the assets purchased or taken as collateral.

Second, they run the risk of blurring the lines between fiscal and monetary responsibilities. A dynamic use of their balance sheets by central banks has effects on the allocation and distribution of resources in the economy.

They may favour or penalise some types of collateral or certain borrowers.

If central banks take on additional responsibilities in the area of financial stability, they will have to do so in close cooperation with fiscal authorities, thus exposing themselves to possible interferences with monetary policy.

The major risk, however, is the risk of confusion. A multiplicity of interventions could be interpreted as a relative dilution of objectives.

There is a tendency by market participants and some policymakers to consider central banks to be “universal problem solvers” whose balance sheets can be used, without cost, for all purposes.

There is also a doubt, at least an ambiguity, in the minds of some analysts, about the true purpose of government bond purchases.

Central banks’ activism may create doubts as to their ability to stick to their core mandate – price stability – in the face of increasing pressures and constraints.

Overall, the euro area is well protected against all of these risks thanks to the robustness of its institutional framework

Price stability is unambiguously the priority objective of monetary policy

Monetary financing of governments is strictly prohibited

The Eurosystem (the ECB and National Central Banks) is extremely well capitalised, which protects its independence.

This has allowed the Eurosystem to implement nonstandard measures on a large scale without endangering its credibility.

Of course, **we do not control fiscal policy**. We will never accept a situation where fiscal imbalances could constrain monetary policy.

It is very important, therefore, that credible fiscal consolidation takes place across the euro area.

This will make it easier for the Eurosystem to be active in protecting financial stability.

On the contrary, doubts over governments' resolve to ensure the sustainability of public finances would make us powerless to fight instability and expose the euro area to great dangers.

Now for the more normative aspects. We may have to live with nonstandard measures for a long time.

Indeed, some central banks have adopted interest rate guidance announcements covering the next two years.

It is likely that monetary policy will, for some time, make use of a diversity of instruments.

Macro-prudential measures will interact with monetary policies in a complex way.

In that context, it is therefore all the more important to keep clarity of purpose and stick to two crucial features inherited from the pre-crisis consensus: the focus on price stability and, its corollary, central bank independence.

There should be no ambiguity about what central banks are trying to achieve.

The more non-conventional their actions, the less obscurity there should be as to their ultimate purpose.

Non-conventional measures, like any others, can only achieve their objectives if inflation expectations are solidly and clearly anchored.

From that point of view, **calls by some economists and market participants for a temporary relaxation of price stability objectives are, in my view, totally misguided.**

I find it significant, on the contrary, that two major central banks have recently decided to quantify their price stability objectives and enhance their communication accordingly.



FSA review into anti-bribery and corruption systems and controls in investment banks and proposed new guidance for all firms

29 Mar 2012

The Financial Services Authority (FSA) published the findings of its thematic review into anti-bribery and corruption (ABC) systems and controls in investment banks.

In response to those findings, the FSA will consult on proposed amendments to the FSA's regulatory guidance, 'Financial crime: a guide for firms'.

This proposed new guidance applies to all firms within scope of our financial crime rules, not just investment banks.

From August 2011, the FSA visited 15 firms, including **eight major global investment banks** and a number of smaller operations, to examine how firms mitigate bribery and corruption risk.

Bribery and corruption risk is the risk of the firm, or anyone acting on the firm's behalf, engaging in bribery and corruption.

The FSA found that, despite a long-standing regulatory requirement to mitigate financial crime risk, **the majority of firms in our sample had more work to do** to implement effective anti-bribery and corruption systems and controls.

In particular, we found the following common weaknesses:

- Most firms had **not properly taken account** of our rules covering bribery and corruption, either before the implementation of the Bribery Act 2010 or after;

Basel iii Compliance Professionals Association (BiiiCPA)
www.basel-iii-association.com



- Nearly half the firms in our sample **did not have an adequate ABC risk assessment;**
- **Management information on ABC was poor**, making it difficult for us to see how firms' senior management could provide effective oversight;
- Only two firms had either started or carried out specific ABC internal audits;
- There were **significant issues** in firms' dealings with third parties used to win or retain business;
- Though many firms had recently tightened up their gifts, hospitality and expenses policies, few had processes to ensure gifts and expenses in relation to particular clients/projects were reasonable on a cumulative basis.

Although firms in our sample had been slow and reactive in managing bribery and corruption risk, our visits and the introduction of the Bribery Act had acted as a trigger for firms to focus on ABC issues.

The FSA is considering whether further regulatory action is required in relation to certain firms in its review.

Tracey McDermott, acting director of enforcement and financial crime, said:

“It is imperative that firms have adequate arrangements to control the risks of financial crime.

We have seen examples of good practice and some examples of poor practice.

Overall, despite the high profile of the issue, the investment banking sector has been too slow and too reactive in managing bribery and corruption risks.

“Firms across all sectors must have appropriate controls to manage their financial crime risks, whether related to bribery and corruption or otherwise.

The FSA and, from next year, the Financial Conduct Authority will continue to focus on financial crime risks in this sector and beyond to ensure firms are meeting their legal and regulatory obligations.”

Notes for editors

The FSA requires firms to establish and maintain effective systems and controls to mitigate financial crime risk.

Financial crime risk includes the risk of bribery and corruption.

In addition to these regulatory requirements, bribery, whether committed in the UK or abroad, is a criminal offence under the Bribery Act 2010, which has consolidated and replaced previous anti-bribery and corruption legislation in the UK.

The FSA does not enforce, or give guidance on, the Bribery Act.

FSA Principles require FSMA authorised firms to **conduct their business with integrity and with due skill, care and diligence; and to take reasonable care** to organise and control their affairs responsibly and effectively with adequate risk management systems.

The FSA regulates the financial services industry and has four objectives under the Financial Services and Markets Act 2000:

1. Maintaining market confidence;
2. Securing the appropriate degree of protection for consumers;
3. Fighting financial crime; and
4. Contributing to the protection and enhancement of the stability of the UK financial system.



**Address by Mr Lee Boon Ngiap, Assistant Managing Director,
Monetary Authority of Singapore,
General Insurance Association of Singapore Annual General Meeting
Luncheon, 27 March 2012, Intercontinental Hotel, Singapore**

GIA President, Mr Derek Teo, Distinguished Guests, Ladies and Gentlemen,

1 Thank you for inviting me to your Annual General Meeting Luncheon. May I congratulate Mr Derek Teo on your re-election as President of GIA, as well as the other newly-elected management committee members.

I would also like to thank them for agreeing to take up the challenge of leading the industry over the next year.

2 This afternoon, I will start off by recapping some of the major achievements of GIA, before outlining **some of the immediate challenges facing the general insurance industry**.

GIA's Contributions

3 Under the leadership of its management committee, GIA has accomplished much in the past few years.

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4 I would like to commend GIA for its pro-active approach in strengthening the self-regulatory framework for general insurance agents. GIA's Agents' Registration Board has put in much efforts to **improve the standards of general insurance agents through initiatives such as the Trade Specific Agent Schemes.**

An industry working group formed by the GIA is now finalising a Telemarketing Code of Practice for general insurers.

These initiatives will continue to raise the competency and professional standards of the general insurance industry, and provide consumers with better quality advice and higher service standards.

These augur well for the development of the industry.

5 Over the past year, GIA has been active in **educating consumers on general insurance products.**

One example is the travel insurance seminar jointly organized by GIA with the National Association of Travel Agents Singapore and the Consumers Association of Singapore.

The seminar provided a useful platform for the industry to share insights and knowledge on how consumers can purchase the right type of travel insurance for their needs.

GIA was also involved in the revamp of the Moneysense website, and had made contributions to the publications on the website.

I am glad to note that GIA will continue such efforts to educate consumers on the specific risks and considerations when buying general insurance products.

6 GIA has also made active contributions to an industry-led working group that is looking to **enhance reinsurance contract certainty practices** in Singapore.

Together with the Singapore Reinsurance Association, Reinsurance Brokers Association, Lloyd's and Insurance Law Association of Singapore, the working group is finalising guidelines and best practices to secure contract certainty.

The guidelines will highlight the need for reinsurers and brokers to provide cedants with their signed copy of the contract.

It will also require both parties to ensure that there is no ambiguity in the terms and conditions of the contract prior to risk inception.

This will minimise potential disputes over claims and coverage.

MAS views this as a very important initiative and will work with the industry on a smooth implementation of these new guidelines and best practices.

7 On the talent development front, GIA, with the Regional Development Committee, have contributed significantly through its Global Internship Program (GIP).

According to Lloyd's Risk Index 2011, “talent and skills shortage” was identified as one of the top three risks facing the insurance industry in the Asia Pacific region. GIA’s efforts in helping to build the talent pipeline is crucial.

I would like to encourage GIA to continue to explore talent initiatives to support the industry’s needs in more specialised risk areas as well as actuarial and leadership development.

MAS will continue to work with GIA to explore the possibility of expanding the depth and breadth of the GIP to better cater to the growing needs of the industry.

Challenges Ahead

8 GIA should be proud of these achievements, which has contributed much to the development of the general insurance industry in Singapore. There is much more work in the years ahead as the industry faces important challenges in a riskier and more difficult market. Allow me to share my thoughts on **two of these immediate challenges**.

9 **First**, let me congratulate the industry for **reporting underwriting profits in all lines of domestic business last year**.

In particular, the motor business registered its first underwriting profit in six years.

The last time the industry managed to turn a profit in the highly competitive motor business was in 2004 and 2005, **after more than a decade of losses**.

But **stiff competition set in immediately and many insurers started compromising on underwriting and pricing discipline in pursuit of market share**.

Problems with fraudulent and inflated claims also started to plague the motor insurance business.

This resulted in the industry reporting record underwriting losses of \$168 million in 2008, with losses in each subsequent year until last year.

10 GIA, through its introduction of the **Motor Claims Framework** in 2008, and active participation in the Motor Insurance Task Force, has contributed to measures to minimise fraudulent and inflated claims.

These efforts are commendable and MAS is committed to working together with GIA and other relevant stakeholders to combat this problem.

But such measures alone will not sustain the profitability of the motor business if insurers do not exercise underwriting and pricing discipline.

11 While competitive premium rates may benefit consumers, they are not sustainable if they are achieved without regard to sound underwriting and pricing.

Eventually, insurers will suffer losses which become too great to bear and some will exit the business, leaving consumers with fewer choices.

Those that remain will be forced to raise premium rates sharply, and complaints from unhappy motorists can be expected to follow.

Ultimately, this is detrimental to consumers and the insurance industry.

We have seen this episode played out before in the domestic motor insurance market.

The challenge for the industry therefore is to take heed of the lessons learnt and maintain your underwriting and pricing discipline this time round.

It is in the interest of both consumers and insurers that all of you only pursue business strategies that are sustainable and not sacrifice prudence for potential short-term gains.

12 The second challenge for the industry that I would like to touch on is the need to keep pace with global regulatory reforms.

Much has been said and written about the weaknesses in regulations and business practices that caused the global financial crisis.

The insurance business model enabled the majority of insurers to withstand the financial crisis better than other financial institutions.

Nevertheless, there are corporate governance, capital adequacy and risk management lessons from the crisis that are applicable to the insurance industry. Let me share the regulatory initiatives in these areas that MAS is focusing on this year.

13 First, one lesson from the crisis is that good corporate governance matters.

The failure by Boards to exercise effective risk management oversight had damaging consequences for many institutions.

To raise the corporate governance standards of the insurance industry, MAS recently issued a consultation paper proposing to extend the Insurance Corporate Governance Regulations to all locally-incorporated insurers.

We intend to make it mandatory for all locally-incorporated general insurers to meet minimum corporate governance requirements, which will be calibrated to take into account the significance of an insurer's operations.

Insurers' compliance with the Corporate Governance Regulations will be assessed as part of MAS' ongoing supervisory programme.

14 Second, MAS will shortly issue a consultation paper to propose enhancements to our capital framework for insurance companies. Singapore was among the first in Asia to introduce a risk-based capital (RBC) framework for insurance companies back in 2005.

Our proposed enhancement aims to improve the comprehensiveness of risk-coverage and the risk-sensitivity of the framework, while ensuring that the proposals are practical and takes into account market realities.

Unlike in banking, there is no common global capital standard for insurance companies.

So a review of our RBC framework is a major undertaking requiring both a fundamental analysis of the appropriateness of our existing framework as well as a comparative study of the insurance capital frameworks in other jurisdictions.

I look forward to receiving feedback from GIA and its members when our consultation paper is issued.

15 Third, MAS' efforts to improve risk management standards in the industry will continue apace.

MAS issued a set of guidelines on risk management practices for insurance companies in 2007.

The guidelines spell out sound risk management practices for each core activity such as product development, pricing and underwriting.

MAS will add to these guidelines with additional rules on enterprise risk management (ERM).

The ERM standards will go beyond addressing risks in each core activity to also cover MAS' expectations on how insurers identify and manage interdependencies between key risks, and how this is translated into strategic management actions and capital planning.

Conclusion

16 In conclusion, let me once again thank GIA for its good work in raising the standards of general insurance agents, educating and empowering consumers, assisting MAS in our regulatory work, and developing talent for the industry.

But there is no room for complacency. The insurance environment has become more volatile in recent years, and consumers are increasingly more sophisticated and demanding.

So the industry must enhance its ability to operate in a riskier environment, and service standards must continue to improve.

MAS will continue to work closely with GIA to promote a sound and dynamic general insurance industry in Singapore.

We have enjoyed a very good working relationship over the years and we look forward to continuing this partnership in the years ahead.

17 Thank you.

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Developing a Single Rulebook in banking

Andrea Enria, Chairperson European Banking Authority, Central Bank of Ireland – Stakeholder Conference ‘FINANCIAL REGULATION - THINKING ABOUT THE FUTURE’ 27 April 2012

Ladies and Gentlemen,

My main topic today will be the **Single Rulebook**, the main path ahead of us to achieve the objectives of the new European institutional framework established with the endorsement of the recommendations of the de Larosière report.

I will primarily focus on own funds, as this is a key issue for **re-establishing the regulatory framework** on a sound footing and the EBA is currently running a public consultation on this.

I will also briefly touch on another important component of the **Single Rulebook: the liquidity requirements**.

However, before tackling these issues, I would like to give you an overview of the first year of existence of the EBA and especially of the work done to face the challenges posed by the current crisis.

1. The efforts of the EBA in tackling the financial crisis

In the first year of its life, the priorities of the EBA had to be focused on

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the challenges raised by the deterioration of the financial market environment.

The **stress test exercise** we conducted in the first part of 2011 focused on credit and market risks but also, in recognition of the risks that subsequently crystallised, incorporated sensitivity to movements in funding costs.

Banks were also required to **assess the credit risk in their sovereign portfolios**.

In many respects, I believe the exercise was successful: in order to achieve the tougher capital threshold, anticipating many aspects of the new Basel standards, **banks raised € 50 bn in fresh capital** in the first four months of the year; we set up a comprehensive peer review exercise, which ensured consistency of the exercise across the Single Market, notwithstanding the many differences in national regulatory frameworks; the exercise included an unprecedented disclosure of data (more than 3200 data points for each bank), including amongst other things detailed information on sovereign holdings.

However, **the progress of the stress test was tracked by a significant further deterioration in the external environment**.

The **main objective** of restoring confidence in the European banking sector was **not achieved**, as the sovereign debt crisis extended to more countries, thus reinforcing the pernicious linkage between sovereigns and banks.

Most EU banks, especially in countries under stress, **experienced significant funding challenges**.

In this context, **the IMF and the European Systemic Risk Board (ESRB)** called for coordinated supervisory actions to strengthen the banks' capital positions.

The EBA assessment was that without policy responses, the freeze in bank funding would have led to an abrupt deleveraging process, which would have hurt growth prospects and fuelled further concerns on the fiscal position of some sovereigns, in a negative feedback loop.

We then called for coordinated action **on both the funding and the capitalisation side.**

While advising the establishment of an EU-wide funding guarantee scheme, the EBA focused its own efforts on those areas where it had control, primarily bank capitalisation.

To this end, **the Board of Supervisors, comprising the heads of all 27 national supervisory authorities**, discussed and agreed that a further recapitalisation effort was required as part of a suite of coordinated EU policy measures.

Our Recommendation identified a temporary buffer to address potential concerns over EU sovereign debt holdings and required banks to reach 9% CT1.

The [total shortfall identified was € 115 bn.](#)

The measure was agreed in October and enacted in December 2012.

It was swiftly followed by the ECB's long term refinancing operations (LTROs), arguably the key "game changer" in this context.

But **the recapitalisation was a necessary complementary measure**: while banks needed unlimited liquidity support, to avoid a credit crunch, they had to be asked to accelerate their action to repair balance sheets and strengthen capital positions.

These measures have [bought time](#) but should not bring complacency.

The recapitalisation plan has seen banks make significant efforts to strengthen their capital position without disrupting lending into the real economy.

The EBA's intensive monitoring of the process shows that 96% of the shortfall identified was met by direct capital actions.

Moreover, there has been a strong spirit of cooperation between home and host supervisors in discussing and taking forward these plans through colleges of supervisors, which has acted as a meaningful counterweight to the trend for national concerns to come to the fore in the current environment.

Going forward, heightened attention to addressing residual credit risk, making efforts to meet the new CRD IV requirements, setting in place plans to gradually restore access to private funding and exit the extraordinary support of the ECB will be key.

2. The Single Rulebook in banking

As the finalisation of the new legislative framework for capital and liquidity requirements was coming closer, the focus of the EBA work has been increasingly moving to our tasks in the rule-making process.

The key task that the reform proposed by the de Larosière report assigns to the EBA is the establishment of a Single Rulebook, ensuring a more robust and uniform regulatory framework in the Single Market and preventing a downward spiral of competitive relaxation of prudential rules.

The EBA is asked to draft technical standards that, once endorsed by the Commission, will be adopted as EU Regulations.

The standards will therefore be directly applicable to all financial institutions operating in the Single Market, without any need for national implementation or possibility for additional layers of local rules.

I see that at the moment, while the negotiations on the capital requirement directive and regulation (CRD4-CRR) are entering the final stages, there is a call for more national flexibility.

It is often argued that minimum harmonisation is all that is needed, as the decision of a national authority to apply stricter requirements would only penalise financial institutions chartered in that jurisdiction.

This argument neglects the fact that we have lived in a world of minimum harmonisation until now, and this has delivered an extremely diverse regulatory environment, prone to regulatory competition.

It is a fact that the flexibility left by EU Directives has been a key ingredient in the run-up to the crisis.

The Directives left significant flexibility to national authorities in the definition of key prudential elements (e.g., definition of capital, prudential filters for unrealised gains and losses), the determination of risk weights (e.g., for real estate exposures), the approaches to ensure that all the risks are captured by the requirements (e.g., effectiveness of risk transfers).

All these elements of flexibility have been used by banks to put pressure on their supervisors, triggering a process that led to excessive leverage and fuelled credit and real estate bubbles.

The heterogeneity of the regulatory environment also complicated significantly the effective supervision of cross-border groups, which were at the epicentre of the crisis: supervisors had serious difficulties both building up a firm-wide view of risks and acting in a timely and coordinated fashion.

Furthermore, regulatory arbitrage drove business decision. This problem has not been fixed yet.

In its first year of activity, the EBA identified a number of differences in

regulatory treatment that lead to very material discrepancies in key requirements.

For instance, the EBA staff conducted a simple exercise on the data collected for the recapitalisation exercise.

The capital requirement for the same bank were calculated using the less stringent and the most restrictive approaches in four areas where national rules present important differences – the calculation of the Basel I floors, the application of the prudential filters, the treatment (deduction from capital or inclusion in assets with a 1250% weight) of IRB shortfalls and of securitisations.

As a result, **the ratio was 300 bps lower when the stricter methodologies were applied, showing that differences can be very material and difficult to spot.**

In integrated financial markets, these differences can have very disruptive effects.

Once risks generated under the curtain of minimum harmonisation materialise, **the impact is surely not contained within the jurisdictions that adopted less conservative approaches.**

Without using exactly the same definition of regulatory aggregates and the same methodologies for the calculation of key requirements, the problem will not be fixed.

At the same time, it is absolutely true that the new regulatory framework has to be shaped in such a way to leave a certain degree of national flexibility in the activation of macroprudential tools, as credit and economic cycles are not synchronised across the EU.

Also, there could be structural features of financial sectors, or components thereof, which might require tweaking prudential requirements to prevent systemic risk.

But **the same source of systemic risk should be treated in a broadly consistent manner in different jurisdictions** across the Single Market, to avoid an unlevel playing field and less stringent approaches that might subsequently generate spillovers in other countries.

The ideal long-term solution for avoiding conflicts between the flexibility needed for macroprudential supervision and the degree of regulatory harmonisation called for by the Single Rulebook is constructing a suite of macroprudential instruments along the blueprint of the countercyclical buffer.

This provides a significant leeway for tightening standards while the **European Systemic Risk Board (ESRB)** is entrusted with the task of drafting guidance on the activation of the tool and of conducting ex post reviews.

At the same time, reciprocity in the application of the tool allows for cross-border consistency and reduces the room for regulatory arbitrage.

So, we may well have a single rule, adopted through an EU Regulation, while this rule provides for flexibility in its application, with a framework that the Basel Committee has labelled as “constrained discretion”.

3. Giving life to the Single Rulebook: the new regulatory framework of bank capital and liquidity

In giving life to the Single Rulebook in banking, the EBA is facing a **major challenge**.

The CRD4-CRR proposal envisages around **200 tasks, more than 100 technical standards - 40 of which will have to be finalised by the end of this year**.

We will have to ensure standards of high legal quality as they will be immediately binding in all 27 Member States when endorsed by the European Commission.

We will have to respect due process, with wide and open consultations and adequate impact assessments.

As to the substance of the new regulatory framework, I will focus today on the definition of capital and the quality of own funds, which I consider as one of the cornerstones of the Single Rulebook in banking.

3.1. Own funds

The **definition of capital has been a major loophole** in the run-up to the crisis.

As **financial innovation** brought about increasingly complex hybrid instruments, national authorities have been played against each other by the industry, with the result that the standards for the quality of capital were continuously relaxed.

As a consequence, once the crisis hit, a significant amount of capital instruments proved to be of inadequate quality to absorb losses.

In several cases, taxpayers' money was injected while the holders of capital instruments continue to receive regular payments.

The Basel Committee has done an outstanding job in **significantly strengthening the definition of capital and we must make sure that this is not lost in the implementation of the standards.**

The EBA already achieved some progress in the use of stringent uniform standards when imposing the use of a common definition of capital for the purpose of the stress test and the recapitalisation exercise.

This proves that collective enhancements can be reached when necessary.

But what can be done in periods of stress must be perpetuated in normal times.

For this purpose, on 4 April, the EBA published a consultation on a first set of regulatory technical standards on own funds.

These cover most areas of own funds, fleshing out the features of instruments of different quality (from CET1 to Tier 2 instruments). The consultation will provide appropriate input from interested parties and regular contacts with banks and market participants are already under way.

The standards elaborate on the characteristics of the instruments themselves, as well as on deductions to be operated from own funds.

It is indeed crucial to ensure that there is a uniform approach regarding the deduction from own funds of certain items like losses for the current financial year, deferred tax assets that rely on future profitability, defined benefit pension fund assets.

It is also necessary to ensure that, where exemptions from and alternatives to deductions are provided, sufficiently prudent requirements are applied.

The standards cover also several areas affecting more directly cooperative banks and mutuals, whose particular features have to be taken into adequate account.

At the same time, it is necessary to define appropriate limitations to the redemption of the capital instruments by these institutions.

The standards will also contribute to increase the permanence of capital instruments more generally by strengthening the features of the latter and by specifying the need for supervisory consent when reducing own funds.

Finally, the standards will also increase the loss absorbency features of eligible hybrid instruments, in line with the objective to bring investors closer to shareholders and share losses on a pari passu basis.

In order to complete its current work on own funds, **the EBA will soon publish a technical standard on disclosure by institutions.**

The work of the EBA on own funds will not be concluded with the endorsement of the new technical standards.

Indeed, although technical standards, like EU Regulations, should not leave room for interpretation, it cannot be excluded that some provisions will not work as they are meant to.

This is the reason why a close review of the application of the standards is necessary to detect potential loopholes and propose changes when needed.

A framework should be developed, probably in the form of a Q&A platform, in order to address technical issues that may well emerge in the practical application of the standards.

Furthermore, an important task that has been attributed to the EBA is the publication of a list of instruments included in Common Equity Tier 1 (CET1) as well as the monitoring of the quality of capital instruments.

I believe the current text of the CRD4-CRR does not go far enough in ensuring a strong control on the instruments that will be included in the capital of higher quality.

I understand the decision of the EU institutions to follow an approach that privileges substance over form: **the definition of Common Equity Tier 1 will not be restricted to ordinary shares, as there is no harmonised EU-wide definition that could be relied upon.**

Instead, the legislation will require that only instruments that are in line with all the principles defined by the Basel Committee will qualify.

In order for this to ensure a strict control on the quality of these instruments, strong mechanisms should be put in place to make sure that there is no room for watering down the requirements.

The “substance” needs to be checked and has to be the same across the Single Market.

From my perspective, the list that the EBA will keep should be legally binding.

There should be an in-depth scrutiny of the instruments conducted at the EU level by the EBA, in cooperation with national supervisors, to confirm the inclusion in the list.

If an instrument is included in the list, it should be accepted throughout the Single Market.

If it is not included in the list, no authority should have the possibility to consider it eligible as CET1.

The present text limits the role of the EBA to the publication of an aggregated list only based on the assessment done at national level.

This would not bring any added value compared to a situation where Member States would be required to publish by themselves a list of instruments recognised in their jurisdictions.

On the contrary, this could be misleading, as it could convey the impression that the instruments have received an EU-wide recognition.

In any case, even if the legislative framework does not provide the EBA with the necessary legal tools, we are committed to fully exploiting the draft Regulation’s provisions that require the EBA to monitor the quality of own funds across the Single Market and to notify the Commission in case of evidence of material deterioration in the quality of those instruments.

If we consider that some instruments that are not of sufficient quality have been accepted, we also have the possibility to open formal procedures for breach of European law.

Having strong enforcement tools is essential: **supervisors have lost control of the definition of capital once and we should not allow this to happen again.**

We are acutely aware that the new rules will trigger a new wave of financial innovation, aimed at limiting the restrictive impact of the reform. Indeed, this is already under way.

We already hear that new ways are being devised to smooth the impact of permanent write-downs or to circumvent the prohibition of dividend stoppers for hybrid instruments.

Our monitoring of capital issuances is ongoing.

The EBA recently decided to develop a set of benchmarks for hybrid instruments to give more clarity on what are the terms and conditions – in terms of permanence, flexibility of payments, loss absorbency – that make an instrument compliant with applicable rules.

The work in this area will begin when the final legislation is in place and a sufficient number of new issuances are available, in order to have a meaningful sample of instruments to assess.

In the future, hopefully, this work could move a step further, towards **providing common templates, which could lead to the harmonisation of the main contractual provisions of hybrid capital instruments, in line with the objectives of a Single Rulebook.**

A concrete illustration of these common templates has already been given by the EBA when publishing a common term sheet for the convertible instruments accepted for the purpose of the recapitalisation exercise.

3.2. Liquidity

The new liquidity standards represent a second important area of work for the EBA.

The first deliverable is due at the end of 2012, when we will have to provide for uniform reporting formats.

The framework is currently under development and is expected to be released for public consultation over the summer.

However, we can already foresee that the reporting is likely to be fairly similar to that used by the Basel Committee for the quantitative impact study, which many European banks are already familiar with.

But the most important and delicate area of work is **the definition of liquid assets and, more generally, the calibration of the new requirements.**

We are aware that the banking industry has raised serious concerns on the two liquidity standards defined by the Basel Committee, the **liquidity coverage ratio (LCR)** and the **net stable funding ratio (NSFR)**.

The Basel Committee itself is **reviewing the calibration** of the ratios, recognising that some underlying assumptions are excessively conservative, even if confronted with the toughest moments of the financial crisis.

The key principles underlying the LCR and the NSFR are sound and cannot be given up by regulators: **banks need to have sufficient buffers of liquid assets to withstand a shock** for some time without the need for public support; maturity transformation needs to be constrained to some extent, so as to prevent banks from adopting fragile business models relying excessively on volatile, short term wholesale funding to support longer term lending.

But it is essential to get the calibration right, as funding is and will increasingly be the main driver of the deleveraging process at EU banks.

Time is needed to do a proper job: we have to ensure that data of adequate quality is available – hence the need for a uniform reporting provided at the end of 2012 – and to allow for in-depth analyses.

The first impact assessments on LCR and the NSFR are due in 2013 and 2015 respectively.

The EU has taken the decision to use the monitoring period until 2015 for the LCR and 2018 for the NSFR, before proposing legislation for a final calibration of the liquidity ratios.

This monitoring phase exactly mirrors the Basel Committee's timeline.

It is in my view the right choice to allow for this extensive observation period. I would strongly argue that we should avoid making any policy choice before proper evidence on the potential impact of the two ratios.

Conclusions

Ladies and gentlemen,

Today I tried to convey to you a bird's eye picture on the difficult challenges the EBA is facing.

In the first year of activity we have already done a huge effort to strengthen the capital position of EU banks and to restore confidence in their resilience. The work is not over in this area.

The liquidity support provided by the ECB avoided an abrupt deleveraging process, but **banks are still in the process of repairing and downsizing their balance sheets and of refocusing their core business.**

We, as supervisors, need to accompany this process and do our utmost to ensure that it occurs in an ordered fashion, without adverse consequences on the financing of the real economy.

One way to support the process is the introduction of the reforms on capital and liquidity standards endorsed by the G20.

I strongly believe that we need to exploit this opportunity to move to a truly harmonised regulatory framework, a Single Rulebook that ensures that high quality standards are enforced throughout the Single Market.

We have to be particularly rigorous on the definition of capital, as this is the basis for most prudential requirements.

We cannot afford anymore financial innovation that allows instruments to be accepted as capital, while not respecting the key principles of permanence, flexibility of payments and loss absorbency.

The control on eligible capital instruments needs to be very strict and should be performed at the EU level. Ideally, the co-legislators should give the EBA the legal basis to perform this difficult task.

But in any case we will conduct a close monitoring of capital issuances, as we consider our duty to ensure that only the instruments of the best quality are accepted as regulatory capital.

As to liquidity standards, I believe that while the principles embodied in the Basel text are absolutely shared, we need to do more work on the calibration of the requirements.

We understand the concerns expressed by the industry, but it is important that we collect solid empirical evidence before taking any decision in this delicate area, which will provide a major driver for the needed changes in banks' business models.

Thank you for your attention.



FSA Japan - Press Conference by Shozaburo Jimi, Minister for Financial Services (Excerpt)

[Opening Remarks by Minister Jimi]

This morning, the Minister of Economic and Fiscal Policy, the Minister of Economy, Trade and Industry and the Minister for Financial Services held a meeting, and I will make a statement regarding the policy package for management support for small and medium-size enterprises (SMEs) based on the final extension of the SME Financing Facilitation Act.

Recently, [the Diet passed and enacted an amendment bill to extend the period of the SME Financing Facilitation Act](#) for one year for the last time and an amendment bill to extend the deadline for the determination of support by the Enterprise Turnaround Initiative Corporation of Japan, over which Minister of Economic and Fiscal Policy Furukawa has jurisdiction, for one year, and the new laws were promulgated and put into force.

I believe that this year will be very important for creating an environment for vigorously implementing support that truly improves the management of SMEs, namely an exit strategy.

From this perspective, the ministers who represent the Cabinet Office, the Financial Services Agency (FSA) and the Small and Medium Enterprise Agency held a meeting and adopted the policy for management support for SMEs.

The FSA will seek to facilitate financing for SMEs through measures related to the final extension of the period of the SME Financing Facilitation Act, including this policy package, and will also create an environment favorable for management support for SMEs while maintaining cooperation with relevant ministries and agencies.

For details, the FSA staff will later hold a press briefing, so please ask your questions then.

[Questions & Answers]

Q. The G-20 meeting started on April 19.

I hear that the expansion of the International Monetary Fund's lending facility, which has been the focus of attention, may be put off, and the market could fall into turmoil again, with the yield on Spanish government bonds rising in Europe.

Could you tell me how you view the recent financial market developments?

A. As for the current situation surrounding the European debt problem that you mentioned now, individual countries' financial and capital markets have generally been recovering for the past several months as a result of efforts made by euro-zone countries and the European Central Bank, as you know.

On the other hand, concern over the European fiscal problem has not been dispelled, as indicated by unstable market movements caused by concern over Spain's fiscal condition.

The euro zone has set forth the path to fiscal consolidation and President Draghi of the European Central Bank (ECB) has taken bold measures, as you know well.

Such measures as the ECB's long-term refinancing operation and the strengthening of the firewall have been taken.

To ensure that the market will be stabilized and the European debt problem will come to an end, it is important not only that the series of measures adopted by the euro zone is carried out but also that the IMF's financial base is strengthened.

From this perspective, Minister of Finance Azumi recently expressed an intention to announce Japanese financial support worth 60 billion dollars for the IMF at the G-20 meeting.

I hope that this Japanese action, combined with Europe's own efforts, will help to resolve the European debt problem.

As you know, it is unusual for Japan to exercise initiative and announce support for the IMF.

Although Japan has various domestic problems, it is the world's third-largest country in terms of GDP.

In addition, as I have sometimes mentioned, Japan is the only Asian country that has maintained a liberal economy and a free market since the latter half of the 19th century.

Even though Japan lost 65% of its wealth because of World War II, it went on to recover from the loss.

In that sense, it is very important for Japan to exercise initiative, on which the United States eventually showed an understanding from what I have heard informally.

Q. It has been decided that Kazuhiko Shimokobe of the **Nuclear Damage Liability Facility Fund** will be appointed as Tokyo Electric Power Company's new chairman.

Tokyo Electric Power's management problem has had some effects on the corporate bond market and also has affecteds SMEs through a hike in electricity rates. What do you think of this appointment?

A. I am aware that Mr. Shimokobe, who is chairman of the Nuclear Damage Liability Facility Fund's management committee, has accepted the request to serve as Tokyo Electric Power's chairman, but the FSA would like to refrain from commenting on personnel affairs.

Formerly, I, together with Mr. Yosano, joined the cabinet task force, which was responsible for determining the scheme for rehabilitating Tokyo Electric Power, in response to the economic damage caused by the nuclear station accident, as additional members, and our efforts led to the enactment of the Act on the Nuclear Damage Liability Facility Fund.

I understand that **Tokyo Electric Power and the Nuclear Damage Liability Facility Fund** are drawing up a comprehensive special business plan.

What kind of support Tokyo Electric Power will ask stakeholders to provide and how stakeholders including financial institutions will respond are matters to be discussed at the private-sector level, as I have been saying, so the FSA would like to refrain from making comments for the moment.

In any case, regarding Tokyo Electric Power's damage compensation, **making damage compensation payments quickly and appropriately and**

ensuring stable electricity supply are important duties that electric power companies must fulfill.

Therefore, with the fulfillment of those duties as the underlying premise, it is important to prevent unnecessary, unpredictable adverse effects - you mentioned the effects on the corporate bond market earlier - so I will continue to carefully monitor market developments.

Q. On April 19, the Democratic Party of Japan's working team on the examination of the future status of pension asset management and the AIJ problem adopted an interim report.

Could you tell me about the status of the FSA's deliberation on measures to prevent the recurrence of the problem, including when the measures will be worked out?

A. I read about that in a newspaper article.

Regarding problems identified in this case, **it is necessary to ensure the effectiveness of countermeasures while taking account of practical financial practices.**

That report is an interim one, so it stated that various measures will be worked out in the future. I have my own thoughts as the person in charge of the FSA.

However, I think that the FSA needs to conduct a study on measures such as strengthening punishment against false reporting and fraudulent solicitation - as you know, false reports were made in this case - establishing a mechanism that **ensures effective checks by third-parties like companies entrusted with funds, auditing firms and trust banks** - the checking function did not work at all in this case - and including in investment reports additional information useful for pension fund associations to judge the reliability of companies managing customers' assets under discretionary investment contracts and the investment performance.

In any case, regarding measures to prevent the recurrence of this case, we will quickly conduct deliberation while taking into consideration the results of the Securities and Exchange Surveillance Commission's additional investigation and the survey on all companies managing customers' assets under discretionary investment contracts - the second-round survey is underway - as well as the various opinions expressed in the Diet, including the arguments made in the interim report, which was written under Ms. Renho's leadership.

We will implement measures one by one after each has been finalized.

Q. Regarding the policy package announced today, several people said in the Diet that more efforts should be devoted to measures to support SMEs in relation to the extension of the period of support by the Enterprise Turnaround Initiative Corporation of Japan.

In relation to the policy package, do you see any problems with the collaboration that has so far been made with regard to management support for SMEs?

A. Twenty-two years ago, in 1990, I became parliamentary secretary for international trade and industry, and served in the No. 2 post of the former Ministry of International Trade and Industry for one year and three months under then Minister of International Trade and Industry Eiichi Nakao.

At that time, I was in charge of financing for SMEs, such as financing provided by Shoko Chukin Bank, the Japan Finance Corporation for Small and Medium Enterprise, the National Life Finance Corporation and the Small Business Corporation, for one year and three months.

Many departments and divisions are involved in the affairs of SMEs.

While diversity and nimbleness are important for SMEs, I know from my experiences that they lack human resources and that unlike large

companies, it is difficult for them to change business policies quickly in response to tax system changes.

The FSA will continue to cooperate with relevant ministries and agencies and relevant organizations, such as the Enterprise Turnaround Initiative Corporation of Japan, liaison councils on support for the rehabilitation of SMEs, financial institutions and related organizations, including the Japanese Bankers Association, and commerce and industry groups - there are four traditional associations of SMEs - as well as prefectural credit guarantee associations, which play an important role for the government's policy for SMEs.

In addition, the FSA will cooperate with government-affiliated financial institutions and take concrete actions, and I hope that **recovery and revitalization of local economies based on the rehabilitation of regional SMEs will lead to the development of the Japanese economy.**

However, between the three ministers who held a meeting today, the policy toward SMEs tends to lack coordination.

In Tokyo, Minister of Economy, Trade and Industry Edano and Minister of Economic and Fiscal Policy Furukawa and I worked together to adopt the policy package. In Japan's 47 prefectures, there are liaison councils on support for rehabilitation of SMEs and there are commerce and industry departments in prefectural and municipal governments, and these organizations will also be involved, so the policy for SMEs is wide-ranging and involves various organizations.

Therefore, while we provide management support, these various organizations tend to act without coordination.

Today, the three of us held a meeting to exercise central government control, and we will keep close watch on minute details so as to ensure coordination.

As I have often mentioned, there are 4.3 million SMEs, which account for 99.7% of all Japanese corporations in Japan, and 28 million people, which translates into one in four Japanese people, are employed by SMEs, so SMEs have large influence on employment.

We will maintain close cooperation with relevant organizations.

Q. In relation to the previous question, I understand that the Enterprise Turnaround Initiative Corporation of Japan has mostly handled cases involving SMEs.

At a board meeting yesterday, it was decided that a former official of a regional bank will be appointed to head the corporation. How do you feel about that?

A. I read a newspaper article about the decision to appoint a former president of Toho Bank.

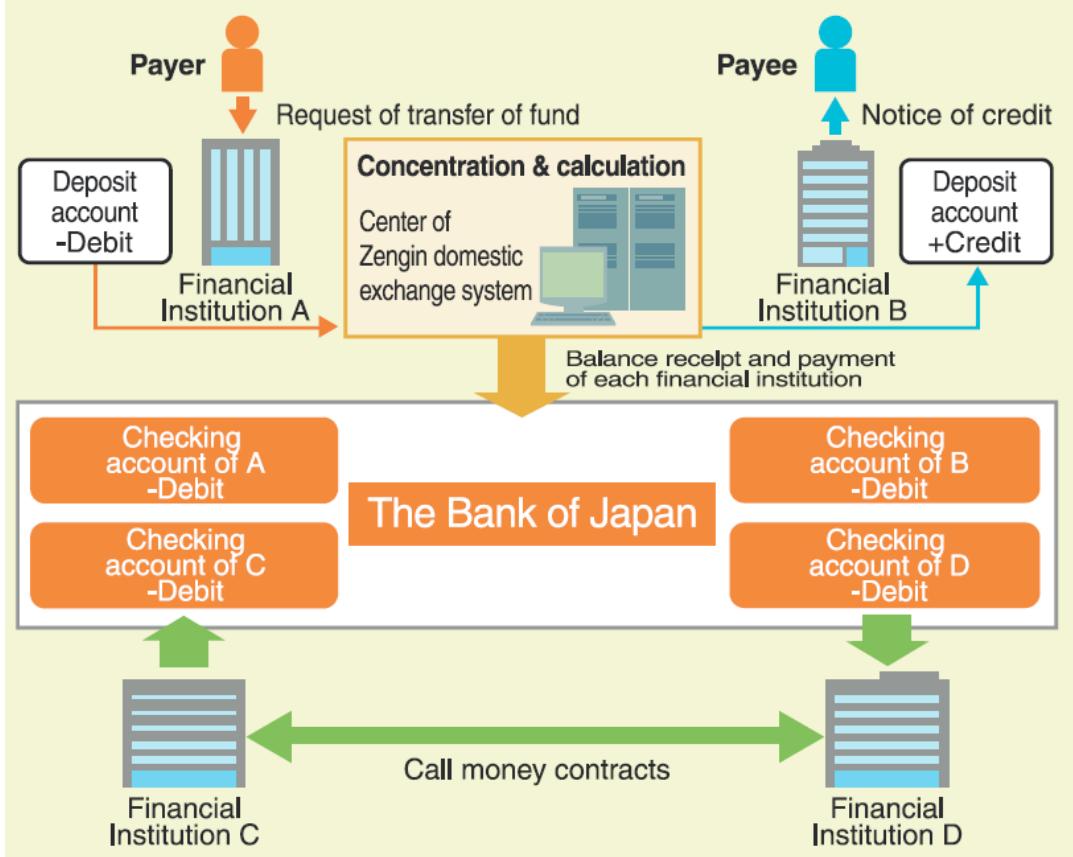
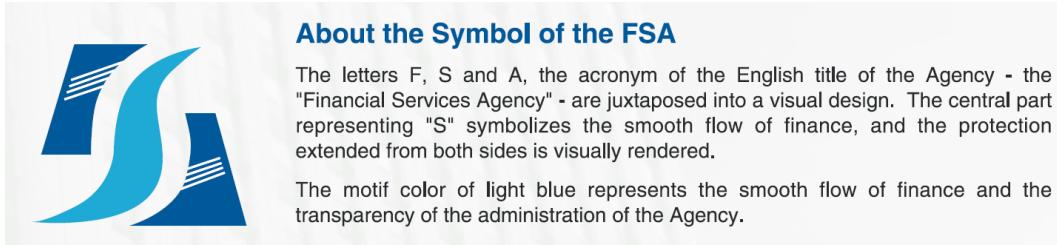
Toho Bank is the largest regional bank in Fukushima Prefecture, and personally, I am pleased that a very suitable person will be appointed as a new president.

Fukushima Prefecture has been stressing that the revival of Japan would be impossible without the revival of Fukushima in relation to the nuclear station accident.

In that sense, the selection of the former president of Toho Bank, a fairly large regional bank, who also served as chairman of the Regional Banks Association of Japan, is appropriate.

This morning, Minister of Economic and Fiscal Policy Furukawa reported on the selection.

I think that a very suitable person has been selected.



There are many risk management experts that discuss this interesting speech

Shareholder value and stability in banking: Is there a conflict?

Speech by Jaime Caruana, General Manager, Bank for International Settlements



Understandably, the global regulatory response to the global financial crisis has stirred controversy.

That response, **with Basel III at its core, seeks to strengthen the resilience of the banking system.**

In doing so, it **asks shareholders to give up high leverage as a source of high returns on equity.**

And it asks bondholders, especially those of systemically important institutions, to **take more of a hit in the event of failure.**

In this light, it is easy enough to imagine that **investors would have little reason to hail the new framework.**

This view, however, tells only **part of the story.**

It assumes that, on balance, bank investors were well served by the pre-crisis system.

It also posits a conflict between value for shareholders on the one hand and the public interest in safer banking on the other.

In my remarks today I would like to suggest that this supposed conflict of interests is overstated.

Yes, tensions may arise over a short investment horizon.

But over long horizons, they tend to disappear – because, in the long term, the focus necessarily shifts to sustainable profits and returns.

This is not just theorising: we'll take a look at the statistical evidence in a moment.

And unless one believes that markets can be consistently timed – a rare gift at best – it is long horizons that should matter for investors.

Let me first outline what we in Basel mean by safer banking and take stock of where we stand in the development and implementation of new standards.

This is an issue in which, I am sure, you will have a keen interest.

I shall then argue that the concerns of investors and bank supervisors are remarkably well aligned in the long term.

Basel's vision of safe banking

In the past few years, the Basel Committee on Banking Supervision has conducted a **sweeping review of regulatory standards** and it has put in place a strengthened framework that incorporates new macroprudential elements.

This framework is in several ways a great improvement over the pre-crisis regulatory approach.

First of all, it sets a much more conservative minimum ratio for capital that is of far better quality.

When the whole Basel III package is implemented, banks' common equity will need to be **at least 7% of risk-weighted assets**.

This compares to a Basel II level of 2% – and that is before taking account of the changes to definitions and risk weights that make the effective increase in capital all the greater.

Among the improvements in capturing risk on the assets side, I would especially point to the improved treatment of risks arising from securitisation and contingent credit lines.

Moreover, **these risk-based capital requirement measures will be supplemented by a non-risk-based leverage ratio, which will serve as a backstop and limit model risk.**

This new framework responds to the main lessons from the crisis: banks had leveraged excessively, had understated the riskiness of certain assets (particularly those considered practically risk-free), and had made innovations that reduced the loss-absorbing capacity of headline capital ratios.

Second, Basel III takes the notion of a “buffer” much more seriously.

The 7% figure includes a 2.5% capital conservation buffer, which banks can draw upon in difficult times.

Dividends and remuneration will be restricted at times when banks are attempting to conserve capital.

Supervisors will have the discretion to apply an additional, countercyclical buffer when risks show signs of building up in good times, most notably in the form of unusually strong credit growth.

The goal is to build up buffers in good times that banks can draw down in bad times.

Third, the package contains elements to address systemic risk head-on, both by mitigating procyclicality and by cushioning the impact of failures on the entire system.

I have already mentioned the **countercyclical buffer**, which aims to address the procyclical build-up of risk, and the leverage ratio, which will help contain the build-up of excessive leverage in good times.

The framework now also recognises explicitly that stresses at the largest, most complex financial institutions can threaten the rest of the system.

The **Financial Stability Board (FSB)** and the **Basel Committee** envisage that these **systemically important financial institutions, or SIFIs**, will have greater loss absorbency, more intense supervision, stronger resolution and more robust infrastructure.

These aims complement each other, and share a common rationale.

Greater loss absorbency – including capital surcharges that range from 1 to 2.5% for those institutions designated as SIFIs – and better supervision should reduce the probability that problems at these big market players disrupt activity throughout the wider financial system.

Stronger resolution and better infrastructure should reduce the systemic impact of a SIFI's closure or restructuring and thereby strengthen market discipline.

In addition, methods to identify globally systemically important insurers are being developed and should be ready for public consultation by the G20 Leaders' Summit in June 2012.

And, work is under way to address the issue of banks that are systemic on a national rather than a global level, as well as to identify other globally systemic non-bank financial institutions.

Fourth, liquidity standards have been introduced.

These comprise a liquidity coverage ratio, or LCR, and a net stable funding ratio, or NSFR.

The standards will ensure that banks have a stable funding structure and a stock of high-quality liquid assets to meet liquidity needs in times of stress.

Importantly, the group of governors and heads of supervision that oversees the Basel Committee has confirmed that this liquidity buffer is there to be used.

Specifically, banks will be required to meet the 100% LCR threshold in normal times.

But, during a period of stress, supervisors would allow banks to draw down their pools of liquid assets and temporarily to fall below the minimum, subject to specific guidance.

The Committee will clarify its rules to state this explicitly, and will define the circumstances that would justify use of the pool.

Since this is the first time that detailed global liquidity rules have been formulated, we do not have the same experience and high-quality data as we do for capital.

A number of areas will require careful potential impact assessment as we implement these rules.

The Basel Committee has therefore taken a gradual approach in adopting the standards between 2015 and 2018, and will meanwhile assess the impact during an observation period.

At the same time, in order to reduce uncertainty and to allow banks to plan, key aspects of liquidity regulation, such as the pool of high-quality liquid assets, are being reviewed on an accelerated basis.

But any changes will not materially affect the framework's underlying approach, which is to induce banks to lengthen the term of their funding and to improve their risk profiles, instead of simply holding more liquid assets.

Finally, it is time for these new rules and frameworks to be implemented.

The Basel Committee is already engaged in the full, consistent and timely implementation of the framework by national jurisdictions.

To this end, the Committee has started to conduct both peer and thematic reviews through its Standards Implementation Group.

Last October, the Committee published the first regular progress reports on members' implementation of what they have agreed.

Each member will also undergo a more detailed peer review, starting with the EU, Japan and the United States.

And the Committee is currently reviewing the measurement of risk-weighted assets in banking and trading books, with an eye to consistency across jurisdictions.

The goal of these measures is clear: to have a stronger and safer financial system.

This should benefit everyone – the banking industry, users of financial services and taxpayers.

But some may question whether shareholders will benefit as well.

Has the leveraged business model of the past really served them well?

The record, to which I turn next, suggests that it has not.

Shareholder returns and the leveraged business model

Over the long term, banks have turned in a sub-par performance, whether assessed on accounting measures or by return on equity.

Historically, the average return on equity in banking has matched that of other sectors (see Table).

But unlike in other sectors, these returns have involved the generous use of leverage, either on the balance sheet or, frequently, off it.

We know that banking involves leverage and maturity transformation, but the question is how much is appropriate?

There may be no clear answer, but let's look at the data. Bank equity was on average leveraged more than 18 times in 1995–2010. Equity in non-financial firms was leveraged only three times (see Table).

This implies that, compared with other firms, banks have succeeded in delivering only average return on equity over the long term but at the cost of higher volatility and losses in bad times (Graph 1).

Turn now to stock returns and the message does not change much.

Anyone who at the start of 1990 had invested in a portfolio that was long global banking equities and equally short the broad market indices would today be sitting on a loss (Graph 2, right-hand panel).

And, over the long term, risk-adjusted returns have been sub-par.

The main exception is Canada, where banks have barely suffered in the recent crisis (Graph 2, left-hand panel).

It is high leverage that has contributed to the volatility of bank profits. And it is high leverage that makes banks perform so badly on a rainy day.

During periods that comprise the worst 20% of stock market performance, banks do worse than most other sectors (Graph 3, left-hand panel).

Clearly, the flip side is that they do very nicely on sunny days (Graph 3, right-hand panel).

For investors, this is not a compelling value proposition.

To be sure, some may be agile enough to profit from the downside in bank stocks.

But most investors inevitably entered the global financial crisis fully invested or overweight in bank stocks.

And, historically, market timing has proved an elusive strategy.

Not only is the performance of banks over time inconsistent with the notion that shareholders can benefit from high leverage and state support; the evidence across banks actually suggests that the banks that were more strongly capitalised at the outset weathered the crisis better.

The left-hand panel of Graph 4 suggests that no particular relationship existed between Tier 1 capital and the pre-crisis return on equity.

Indeed, banks with stronger Tier 1 equity could and did match the returns of less well capitalised peers.

When the crisis hit, however, the less well capitalised banks scrambled to raise funds in difficult market conditions, while their stronger competitors could avoid fire sales and distressed fund-raising (centre panel).

And it was the banks that had reported high-flying returns before the crisis that were the most likely to resort to fire sales and distressed fund-raising (right-hand panel).

The conclusion is that stronger capital makes a difference.

A further consideration is that it is easier and probably cheaper to raise capital in good times.

Together, these observations suggest that leverage is not the only way to generate returns – and that, when returns don't depend on leverage, they are more sustainable.

What investors can expect from banks

All this indicates that investors could reach a better understanding with bank managements.

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The key is sustained profitability through both good and bad times.

Recent work at the BIS suggests that, when economic activity moves from peak to trough, the betas on bank stocks, relating percentage changes in their value to that of broad market indices, increase by well over 150 basis points.

In effect, banks are generating good returns in good times by writing out-of-the-money puts that come back to haunt them when the market falls.

How did we get here?

The story of a major UK bank is symptomatic.

Twenty years ago, the head of the bank promised investors that the institution would beat its cost of equity, which he took to be 19%.

For a while, the bank was able to achieve this return by closing branches.

But ultimately such promises led bank managers to invest their liquidity reserve in asset-backed securities, boosting earnings in effect by writing puts on both credit and liquidity.

When it came to the crunch, the bank could not keep its return on equity above 20% during the global financial crisis and had to seek help from the state.

Given the trend decline in inflation and government bond yields, 20% in the early 1990s translates to something more like 15% today.

Still, bank managements that continue to promise such returns may find themselves again writing puts, effectively making themselves hostage to bad times in order to pump up returns in good times.

Accounting norms that treat risk premia in good times as distributable profits do not help.

In any case, managements who promise sustained 15% returns in a low-inflation, deleveraging economy may be leading investors astray.

Over time, sustained profitability at more reasonable levels should bring bank share prices back to a premium over book values.

Past behaviour supports this conclusion. In particular, my colleagues estimate that if leverage decreases from 40 to 20, the required return – the return investors demand – drops by 80 basis points.

The intuition is that, when banks increase their equity base (or reduce leverage), they work each unit of equity less – that is, the risk borne by each unit of equity falls—and so does the return investors require.

This prospect would characterise a new long-run understanding between shareholders and bank managements that produce sustained profits. But how should banks get there?

Here I do not refer to the immediate problem banks face in bringing their assets into line with their capital, leading to considerable deleveraging. Instead, I refer to the longer-term problem.

How should banks generate returns in order to be sustainable?

I would argue that such returns can arise from a reconsideration of banks' business models.

In line with the lessons drawn from the crisis by banks, investors and prudential authorities, these models would recognise that our knowledge of systemic risk is incomplete.

As a result, bank managers would seek sustainable profit less in risk-taking and maturity transformation and more in operational and cost efficiency.

Cost efficiency can powerfully contribute to bank earnings.

As a rule of thumb, on average across countries, a 4% reduction in operating expenses translates into roughly a 2 percentage point increase in return on equity.

Moreover, experience strongly suggests that determined attempts to clean up balance sheets and cut costs can go hand in hand with a sustained recovery in profits on the back of a stronger capital base.

This is precisely the experience of Nordic countries, which suffered serious banking crises in the early 1990s (Graph 5).

With costs under control, banks can achieve higher profitability with stronger capital.

Conclusions

Let me pull together the threads of the argument.

The banks that fared better in the crisis were those that were more prudently capitalised.

Investors as well as regulators want to ensure that this wisdom is written into the rules of the game.

The financial reforms that have been agreed will increase the quality and amount of bank capital in the system; they will also promote increases of capital buffers in good times that can be drawn down in bad times.

Big, interconnected and hard-to-replace banks will carry extra capital.

The authorities are working to ensure that no bank is too complex to be wound down. They are refining new liquidity standards.

And they are taking unprecedented steps to make sure that the new regulations are implemented effectively across countries.

The outcome should be a stronger financial system. But regulation is only part of the answer and stronger market discipline will also be necessary to ensure resilience.

I have presented the case that, over the long term, there is no conflict between shareholder value and the public interest in safer banking.

This proposition is supported by the record of return on equity and bank share price performance – a record that refutes the argument that banks have used leverage to produce sustained shareholder value – and the key word here is “sustained”.

Bank returns may have been comparatively high in good times.

But those returns have melted away in bad times.

And they have come at the cost of greater risk.

In the long run, bank business models have produced middling returns with substantial downside risk.

This means that in good times banks have overpromised and overestimated their underlying profitability.

They have written put options on their liquidity and credit and reported the premia as current income.

In effect, they have made distributions out of what should have been treated as expected losses.

How can investors help banks move in the right direction?

They could encourage sustainable business models based less on risk-taking and more on a careful analysis of competitive advantage and operational efficiencies.

And they should be wary of entertaining unrealistic expectations about sustainable rates of return.

Only when solid business models and realistic commitments to sustainable returns are rewarded can shareholder value be reconciled with safe banking.

Indeed, there is no other way.

As a postscript, and for the sake of completeness, let me outline **three** other regulatory initiatives.

First, the FSB, with the involvement of the IMF, the World Bank and standard-setting bodies, will draft an **assessment methodology that provides greater technical detail on the Key Attributes of Effective Resolution Regimes for Financial Institutions**.

The FSB will use the draft methodology to begin, in the second half of 2012, a peer review evaluating member jurisdictions' legal and institutional frameworks for resolution regimes (and of any planned changes).

And supervisors plan to put in place resolution plans and institution-specific cooperation agreements for all 29 G-SIFIs by end-2012.

Second, work continues towards strengthening **OTC derivatives markets**.

This includes meeting the commitments by G20 Leaders to move trading in standardised contracts to exchanges and central counterparties by end-2012.

Market supervisors and settlement system experts are close to finalising standards for strengthening CCPs and other financial market infrastructures.

Meanwhile, banking supervisors are reviewing the incentives for banks to trade and clear derivatives centrally.

Another important initiative here is the establishment of a global, uniform legal entity identifier, for which the FSB, with the support of an industry advisory panel, is developing recommendations to be presented to the next G20 Summit in Mexico in June.

Third, potential risks related to the shadow banking system are being addressed.

Banking supervisors are examining banks' interactions with shadow banking, including issues related to consolidation, large exposure limits, risk weights and implicit support, and will propose any needed changes by July 2012.

Market supervisors are looking at the regulation of money market funds and at issues relating to securitisation on the same schedule.

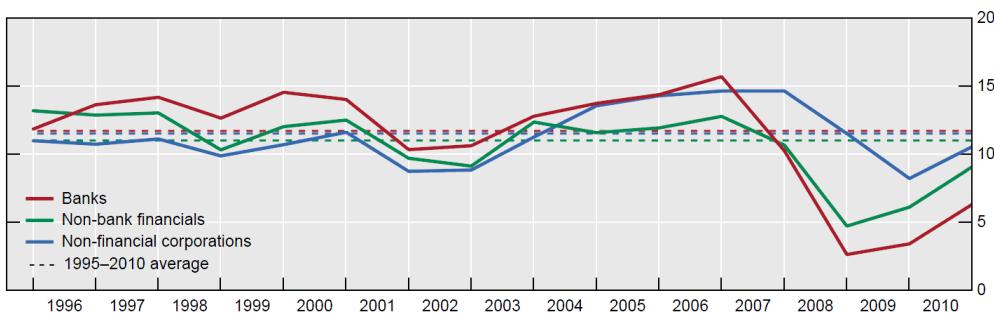
Multidisciplinary FSB task forces are examining other shadow banking entities and, separately, securities lending and repo markets, with a view to making policy recommendations later this year

Table: Profitability and leverage (1995–2009)¹

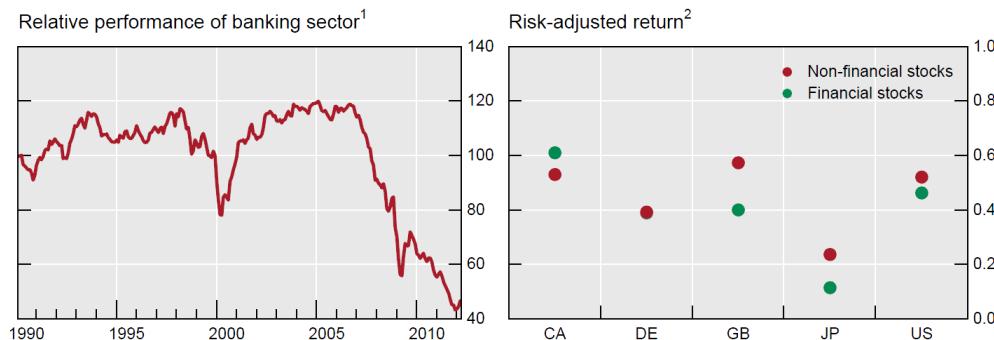
	Return on assets ²				Return on equity ³				Leverage ⁴			
	All years	95–00	01–07	08–09	All years	95–00	01–07	08–09	All years	95–00	01–07	08–09
Banks	0.6	0.7	0.7	0.2	12.2	13.3	12.8	3.2	18.3	17.8	19.1	17.4
Non-bank financials	0.9	1.0	1.0	0.5	11.2	12.3	11.4	5.4	12.1	12.5	12.1	10.8
Non-financials	3.2	3.0	3.4	2.8	11.7	10.9	12.8	9.8	3.0	3.0	3.0	2.9

¹ Medians across firms and years. Sample includes 102 banks, 25 non-bank financials and 250 non-financial companies. ² Net income over total assets, in per cent. ³ Net income over total shareholder funds, in per cent. ⁴ Total assets over total shareholder funds.

Source: Bloomberg.

Graph 1: Median return on equity¹

¹ Net income over total shareholder funds; in per cent.

Graph 2: Underperformance of bank stocks

CA = Canada; DE = Germany; GB = United Kingdom; JP = Japan; US = United States.

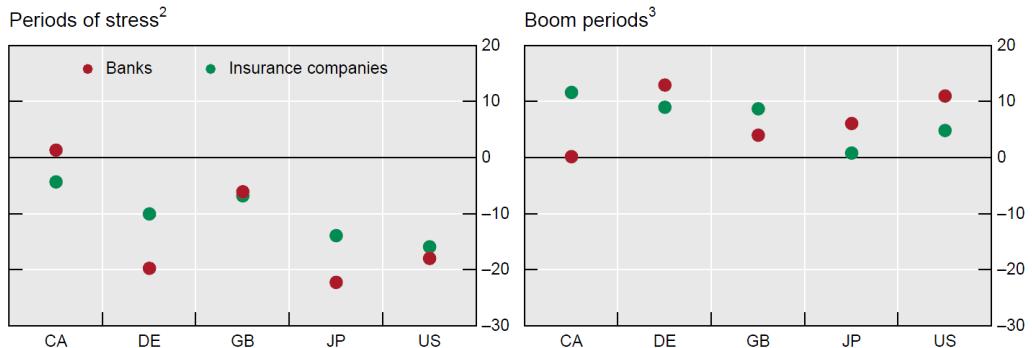
¹ Ratio of banking stock price index to total market index; average for United States, euro area, Japan and United Kingdom; sample period = 100. ² Average return between 1973 and 2010, divided by the corresponding standard deviation of returns.

Sources: Datastream; BIS calculations.

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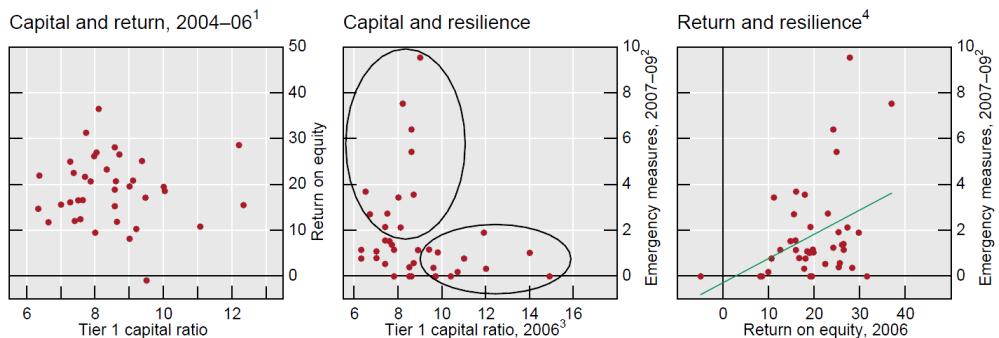


Graph 3: Financial stocks in extreme market events (1973–2010)¹

CA = Canada; DE = Germany; GB = United Kingdom; JP = Japan; US = United States.

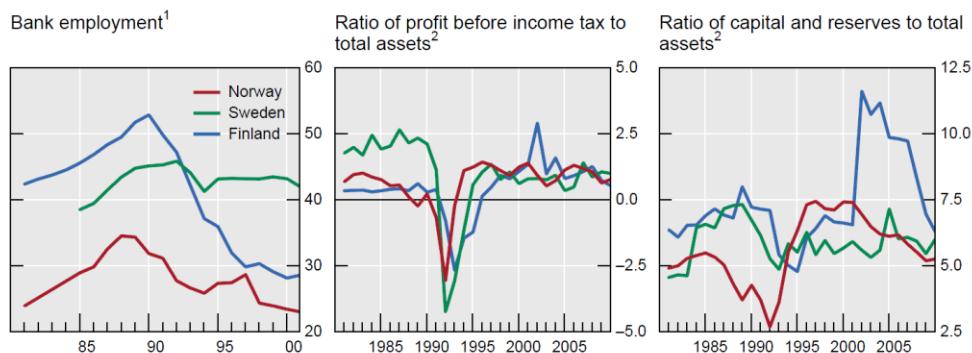
¹ Average quarterly return in each financial subsector minus that in non-financial sectors; annualised; in per cent. ² When the quarterly return in the whole market is equal to or smaller than the 20th percentile of its empirical distribution. ³ When the quarterly return in the whole market is equal to or greater than the 80th percentile of its empirical distribution.

Sources: Datastream; BIS calculations.

Graph 4: Bank characteristics and performance in crisis (40 banks)

¹ Averages for each bank over the period; in per cent. ² Sum of guaranteed debt, capital and hybrid instruments issued and assets sold from mid-2007 to end-2009, divided by total liabilities in 2006; in per cent. ³ At end-year; in per cent. ⁴ The regression line is statistically significant at the 95% confidence level.

Sources: Bankscope; Bloomberg; company reports.

Graph 5: Restructuring after the crisis: Nordic banks

¹ Employees in deposit-taking institutions; in thousands. ² In per cent.

Sources: OECD; BIS calculations.

Jens Weidmann: Global economic outlook – what is the best policy mix?



Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Economic Club of New York, New York, 23 April 2012.

1. Introduction

Ladies and Gentlemen

George Bernard Shaw is said to have made an interesting remark about apples – “If you have an apple and I have an apple and we exchange these apples then you and I will still each have one apple.

But if you have an idea and I have an idea and we exchange these ideas, then each of us will have two ideas.”

I think those words perfectly encapsulate the intention of the Economic Club of New York and of today’s event.

Ideas multiply when you share them and they become better when you discuss them.

I am therefore pleased and honoured to be able to share some ideas with such a distinguished audience today.

And I look forward to discussing them with you.

In a long list of speakers, I am the third Bundesbank President to speak at the Economic Club. The first was Karl Otto Pöhl in 1991, followed by Hans Tietmeyer in 1996.

Although only a few years have passed since then, the global economic landscape has completely transformed in the meantime – just think of the spread of globalisation, think of the introduction of the euro, think of the Asian crisis or the dotcom bubble.

All these events and others have constantly shaped and reshaped our world.

Most recently, we have experienced a crisis that, once again, will change the world as we know it – economically, politically and intellectually.

It is this new unfolding landscape that provides the backdrop to my speech.

I shall address two questions: “Where do we stand?” and “Where do we go from here?”

Of course, it is the second question that is the tricky one.

In answering it, we should be aware that every small step we take now will determine where we stand in the future.

Specifically, I shall argue that measures to ward off immediate risks to the recovery are closely interconnected with efforts to overcome the causes of the crisis.

They are interconnected much more closely and vitally than proponents of more forceful stabilization efforts usually assume.

But, first, let us see where we stand at the present juncture.

2. Where do we stand?

When we look back from where we are standing right now, we see a crisis that has left deep scars.

The International Labour Organisation estimates that up to 56 million people lost their jobs in the wake of the crisis.

This number equals the combined populations of California and the state of New York.

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Or look at government debt: Between 2007 and 2011, gross government debt as a share of GDP increased by more than 20 percentage points in the euro area and by about 35 percentage points in the United States.

I think we all agree that the crisis was unprecedented in scale and scope.

And the first thing to do was to prevent the recession turning into a depression.

Thanks to the efforts of policymakers and central banks across the globe, this has been achieved.

Following a slight setback in 2011, the world economy now seems to be recovering.

In its latest World Economic Outlook, the IMF confirms that global prospects are gradually strengthening and that the threat of sharp slowdown has receded.

Looking ahead, the IMF projects global growth to reach 3.5% in 2012 and 4.1% in 2013.

For the same years, inflation in advanced economies is expected to reach 1.9% and 1.7%.

Basically, I share the IMF's view. However, we all are aware that these estimates have to be taken with a grain of salt – probably a large one.

Being a central banker, I am not quite as calm about inflation.

Taking into account rising energy prices and robust core inflation, prices could rise faster than the IMF expects.

We have to be careful that inflation expectations remain well anchored and consistent with price stability.

Expectations getting out of line might very well turn out to be a non-linear process.

If this were to happen, it would be difficult and expensive to rein in expectations again.

Even though the outlook for growth has improved over the past months, some risks remain – the European sovereign debt crisis being one of them. And this seems to be the one risk that is weighing most heavily on peoples' minds – not just in Europe but here in the United States, too.

The euro-area member states have responded by committing to undertake ambitious reforms and by substantially enlarging their firewalls.

This notwithstanding, the sovereign debt crisis has not yet been resolved.

The renewed tensions over the past two weeks are a case in point.

Thus, we have to keep moving, but each step we take has to be considered very carefully.

As I have already said: each small step we take now will determine where we stand in the future.

3. Where do we go from here?

Eventually, three things will have to happen in the euro area.

First, structural reforms have to be implemented so that countries such as Greece, Portugal and Spain become more competitive.

Second, public debt has to be reduced – a challenge that is not confined to the euro area.

Third, the institutional framework of monetary union has to be strengthened or overhauled, and we need more clarity about which direction monetary union is going to take.

I think we all agree on this – including the IMF in its latest World Economic Outlook.

However, there is much less agreement on the correct timing.

Since the crisis began, the imperatives I have just mentioned have tended to be obscured by short-term considerations.

And surprisingly, this tendency seems to be becoming stronger now that the world economy is getting back on track.

This view is reflected by something Lawrence Summers wrote in the Financial Times about four weeks ago.

Referring to the US, he said that “*... the most serious risk to recovery over the next few years [...] is that policy will shift too quickly away from its emphasis on maintaining adequate demand, towards a concern with traditional fiscal and monetary prudence.*”

It is in this spirit that some observers are pushing for policies that eventually boil down to “more of the same”: firewalls and ex ante risk sharing in the euro area should be extended, consolidation of public debt should be postponed or, at least, stretched over time, and monetary policy should play an even bigger role in crisis management.

I explicitly do not wish to deny the necessity of containing the crisis.

But all that can be gained is the time to address the root problems.

The proposed measures would buy us time, but they would not buy us a lasting solution.

And five years after the bursting of the subprime bubble and three years after the turmoil in the wake of the Lehman insolvency, we have to ask ourselves: Where will it take us if we apply these measures over and over again – measures which are obviously geared towards alleviating the symptoms of the crisis but which fail to address its underlying causes?

In my view, this would take us nowhere.

There are **two reasons for this.**

First, the longer such a strategy is applied, the harder it becomes to change track.

More and more people will realise this and they will **start to lose confidence.**

They will lose confidence in policymakers' ability to bring about a lasting solution to our problems.

And we should bear in mind that **the crisis is primarily a crisis of confidence:** of confidence in the sustainability of public finances, in competitiveness and, to some extent, in the workings of EMU.

But there is a **second** reason why the “more of the same” will not take us anywhere.

The analgesic we administer comes with side effects.

And the longer we apply it, the greater these side effects will be, and they will come back to haunt us in the future.

In the end, it is just not possible to separate the short and the long term.

You will be tomorrow what you do today.

With these two caveats in mind, let us take a closer look at the suggested policy mix.

For the sake of brevity, I shall focus on monetary and fiscal policies.

3.1 An even bigger role for monetary policy?

To contain the crisis, the EMU member states have built a wall of money that recently reached the staggering height of **700 billion euros**.

As I have already said, ring-fencing is certainly necessary, but again: it is not a lasting solution.

And it is not the sky that's the limit – the limits are financial and political.

In the face of such limits, the Eurosystem is now seen as the “last man standing”.

Consequently, **some observers are demanding that it play an even bigger role in crisis management**.

More specifically, such demands include lower interest rates, more liquidity and larger purchases of assets.

But does the assumption on which these demands are based hold true when we take a closer look at it?

In the end, monetary policy is not a panacea and central bank “firepower” is not unlimited, especially not in monetary union.

True, this crisis is exceptional in scale and scope, and extraordinary times do call for extraordinary measures.

But the central banks of the Eurosystem have already done a lot to contain crisis.

Now we have to make sure that by solving one crisis, we are not preparing the ground for the next one.

Take, for example, the side effects of low interest rates.

Research has found that risk-taking becomes more aggressive when central banks apply unconditional monetary accommodation in order to counter a correction of financial exaggeration, especially if monetary policy does not react symmetrically to the build-up of financial imbalances.

In the end, putting too much weight on countering immediate risks to financial stability will create even greater risks to financial stability and price stability in the future.

The Eurosystem has applied a number of unconventional measures to maintain financial stability.

These measures helped to prevent an escalation of the financial turmoil and constitute a virtually unlimited supply of liquidity to banks.

But monetary policy cannot substitute for other policies and must not compensate for policy inaction in other areas.

If the Eurosystem funds banks that are not financially sound, and does so against inadequate collateral, it redistributes risks among national taxpayers.

Such implicit transfers are beyond the mandate of the euro area's central banks.

Rescuing banks using taxpayers' money is something that should only be decided by national parliaments.

Otherwise, monetary policy would nurture the deficit bias that is inherent to a monetary union of sovereign states.

In this regard, the situation of the Eurosystem is fundamentally different from that of the Federal Reserve or that of the Bank of England.

Moreover, extensive and protracted funding of banks by the Eurosystem replaces or displaces private investors.

This breeds the risk that some banks will not reform unviable business models.

So far, progress in this regard has been very limited in a number of euroarea countries.

And the Eurosystem has also relieved stress in the sovereign bond market.

However, we should not forget that market interest rates are an important signal for governments regarding the state of their finances and that they are an important incentive for reforms.

Of course, markets do not always get it right.

They may have underestimated sovereign risks for a long time and now they are overestimating it.

But past experience taught us that their signal is still the most powerful incentive we have.

At any rate, I would not rely on political insight or political rules alone.

After all, monetary policy must not lose sight of its primary objective: to maintain price stability in the euro area as a whole.

What does this mean?

Let us say that monetary policy becomes too expansionary for Germany, for instance.

If this happens, Germany has to deal with this using other, national instruments.

But by the same token, we could say this: even if we are concerned about the impact on the peripheral countries, monetary policymakers must do what is necessary once upside risks for euro-area inflation increase.

Delivering on its primary goal of maintaining price stability is essential for safeguarding the most precious resource a central bank can command: credibility.

To sum up: what we do in the short-term has to be consistent with what we are trying to achieve in the long-term – price stability, financial stability and sound public finances.

This implies a delicate balancing act – a balancing act we shall upset if we overburden monetary policy with crisis management.

3.2 Rethinking consolidation and structural reforms?

Now, what about consolidation and structural reforms?

Here, too, we have to strike the right balance between the short and the long run.

Those who propose putting off consolidation and reforms argue that embarking on ambitious consolidation efforts or far-reaching structural reforms at the present moment would place too great a burden on recovery.

They do not deny the necessity of such steps over the medium term, but in the short-run they consider it more important to maintain adequate demand, avoid unsettling people and nurture the recovery.

But in the end, the current crisis is, to a large degree, a crisis of confidence.

And if already announced consolidation and reforms were to be delayed, would people not lose even more confidence in policymakers' ability to get to the root of the crisis?

We can only win back confidence if we bring down excessive deficits and boost competitiveness.

And it is precisely because these things are unpopular that makes it so tempting for politicians to rely instead on monetary accommodation.

It is true that consolidation, in particular, might, under normal circumstances, dampen aggregate demand and economic growth.

But the question is: **are these normal circumstances?**

It is quite obvious that everybody sees public debt as a major threat.

The markets do, politicians do, and people on Main Street do.

A widespread lack of trust in public finances weighs heavily on growth: there is uncertainty regarding potential future tax increases, while funding costs are rising for private and public creditors alike.

In such a situation, consolidation might inspire confidence and actually help the economy to grow.

In my view, the risks of frontloading consolidation are being exaggerated. In any case, there is little alternative.

In the end, you cannot borrow your way out of debt; cut your way out is the only promising approach.

4. Conclusion

Allow me to conclude by going back to the beginning of my speech where I mentioned the benefits of sharing and discussing ideas.

I have stressed that we have to embark on reforms that make the crisis countries more competitive; that we have to reduce public debt and that we have to further improve the institutional framework of monetary union.

But the spirit of my argument was expressed succinctly some 20 years ago by Karl Otto Pöhl.

In his speech at the Economic Club he said: “**The true function of a central bank must be, however, to take a longer-term view.**”

And after five years of crisis, the long term might catch up with us faster than we expect.

We therefore have to think about the future now – and we have to act accordingly as well. Thank you for your attention.

Andreas Dombret: Towards a more sustainable Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Euromoney Germany Conference, Berlin, 25 April 2012.

1 Introduction

Ladies and Gentlemen

I am delighted to have the opportunity to speak to you today at the Euromoney Germany conference.

Now in its 8th year, the conference has established itself as a first-class opportunity for policymakers and financial practitioners to exchange views.

I firmly believe that this free flow of ideas is of benefit to us all, and I am looking forward to sharing my views with you in the next 20 minutes.

We are facing a crisis that is no longer confined to individual countries.

Throughout and beyond Europe, it weighs heavily on people's minds.

Some believe, it even challenges the viability of monetary union in its current form.

Given the exceptional scale and scope of the crisis, it is hardly surprising that views diverge on how to overcome it.

But it is worth recalling that despite intense debates on the best way forward, we share a common vision for the future of our monetary union: a sound currency, sound public finances, competitive economies, and a stable financial system.

These are the principles enshrined in the Maastricht Treaty.

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With the adoption of the treaty, all euro-area member states committed to a European stability culture.

Among those most eager to join were the countries with first-hand experience of the painful consequences of deficits spiralling out of control and of a monetary policy not always fully committed to maintaining price stability.

The unholy “marriage” between Banca d’Italia and the Italian treasury in 1975 is a perfect example.

Banca d’Italia vowed to act as buyer of last resort for government bonds.

Up to the “divorce” in 1981, Italian government debt more than tripled while average inflation stood at 17%.

After Banca d’Italia was granted greater independence, inflation rates began to fall significantly.

The principles of a sound currency, sound public finances and a competitive economy thus remain the cornerstones of a strong and sustainable monetary union.

Far from being a specifically German conviction, they serve the well-being of citizens throughout the euro area.

And the ongoing validity of these principles is a prerequisite for the public acceptance of monetary union.

Thus, any approach that does not respect and comply with these principles will not bring about a lasting solution to the crisis.

The current crisis is not a crisis of the euro as our common currency. Since the start of the euro, inflation has been in line with the Eurosystem’s definition of price stability, and the euro continues to be a strong currency – to some, it actually appears to be too strong.

But it is generally accepted that the two central elements of the crisis are large macroeconomic imbalances stemming from diverging competitiveness levels, and unsustainable levels of public debt.

2 The root causes of the crisis: macroeconomic imbalances and over-indebtedness

No lasting solution to the crisis will be achieved unless these root causes are tackled.

Firewalls can help some countries to cope better with the effects of sudden shifts in investor sentiment, but, ultimately, all it can do is buy time.

As the IMF points out in its recent World Economic Outlook , firewalls by themselves cannot solve the difficult fiscal, competitiveness and growth issues that some countries are now facing.

2.1 Macroeconomic imbalances

There is broad consensus that macroeconomic imbalances, which have built up in recent years, lie at the heart of the crisis.

But the best way to correct these imbalances has been the subject of intense debate.

Exchange rate movements are usually an important channel through which unsustainable current account positions are corrected – deficit countries eventually see a devaluation, while surplus tend to revalue their currencies.

The reactions that this triggers in imports, exports and corresponding capital flows then help to bring the current account back closer to balance.

In a monetary union, however, this is obviously no longer an option.

Spain no longer has a peseta to devalue; Germany no longer has a deutsche mark to revalue.

Other things must therefore give instead: prices, wages, employment and output.

The question now is which countries have to shoulder the adjustment burden.

Naturally, this is where opinions start to differ.

The German position could be described as follows: the deficit countries must adjust.

They must address their structural problems, reduce domestic demand, become more competitive and increase their exports.

But this position has not gone uncontested.

Indeed, well-known commentators suggest that surplus countries should bear part of the adjustment burden in order to avoid deflation in deficit countries.

They also point out that not all countries can act like Germany, in other words, not all countries can run a current account surplus.

Hence, they suggest that surplus countries should shoulder at least part of the burden.

But this criticism misses the point of what the correction of domestic imbalances actually means:

As regards the lingering threat of a protracted deflation, it is rather a one-off reduction of prices and wages that is required, not a lasting deflationary process.

In fact, frontloading reforms and necessary adjustment has proven to be more successful than protracted adjustment, as experience in the Baltic states and Ireland shows.

And while not all countries can run a current account surplus, all can become more competitive – higher competitiveness due to productivity increases or lower monopoly rents in, up to now, overregulated sectors is not a zero sum game.

Structural reforms can unlock the potential to increase productivity and thus improve competitiveness without inducing deflation.

There is no way around the fact that Europe is part of a globalised world.

And, at the global level, we are competing with economies such as the United States or China.

To succeed, **Europe as a whole has to become more dynamic, more inventive and more productive.**

Once the deficit countries start to become more competitive, surplus countries will adjust automatically.

They will become less competitive in relative terms, exporting less and importing more.

And we should acknowledge that this process has already been set in motion.

Exports of a number of peripheral countries have started to grow, bringing down current account deficits in the process.

Correspondingly, German imports from the euro area have grown strongly over the last two years, almost halving the current account surplus between 2007 and 2011.

To facilitate the adjustment process, euro area members have committed significant funds within the framework of the EFSF and the ESM. Germany is contributing the biggest share.

This support is based on the high reputation Germany enjoys among investors.

We would put this trust in jeopardy if we were to give in to calls for fiscal stimulus in Germany in order to raise demand for imports from the peripheral euro area.

But **weakening Germany's fiscal position would lead to higher refinancing costs and, therefore, either reduce the capacity of the firewalls or raise the borrowing costs for programme countries.**

Moreover, studies by the IMF suggest that positive spill-over effects from an increase in German demand to partner countries in the euro area would be minimal.

So, instead of stimulating exports in peripheral euro-area countries, additional fiscal stimulus at a time when Germany's economy is already running at normal capacity would be of detriment to all parties.

2.2 Fiscal consolidation

Turning to fiscal consolidation, it is often stressed that such measures, together with structural reforms, would be too much of a burden.

They would create a vicious circle of decreasing demand and further budget pressure that would eventually bring the economy down.

But to the extent that the current output level was fuelled by an unsustainable ballooning of private and public debt, correction as such is unavoidable, and the only question that remains is that of the best timing.

However, **this crisis is a crisis of confidence.**

While, under normal circumstances, consolidation might dampen the economy, the lack of trust in public finances and in policymakers' willingness to act is a huge burden for growth.

Thus, frontloaded, and therefore credible, consolidation would instead strengthen confidence, actually help the economy to grow and reduce the danger of the crisis spreading to the financial system.

In addition, urgently needed structural reforms and consolidation are often hard to disentangle.

For example, a bloated public sector or very generous pension system are both a drag on growth and a burden on the budget.

The same applies to inefficient companies that are state-owned or operate in highly regulated sectors.

The risks to growth emanating from immediate fiscal consolidation therefore have to be put into perspective.

Negative short-term effects cannot be ruled out.

But to the extent that consolidation constitutes necessary corrections of an unsustainable development and brings about greater efficiency, the long-term gains do not only vastly exceed potential short-term pain, they also help to alleviate it now by restoring the lost credibility in the ability to tackle the root causes of the crisis.

3 The role of monetary policy

Up to now, the picture has been mixed in this regard.

We have seen substantial progress, often initiated by new, more reform-minded governments, but also some setbacks.

A much clearer pattern has emerged with respect to the expectations placed on monetary policy.

Whenever a new intensification of the crisis looms, the first question seems to be “What can the central banks do about this?”

To me, this is a **worrisome development**. Monetary policy has already gone a very long way towards containing the crisis.

But we have to be aware that the medicine of a very low interest rate policy, ample provision of liquidity at very favourable conditions and large-scale financial market intervention does not come without side effects – which are all the more severe, the longer the drug is administered.

In the course of this crisis, the role of central banks has changed fundamentally.

Before the crisis, they provided scarce liquidity; now they increasing serve as a regular source of funding for banks, and this threatens to replace or displace private investors.

This may give rise to new financial instability if, as a result of the measures, banks and investors behave carelessly or embark on unsustainable business models, for instance, due to substantial carry trades.

But emergency measures will not become the “new normal”.

Banks, investors and governments have to be fully aware of this, and central banks cannot tolerate that their well-intentioned emergency

measures result in a delay in necessary adjustments in the financial sector or protracted consolidation and reform efforts among governments.

4 Conclusion

Ladies and Gentlemen, In my remarks, I have focused on necessary reforms in the euro area member states.

This is not to say that changes to the institutional set-up of monetary union are not important.

If member states want to retain autonomy with regard to fiscal policy, we need stricter rules to account for the incentives to accumulate debt that exist in a monetary union.

The fiscal compact is a promising step forward. Now, it is essential that the rules are applied rigorously.

Referring to the motto of this conference “A German Europe or a European Germany”, how should one label the recipe to overcome the crisis that I have just presented?

Well, it is, quite obviously, a European solution.

And that is because it fully reflects and respects the letter as well as the spirit of the European Treaty and therefore of the principles that I stressed at the beginning.

The current crisis is most certainly a defining moment for monetary union.

But the crisis and the measures taken to overcome it should not be allowed to redefine implicitly what monetary union actually is.

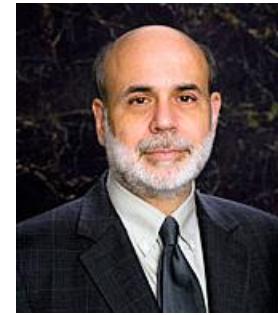
This time we really cannot “let this crisis go to waste”, as the former White House chief of staff, Rahm Emanuel, put it. The crisis has laid bare structural flaws at many levels.

It has questioned the way we adhered to the principles of EMU, but did not invalidate the principles themselves, quite the contrary.

I am confident that having stared into the abyss, Europe will make the right choices and pave the way for a more prosperous and sustainable future – to the benefit of Germany as well as of the euro area as a whole.

**Speech, Chairman Ben S. Bernanke
At the Russell Sage Foundation and The Century
Foundation Conference on "Rethinking Finance"
New York**

**Some Reflections on the Crisis and the Policy
Response**



I would like to thank the conference organizers for the opportunity to offer a few remarks on the causes of the 2007-09 financial crisis as well as on the Federal Reserve's policy response.

The topic is a large one, and today I will be able only to lay out some basic themes.

In doing so, I will draw from talks and testimonies that I gave during the crisis and its aftermath, particularly my testimony to the Financial Crisis Inquiry Commission in September 2010.

Given the time available, I will focus narrowly on the financial crisis and the Federal Reserve's response in its capacity as liquidity provider of last resort, leaving discussions of monetary policy and the aftermath of the crisis to another occasion.

Triggers and Vulnerabilities

In its analysis of the crisis, my testimony before the Financial Crisis Inquiry Commission drew the distinction between triggers and vulnerabilities.

The triggers of the crisis were the particular events or factors that touched off the events of 2007-09--the proximate causes, if you will.

Developments in the market for subprime mortgages were a prominent example of a trigger of the crisis.

In contrast, the **vulnerabilities** were the ***structural, and more fundamental, weaknesses*** in the financial system and in regulation and supervision that served to propagate and amplify the initial shocks.

In the **private sector**, some key vulnerabilities included **high levels of leverage; excessive dependence on unstable short-term funding; deficiencies in risk management in major financial firms; and the use of exotic and nontransparent financial instruments that obscured concentrations of risk.**

In the **public sector**, my list of vulnerabilities would include **gaps in the regulatory structure** that allowed systemically important firms and markets to escape comprehensive supervision; failures of supervisors to effectively apply some existing authorities; and insufficient attention to threats to the stability of the system as a whole (that is, the lack of a macroprudential focus in regulation and supervision).

The distinction between triggers and vulnerabilities is helpful in that it allows us to better understand why the factors that are often cited as touching off the crisis seem disproportionate to the magnitude of the financial and economic reaction.

Consider subprime mortgages, on which many popular accounts of the crisis focus.

Contemporaneous data indicated that the **total quantity of subprime mortgages outstanding in 2007 was well less than \$1 trillion; some more-recent accounts place the figure somewhat higher.**

In absolute terms, of course, the potential for losses on these loans was large--on the order of hundreds of billions of dollars.

However, **judged in relation to the size of global financial markets, aggregate exposures to subprime mortgages were quite modest.**

By way of comparison, it is not especially uncommon for one day's paper

losses in global stock markets to exceed the losses on subprime mortgages suffered during the entire crisis, without obvious ill effect on market functioning or on the economy.

Thus, losses on subprime mortgages can plausibly account for the **massive reaction** seen during the crisis only insofar as they interacted with other factors--more fundamental vulnerabilities--that served to amplify their effects.

On the surface, the puzzle of **disproportionate cause and effect** seems somewhat less stark if one takes the boom and bust in the U.S. housing market as the trigger of the crisis, as the paper gains and losses associated with the swing in house prices were many times the losses associated directly with subprime loans.

Indeed, the 30 percent or so aggregate decline in house prices since their peak has by now **eliminated nearly \$7 trillion in paper wealth**.

However, on closer examination, it is not clear that even the large movements in house prices, in the absence of the underlying weaknesses in our financial system, can account for the magnitude of the crisis.

First, much of the decline in house prices has occurred since the most intense phase of the crisis; the decline in prices since September 2008 is probably better viewed as largely the result of, rather than a cause of, the crisis and ensuing recession.

More fundamentally, however, any theory of the crisis that **ties its magnitude to the size of the housing bust** must also explain why the fall of dot-com stock prices just a few years earlier, which destroyed as much or more paper wealth--more than \$8 trillion--resulted in a relatively short and mild recession and no major financial instability.

Once again, the explanation of the differences between the two episodes must be that **the problems in housing and mortgage markets interacted with deeper vulnerabilities in the financial system in ways that the**

dot-com bust did not.

So let me turn, then, to a discussion of those vulnerabilities and how they amplified the effects of triggers like the collapse of the subprime mortgage market.

A number of the vulnerabilities I listed a few moments ago were associated with the increased importance of the so-called shadow banking system.

Shadow banking, as usually defined, comprises a diverse set of *institutions and markets that, collectively, carry out traditional banking functions*--but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions.

Examples of important components of the shadow banking system include **securitization vehicles, asset-backed commercial paper (ABCP) conduits, money market mutual funds, markets for repurchase agreements (repos), investment banks, and mortgage companies**.

Before the crisis, the shadow banking system had come to play a major role in global finance.

Economically speaking, as I noted, shadow banking bears strong functional similarities to the traditional banking sector.

Like traditional banking, the shadow banking sector facilitates maturity transformation (that is, it is used to fund longer-term, less-liquid assets with short-term, more-liquid liabilities), and it channels savings into specific investments, mostly debt-like instruments.

In part, the rapid growth of shadow banking reflected various types of regulatory arbitrage--for example, the minimization of capital requirements.

However, instruments that fund the shadow banking system, such as

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money market mutual funds and repos, also met a rapidly growing demand among investors, generally large institutions and corporations, seeking cash-like assets for use in managing their liquidity.

Commercial banks were limited in their ability to meet this growing demand by prohibitions on the payment of interest on business checking accounts and by relatively low limits on the size of deposit accounts that can be insured by the Federal Deposit Insurance Corporation (FDIC).

As became apparent during the crisis, a key vulnerability of the system was the **heavy reliance of the shadow banking sector**, as well as some of the largest global banks, on various forms of short-term wholesale funding, including commercial paper, repos, securities lending transactions, and interbank loans.

The **ease, flexibility, and low perceived cost** of short-term funding also supported a broader trend toward higher leverage and greater maturity mismatch in individual shadow banking institutions and in the sector as a whole.

While banks also rely on short-term funding and leverage, they benefit from a government-provided safety net, including deposit insurance and backstop liquidity provision by the central bank.

Shadow banking activities do not have these safeguards, so they employ alternative mechanisms to gain investor confidence.

Among these mechanisms are the **collateralization of many shadow banking liabilities; regulatory or contractual restrictions placed on portfolio holdings, such as the liquidity and credit quality requirements applicable to money market mutual funds; and the imprimaturs of credit rating agencies.**

Indeed, the very foundation of shadow banking and its rapid growth before the crisis was the **widely held view** (among both investors and regulators) that these safeguards would protect shadow banking activities

against runs and panics, similar to the protection given to commercial banking by the government safety net.

Unfortunately, this view turned out to be wrong.

When it became clear to investors that these alternative protections might not be adequate to protect against losses, widespread flight from the shadow banking system occurred, with pernicious dynamics reminiscent of the banking panics of an earlier era.

Although the vulnerabilities associated with short-term wholesale funding and excessive leverage can be seen as **structural weaknesses** of the global financial system, they can also be viewed as a **consequence of poor risk management** by financial institutions and investors, which I would count as another major vulnerability of the system before the crisis.

Unfortunately, the crisis revealed a **number of significant defects in private-sector risk management and risk controls**, importantly including insufficient capacity by many large firms to track firm wide risk exposures, such as **off-balance-sheet exposures**.

This lack of capacity by major financial institutions to track firm wide risk exposures led in turn to **inadequate risk diversification**, so that losses--rather than being dispersed broadly--proved in some cases to be **heavily concentrated** among relatively few, highly leveraged companies.

Here, I think, is the principal explanation of why the busts in dot-com stock prices and in the housing and mortgage markets had such markedly different effects.

In the case of dot-com stocks, losses were spread relatively widely across many types of investors.

In contrast, following the housing and mortgage bust, **losses were felt disproportionately at key nodes** of the financial system, notably highly leveraged banks, broker-dealers, and securitization vehicles.

Some of these entities were forced to engage in **rapid asset sales at fire-sale prices**, which **undermined confidence** in counterparties exposed to these assets, led to sharp withdrawals of funding, and disrupted financial intermediation, with severe consequences for the economy.

Private-sector risk management also failed to keep up with financial innovation in many cases.

An important example is the extension of the traditional **originate-to-distribute** business model to encompass increasingly complex securitized credit products, with wholesale market funding playing a key role.

In general, the originate-to-distribute model breaks down the process of credit extension into components or stages--from origination to financing and to the post financing monitoring of the borrower's ability to repay--in a manner reminiscent of how manufacturers distribute the stages of production across firms and locations.

This general approach has been used in various forms for many years and **can produce significant benefits**, including lower credit costs and increased access of consumers and small and medium-sized businesses to capital markets.

However, the **expanded use** of this model to finance subprime mortgages through securitization was mismanaged at several points, including the initial underwriting, which deteriorated markedly, in part because of **incentive schemes that effectively rewarded originators for the quantity rather than the quality of the mortgages extended.**

Loans were then packaged into securities that proved complex, opaque, and unwieldy; for example, when defaults became widespread, the legal agreements underlying the securitizations made reasonable modifications of troubled mortgages difficult.

Rating agencies' ratings of asset-backed securities were revealed to be

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subject to conflicts of interest and faulty models.

At the end of the chain were investors who often relied mainly on ratings and did not make distinctions among AAA-rated securities.

Even if the ultimate investors wanted to do their own credit analysis, the information needed to do so was often difficult or impossible to obtain.

Dependence on short-term funding, high leverage, and inadequate risk management were critical vulnerabilities of the private sector prior to the crisis.

Derivative transactions further increased risk concentrations and the vulnerability of the system, notably by shifting the location and apparent nature of exposures in ways that were not transparent to many market participants.

But even as private-sector activities increased systemic risk, the public sector also failed to appreciate or sufficiently respond to the building vulnerabilities in the financial system--both because the statutory framework of financial regulation was not well suited to addressing some key vulnerabilities and because some of the authorities that did exist were not used effectively.

In retrospect, it is clear that the statutory framework of financial regulation in place before the crisis contained serious gaps.

Critically, shadow banking activities were, for the most part, not subject to consistent and effective regulatory oversight.

Much shadow banking lacked meaningful prudential regulation, including various special purpose vehicles, ABCP conduits, and many nonbank mortgage-origination companies.

No regulatory body restricted the leverage and liquidity policies of these entities, and few if any regulatory standards were imposed on the quality of their risk management or the prudence of their risk-taking.

Market discipline, imposed by creditors and counterparties, helped on some dimensions but did not effectively limit the systemic risks these entities posed.

Other shadow banking activities were potentially subject to some prudential oversight, but weaknesses in the statutory and regulatory framework meant that in practice they were inadequately regulated and supervised.

For example, the Securities and Exchange Commission supervised the **largest broker-dealer holding** companies but only through an opt-in arrangement that lacked the force of a statutory regulatory regime.

Large broker-dealer holding companies faced serious losses and funding problems during the crisis, and the instability of such firms as **Bear Stearns and Lehman Brothers** severely damaged the financial system.

Similarly, the insurance operations of **American International Group, Inc. (AIG)**, were supervised and regulated by various state and international insurance regulators, and the Office of Thrift Supervision had authority to supervise AIG as a thrift holding company.

However, oversight of AIG Financial Products, which housed the derivatives activities that imposed major losses on the firm, was extremely limited in practice.

The gaps in statutory authority had the additional effect of **limiting the information available to regulators and, consequently, may have made it more difficult to recognize the underlying vulnerabilities and complex linkages in the overall financial system.**

Shadow banking institutions that were unregulated or lightly regulated were typically **not required to report data that would have adequately revealed their risk positions or practices.**

Moreover, the lack of preexisting reporting and supervisory relationships

hindered systematic gathering of information that might have helped policymakers in the early days of the crisis.

A broader failing was that regulatory agencies and supervisory practices were focused on the safety and soundness of individual financial institutions or markets--what we now refer to as microprudential supervision.

In the United States and most other advanced economies, **no governmental entity had either a mandate or sufficient authority--now often called macroprudential authority**--to take actions to limit systemic risks that could result from the collective behavior of financial institutions and markets.

Gaps in the statutory framework were an important reason for the buildup of risk in certain parts of the system and for the inadequate response of the public sector to that buildup.

But even when the relevant statutory authorities did exist, they were not always used forcefully or effectively enough by regulators and supervisors, including the Federal Reserve.

Notably, **bank regulators did not do enough to force large financial institutions to strengthen their internal risk-management systems or to curtail risky practices.**

The Federal Reserve's **Supervisory Capital Assessment Program**, undertaken in the spring of 2009 and popularly known as the "**stress tests**," played a critical role in restoring confidence in the U.S. banking system, but it also demonstrated that many institutions' information systems could not provide timely, accurate information about bank exposures to counterparties or complete information about the aggregate risks posed by different positions and portfolios.

Regulators had recognized these problems in some cases but did not press firms vigorously enough to fix them.

Even without a macroprudential mandate, regulators could also have done more to try to mitigate risks to the broader financial system.

In retrospect, stronger bank capital standards--notably those relating to the quality of capital and the amount of capital required for banks' trading book assets--and more attention to the liquidity risks faced by the largest, most interconnected firms would have made the financial system as a whole more resilient.

The Crisis as a Classic Financial Panic

Having laid out some of the triggers and vulnerabilities that set the stage for the crisis, I can briefly sketch the evolution of the crisis itself. As I have noted, developments in housing and mortgage markets played an important role as triggers.

Beginning in 2007, declining house prices and rising rates of foreclosure raised serious concerns about the values of mortgage-related assets and considerable uncertainty about where those losses would fall.

The economy officially fell into recession in December 2007, following several months of financial stress.

However, the most severe economic consequences followed the extreme market movements in the fall of 2008.

To a significant extent, the crisis is best understood as a classic financial panic--differing in details but fundamentally similar to the panics described by **Bagehot** and many others.

The most familiar type of panic that has occurred historically, involving runs on banks by retail depositors, had been made largely obsolete by deposit insurance, central bank backstop liquidity facilities, and the associated government supervision of banks.

But a panic is possible in any situation in which longer-term, illiquid

assets are financed by short-term, liquid liabilities and in which providers of short-term funding either lose confidence in the borrower or become worried that other short-term lenders may lose confidence.

The **combination** of dependence on wholesale, short-term financing; excessive leverage; generally poor risk management; and the gaps and weaknesses in regulatory oversight created an environment in which a powerful, self-reinforcing panic could begin.

Indeed, panic-like phenomena arose in multiple contexts and in multiple ways during the crisis.

The **repo market**, a major source of short-term credit for many financial institutions, notably including the independent investment banks, was an important example.

In repo agreements, loans are **collateralized by financial assets**, and the maximum amount of the loan is the current assessed value of the collateral less a safety margin, or haircut.

The secured nature of repo agreements gave firms and regulators confidence that runs were unlikely.

But this confidence was misplaced.

Once the crisis began, **repo lenders became increasingly concerned about the possibility that they would be forced to receive collateral instead of cash, collateral that would then have to be disposed of in falling and illiquid markets.**

In some contexts, lenders responded by imposing increasingly higher haircuts, cutting the effective amount of funding available to borrowers.

In other contexts, **lenders simply pulled away, as in a deposit run; in these cases, some borrowers lost access to repo entirely, and some securities became unfundable in the repo market.**

In either case, absent sufficient funding, borrowers were frequently left with no option but to sell assets into illiquid markets.

These forced sales drove down asset prices, increased volatility, and weakened the financial positions of all holders of similar assets.

Volatile asset prices and weaker borrower balance sheets in turn heightened the risks borne by repo lenders, further boosting the incentives to demand higher haircuts or withdraw funding entirely.

This unstable dynamic was operating in full force around the time of the near failure of **Bear Stearns** in March 2008, and again during the worsening of the crisis in mid-September of that year.

Classic panic-type phenomena occurred in other contexts as well. Early in the crisis, **structured investment vehicles** and many other asset-backed programs were **unable to roll over their commercial paper** as investors pulled back, and the programs were forced to draw on liquidity lines from banks or to sell assets.

The resulting pressure on the bank liquidity providers, evident especially in the market for dollar-denominated loans in short-term funding markets, impeded the functioning of the financial system throughout the crisis.

Following the **Lehman** collapse and the "breaking of the buck" by a money market mutual fund that held commercial paper issued by Lehman, both money market mutual funds and the commercial paper market were also subject to runs.

More generally, during the crisis, **runs of short-term uninsured creditors created severe funding problems for a number of financial firms, including several large broker-dealers and also some bank holding companies.**

In some cases, withdrawals of funds by creditors were augmented by "runs" in other guises--for example, **by prime brokerage customers** of

investment banks concerned about the safety of cash and securities held at those firms or by derivatives counterparties demanding additional margin.

Overall, the emergence of run-like phenomena in a variety of contexts helps explain the remarkably sharp and sudden intensification of the financial crisis, its rapid global spread, and the fact that standard market indicators largely failed to forecast the abrupt deterioration in financial conditions.

The multiple instances of run-like behavior during the crisis, together with the associated sharp increases in liquidity premiums and dysfunction in many markets, motivated much of the Federal Reserve's policy response.

Bagehot advised central banks--the only institutions that have the power to increase the aggregate liquidity in the system--to respond to panics by lending freely against sound collateral.

Following that advice, from the beginning of the crisis, the Fed, like other major central banks, provided large amounts of short-term liquidity to financial institutions, including primary dealers as well as banks, on a broad range of collateral.

Reflecting the contemporary institutional environment, it also provided backstop liquidity support for components of the shadow banking system, **including money market mutual funds, the commercial paper market, and the asset-backed securities markets.**

To be sure, the provision of liquidity alone can by no means solve the problems of credit risk and credit losses, but it can reduce liquidity premiums, help restore the confidence of investors, and thus promote stability.

It can also **reduce panic-driven credit problems in cases in which such problems result from price declines during liquidity-driven fire sales of**

assets.

The pricing of the liquidity facilities was an important part of the Federal Reserve's strategy.

Rates could not be too high; to have a positive effect, and to minimize the stigma of borrowing, the facilities had to be attractive relative to rates available (or nominally available) in illiquid, dysfunctional markets.

At the same time, **pricing had to be sufficiently unattractive that borrowers would voluntarily withdraw from these facilities as market conditions normalized.**

This desired outcome in fact occurred: By early 2010, emergency lending had been drastically reduced, along with the demand for such lending.

The Federal Reserve's responses to the failure or near failure of a number of systemically critical firms reflected the best of bad options, given the absence of a legal framework for winding down such firms in an orderly way in the midst of a crisis--a framework that we now have.

However, those actions were, again, consistent with the Bagehot approach of lending against collateral to illiquid but solvent firms.

The **acquisition of Bear Stearns by JPMorgan Chase** was facilitated by a Federal Reserve loan against a designated set of assets, and the provision of liquidity to AIG was collateralized by the assets of the largest insurance company in the United States.

In both cases the **Federal Reserve determined that the loans were adequately secured**, and in both cases the Federal Reserve has either been repaid with interest or holds assets whose assessed values comfortably cover remaining loans.

To say that the crisis was purely a liquidity-based panic would be to overstate the case.

Certainly, an important part of the **resolution** of the crisis involved **assuring** markets and counterparties of the solvency of key financial institutions, and that assurance was provided in significant part by the injection of capital, including public capital, and the issuance of guarantees--measures not available to the Federal Reserve.

In these respects, the Treasury-managed Troubled Asset Relief Program and the FDIC's Temporary Liquidity Guarantee Program played critical roles. As I have noted, the Federal Reserve did help restore confidence in the solvency of the banking system by leading the **stress tests of the 19 largest U.S. bank holding companies in the spring of 2009**.

These stress tests, which were both rigorous and transparent, helped make it possible for the tested banks to **raise \$120 billion in private capital in the ensuing months**.

The response to the panic also involved an extraordinary amount of international consultation and coordination.

Following a key meeting of the **Group of Seven** finance ministers and central bank governors in Washington on October 10, 2008, the governments of other industrial countries took strong measures to stabilize key financial institutions and markets.

Central banks collaborated closely throughout the crisis; in particular, the Federal Reserve undertook swap agreements with 14 other central banks to help ensure adequate dollar liquidity in global markets and thus keep credit flowing to U.S. households and businesses.

Conclusion

The financial crisis of 2007-09 was **difficult to anticipate for two reasons**:

First, financial panics, being to a significant extent self-fulfilling crises of confidence, are inherently difficult to foresee.

Second, although the crisis bore some resemblance at a conceptual level to the panics known to Bagehot, it occurred in a rather different institutional context and was propagated and amplified by a number of vulnerabilities that had developed outside the traditional banking sector.

Once identified, however, **the panic could be addressed to a significant extent using classic tools, including backstop liquidity provision by central banks, both here and abroad.**

To avoid or at least mitigate future panics, the vulnerabilities that underlay the recent crisis must be fully addressed.

As you know, this process is well under way at both the national and international levels.

I will have to leave to another time a discussion of the extensive changes in regulatory frameworks, as well as the changes in the Federal Reserve's own organization and practices, that have been or are being put in place.

Instead, I will close by noting that the events of the past few years have forcibly reminded us of the damage that severe financial crises can cause.

Going forward, for the Federal Reserve as well as other central banks, the promotion of financial stability must be on an equal footing with the management of monetary policy as the most critical policy priorities.

Notes

- See Ben S. Bernanke (2010), "Causes of the Recent Financial and Economic Crisis," statement before the Financial Crisis Inquiry Commission, Washington, September 2
- According to the Federal Reserve's statistical release "Flow of Funds Accounts of the United States," the value of real estate held by households **fell from \$22.7 trillion in the first quarter of 2006 to \$20.9 trillion in the fourth quarter of 2007** (down 8.1 percent from the first

quarter of 2006).

It then **declined to \$18.5 trillion in the third quarter of 2008 (down 18.6 percent from the first quarter of 2006)** and to **\$16.0 trillion in the fourth quarter of 2011 (down 29.7 percent from the first quarter of 2006)**.

The stock market wealth of U.S. households peaked at \$18.1 trillion in the first quarter of 2000 and fell \$6.2 trillion to \$11.9 trillion through the third quarter of 2001.

After a short-lived recovery, stock market wealth bottomed at **\$9.9 trillion** in the third quarter of 2002.

Overall, stock market wealth fell **\$8.3 trillion (or 46 percent)** between its peak in the first quarter of 2000 and its trough in the third quarter of 2002.

- See Walter Bagehot ([1873] 1897), *Lombard Street: A Description of the Money Market* (New York: Charles Scribner's Sons).

The classic theoretical analysis of "pure" banking panics is in Douglas W. Diamond and Philip H. Dybvig (1983), "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy*, vol. 91 (3), pp. 401-19).

Note that the term "panic" does not necessarily imply irrational behavior on the part of depositors or investors; it is perfectly rational to participate in a run if one fears that the bank will be forced to close. However, the collective action of many depositors or investors can lead to outcomes that are undesirable from the point of view of the economy as a whole. Return to text

- For an analysis of the **determinants of runs on money market mutual funds during the crisis**, see Patrick McCabe (2010), "The Cross Section of Money Market Fund Risks and Financial Crises," *Finance and Economics Discussion Series 2010-51* (Washington: Board of

Governors of the Federal Reserve System, September).

- Prime brokers provide a variety of services for hedge funds and other sophisticated institutional investors.

Their services include clearing of trades, financing of long securities positions, and borrowing of securities to facilitate the establishment of short positions.

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UBS launches education initiative to mark its 150th anniversary



UBS is marking its 150th anniversary with the launch of a broad-based [international education initiative](#).

Its main focus will be the establishment of the UBS International Center of Economics in Society at the [University of Zurich](#).

Five additional fields of education will be supported through the funding of projects for different age groups with the goal of strengthening Switzerland's reputation as a location for education and business.

Switzerland's economic success is due in large part to its attractive operating environment and its outstanding education system.

Education will continue to be Switzerland's most important resource.

UBS has decided to mark its 150th anniversary by launching a broad-based international education initiative.

This will be made up of **six distinct elements** and is aimed at primary and high school students, university students, academics, entrepreneurs and people over 50.

For UBS, this represents a sustainable, long-term investment in the future of Switzerland as an education and business location.

[Collaboration with the University of Zurich enables top-flight research](#)

The core of the UBS education initiative will be the creation of the UBS International Center of Economics in Society at the University of Zurich, which will be led by Professor Ernst Fehr.

UBS will support the establishment of up to five chairs, the first of which will be endowed in 2012, at the Department of Economics of the

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University of Zurich.

These chairs will **facilitate cutting-edge research** into issues related to economics and financial markets, covering a wide range of subjects and promoting interdisciplinary research.

The UBS International Center will emphasize the practical application of knowledge by combining world-class research and entrepreneurial thinking.

Kaspar Villiger, Chairman of UBS's Board of Directors, commented, "The UBS International Center of Economics in Society is a unique educational project within Switzerland that will have outstanding international reach.

We are particularly proud to be working in partnership with Professor Ernst Fehr, one of the most renowned economists of our time, on this project.

Under his leadership and guidance, the Department of Economics at the University of Zurich has long been regarded as one of the top European institutions in the field of economics."

Wide range of education projects

In addition to the partnership with the University of Zurich, the education initiative includes projects for the following stages of education:

Primary and high school

Enhanced support for Explore-it, a platform that enables up to **20,000 primary school students** to develop a greater interest in various scientific topics.

The funds provided by UBS will be used to extend the project nationwide and develop innovative teaching and learning materials.

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With this expanded support, UBS will become the main sponsor of Explore-it.

Extension of UBS's current partnership with the Young Enterprise Switzerland (YES) organization, which organizes educational projects for young people jointly with businesses, schools and the government.

This initiative is designed to **teach young people to apply collaborative thinking, demonstrate entrepreneurialism and present themselves as confident and persuasive.**

With this extended commitment under the education initiative, UBS will become the new main sponsor of YES.

Apprenticeships

Creation of **150 additional apprenticeship positions** within Switzerland over the next five years.

The annual number of apprentices will increase by about 10%.

UBS today employs approximately 900 apprentices making it one of the largest private employers of apprentices in Switzerland.

Internships

Creation of **150 additional internship positions** around the world for students over the next three years as part of a special anniversary program.

This program targets students at the beginning of their academic career.

Entrepreneurs

Support for Genilem, an independent association that supports innovative businesses during their start-up phase.

Genilem analyzes the business plans of start-up companies and also provides a network of mentors and partners, specialized training for budding entrepreneurs and professional long-term coaching which will last for a three-year period.

UBS will also provide its own expert mentors and coaches for this initiative.

Support for the non-profit foundation KMU Next, which provides SMEs and micro-enterprises with the tools they need for the successful transfer or acquisition of companies.

UBS will become a member of the foundation and a special advisor on succession management topics, an area of particular expertise.

People over 50

Support for the Passerelle 50plus project run by Switzerland's Speranza foundation.

The project supports jobseekers over the age of 50 in finding suitable employment in the open job market.

UBS has been a donor to the Speranza foundation for some years now.

Additional funds from the UBS education initiative will be used to support and promote the activities of Passerelle 50plus across Switzerland.

Support for Zeitmaschine.TV, a project for encouraging inter-generational dialog.

The UBS education initiative will provide support to expand this showcase project and make it available to a larger number of school students.

UBS will provide information on these specific educational projects at regular intervals and an inaugural symposium will be held at the UBS International Center of Economics in Society this autumn.

Lukas Gähwiler, CEO UBS Switzerland, and Markus Diethelm, Group General Counsel, will act as ambassadors for this major commitment, developing the initiative and driving it forward.

For Group CEO Sergio P. Ermotti, the education initiative represents a unique opportunity: "Education will become Switzerland's greatest resource as it competes in the global arena, and this is especially true in the service sector.

That's why it was important to us to include a wide range of projects in the UBS education initiative which will benefit different age groups as well as showing UBS's commitment to Switzerland to our clients and employees and the general public."

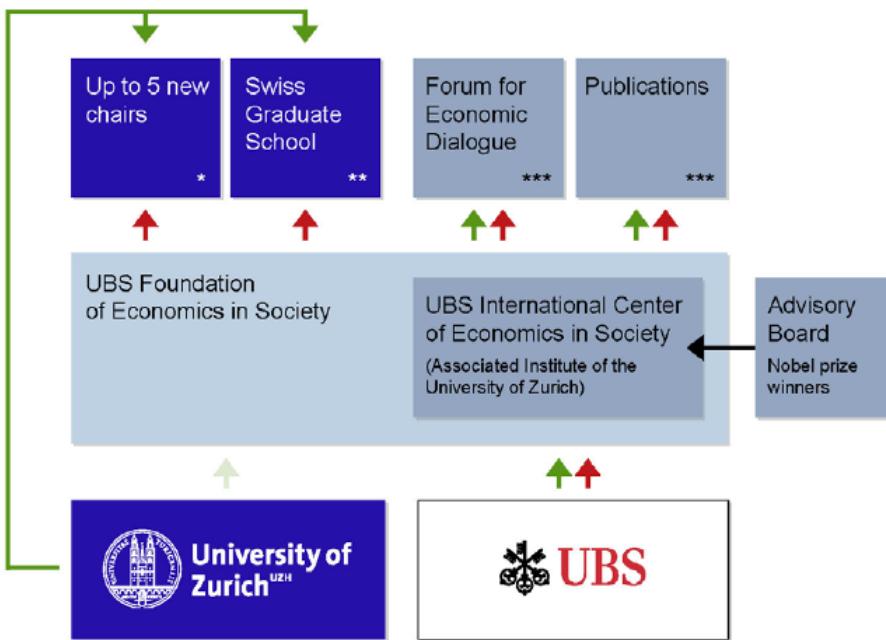
For further information on the UBS Education Initiative, visit www.ubs.com/learn

UBS education initiative to mark the firm's 150th anniversary					
Primary and high school students	Apprenticeships	Internships/practical training programs	University students and academics	Entrepreneurs	People over 50
> Explore-it > Young Enterprise Switzerland	> 150 new apprenticeship places	> 150 new internship places	> UBS International Center of Economics in Society	> KMU Next > Genilem	> Passerelle 50plus (Speranza) > Zeitmaschine.tv

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Structure and configuration of the collaboration between UZH and UBS



* Financed through the UBS International Center by means of its foundation. Legally integrated into and operated by the Department of Economics.

**** Financial support through the UBS International Center by means of doctoral stipends and financing of fully-endowed doctoral chairs. Legally integrated into and operated by the Department of Economics.**

*** Financed by and operated through the UBS International Center.



18 April 2012

**Speech by the Chancellor of the Exchequer,
Rt Hon George Osborne MP, at the City of
London RMB launch event**

I am delighted to be here today to celebrate London as a centre for international Renminbi (RMB) business.

This is a significant moment.



This morning, we saw the launch of the first RMB bond outside of Chinese sovereign territories.

And it happened here in London.

This builds on the progress London has already made toward becoming the western hub for RMB.

By the end of last year, the volume of RMB deposits in London had already reached 109bn RMB – equivalent to around 11bn pounds, of which 35bn RMB – around 3.5bn pounds - are customer deposits.



The annual trading volume in offshore RMB bonds had reached 28 billion RMB – around 3 billion pounds.

And London already represents 26% of the global offshore RMB spot forex market – the majority is based in Hong Kong.

This is a market which grew by over 80% last year.

Let me be clear – London is not in competition with Hong Kong, it is a complement – providing a Western hub for RMB business.

These developments are the culmination of a team effort by global banks with operations in London and Hong Kong, strongly supported by the UK, mainland Chinese and Hong Kong Authorities.

A year ago, when Vice Premier Wang Qishan met with me and my team here in London for the Economic and Financial Dialogue, **the British and Chinese Governments set out a joint communiqué welcoming private sector interest in developing the offshore RMB market in London.**

The **Hong Kong Authorities'** announced at the end of the year their intention to extend the operating hours of the Hong Kong RMB payments system, making it easier for RMB transactions to be settled in London.

I want to commend the Hong Kong authorities on their pioneering work in developing the international RMB market.

In January, at the Asia Financial Forum, Norman Chan, the Chief Executive of the Hong Kong Monetary Authority, and I announced the launch of the London-Hong Kong private-sector forum, to be facilitated by HM Treasury and the Hong Kong Monetary Authority.

The growth of its exciting new RMB business is a natural development for this great city of London.

London has a long history of global financial inventiveness - from founding the first organised market for insurance for trading around the world hundreds of years ago, to the development of the Eurodollar markets through the 1960s, 70s and 80s, and global foreign equities trading in more recent times.

RMB trading is the next step along a 400 year road.

And it is natural that when Chinese banks look westwards, they choose London as the hub for RMB in the West, given London's pre-eminence as a financial centre, and its **expertise in areas such as foreign exchange and**

bond issuance.

It's an important reminder to us in the UK that – while, of course, there are vital questions we need to answer about how we protect taxpayers from banks that are too big to fail, and that we need to ensure the British economy has other strings to its bow as well as financial services – we should have the confidence to look not only at the problems, but also celebrate our successes.

London is the world's pre-eminent financial centre, and it's actually becoming more successful.

Only last month, London retained its position at top of the Global Financial Centres competitiveness Index.

In fact, we were **the only one of the top five financial centres which had increased its competitiveness since the previous year.**

Here in London, we are currently undertaking Europe's largest infrastructure project – Crossrail – which will provide even better transport links to the City.

We've taken the difficult but right decision to make our tax system more competitive – cutting corporation tax rates to 24% from this month to among the lowest in the developed world.

And we're taking the controversial but necessary decision to reduce the top rate of income tax from next year.

Today's event emphasises that we are not prepared to let anyone steal a march on us in terms of new products and new markets.

We are the natural home in the West for those who want to invest in the Chinese economic success story.

The increasing international use of RMB is an important development

for China and for the World Economy.

The growth of the Chinese economy has been quite remarkable.

We all know the statistics.

China has experienced growth of around 10% a year for the last 30 years.

In a generation, China's middle class is forecast to be over three times the size of that of the whole of Western Europe combined.

And it is the strength of Asia's economy which means that despite turbulent times for the world economy, global growth in this decade and the next will be higher than the past 30 years.

But this growth has so far not been matched by the increase in the international use of its currency, so it is clear that the substantial expansion of RMB will be one of the major developments in global markets in the coming decades.

Extension of the market to the Western time zone is a crucial part of its expansion.

It is the ambition of the British Government to make London a Western hub for the sector – with all the benefits that this will bring to our own economy.

And what's so special about today is that not only does it mark the launch of the first RMB bond outside of mainland China and Hong Kong.

Today, we also mark the official launch of the City of London initiative on London as a centre for RMB business.

I want to thank Stuart Fraser, and the City of London Corporation Steering Committee and Expert Advisory Group for their hard work and leadership in getting to this point today.

The involvement of companies like Bank of China, Barclays, Deutsche Bank, HSBC and Standard Chartered will provide the depth of experience on technical, infrastructure and regulatory issues that are needed to develop the market.

Its first output – the Bourse Consult's report into London's capabilities as an offshore RMB centre - is a demonstration of this expertise, providing a clear direction for the market's future development.

It's taken a lot of hard work from people in this room.

But today is not the end of the process; it's the beginning.

I hope that other major European banks and corporate will follow today's lead, and that we will see Chinese institutions and corporations issuing RMB bonds in the London market in the very near future.

In the coming decades, it is China that will act as one of the great powerhouses of the world economy.

By acting as a bridge between East and West, we can secure London's position as the leading financial centre in the years to come – securing growth and prosperity for Britain.

Note for (really new) members

What is the City of London?

The City of London provides local government and policing services for the financial and commercial heart of Britain, the 'Square Mile'.

It is committed to supporting and promoting 'The City' as the world leader in international finance and business services through the policies it pursues and the high standard of services it provides.

Its responsibilities extend far beyond the City boundaries in that it also provides a host of additional facilities for the benefit of the nation.

These range from open spaces such as Epping Forest and Hampstead Heath to the famous Barbican Arts Centre.

The City of London combines its ancient traditions and ceremonial functions with the role of a modern and efficient local authority, looking after the needs of its residents, businesses and over 320,000 people who come to work in the 'Square Mile' every day.

Among local authorities the City of London is unique; not only is it the oldest in the country but it operates on a non-party political basis through its Lord Mayor, Aldermen and members of the Court of Common Council.

The Lord Mayor in particular plays an important diplomatic role with his overseas visits and functions at the historic Guildhall and Mansion House for visiting heads of State.



In addition to the usual services provided by a local authority such as housing, refuse collection, education, social services, environmental health and town planning, the City of London performs a number of very special functions.

It runs its own police force and the nation's Central Criminal Court, the Old Bailey.

It provides five Thames bridges, runs the quarantine station at Heathrow Airport and is the Port Health Authority for the whole of the Thames tidal estuary.

Three premier wholesale food markets (Billingsgate, Spitalfields and Smithfield) which supply London and the South East with fresh produce also belong to the City of London.

Many of these services are funded from the City of London's own

investments at no cost to the public.

The City of London is committed to an **extensive programme of activities designed to assist its neighbours to combat social deprivation so that they can benefit from the wealth the 'Square Mile' generates.**

Staff and members of the City of London have, through centuries of careful stewardship, ensured that the 'Square Mile' has continued to thrive.

Today's City of London, through its philosophy of sustainable development, aims to share these benefits with future generations of residents, businesses and workers.

Joint Press Release

Board of Governors of the Federal Reserve System
 Commodity Futures Trading Commission
 Federal Deposit Insurance Corporation
 Office of the Comptroller of the Currency
 Securities and Exchange Commission

April 19, 2012

Volcker Rule Conformance Period Clarified

The Federal Reserve Board announced its approval of a statement clarifying that an entity covered by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the so-called Volcker Rule, has the full two-year period provided by the statute to fully conform its activities and investments, unless the Board extends the conformance period.



Section 619 generally requires banking entities to conform their activities and investments to the prohibitions and restrictions included in the statute on proprietary trading activities and on hedge fund and private equity fund activities and investments.

Section 619 required the Board to **adopt rules** governing the conformance periods for activities and investments restricted by that section, which the Board did on February 9, 2011.

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Subsequently, the Board received a number of requests for clarification of the manner in which this conformance period would apply and how the prohibitions will be enforced.

The Board is issuing this statement to address this question.

The Board's conformance rule provides entities covered by section 619 of the Dodd-Frank Act a period of two years after the statutory effective date, which would be until July 21, 2014, to fully conform their activities and investments to the requirements of section 619 of the Dodd-Frank Act and any implementing rules adopted in final under that section, unless that period is extended by the Board.

The Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the agencies) plan to administer their oversight of banking entities under their respective jurisdictions in accordance with the Board's conformance rule and the attached statement.

The agencies have invited public comment on a proposal to implement the Volcker rule, but have not adopted a final rule.

The statement is included in the attached *Federal Register* notice, publication of which is expected shortly.

Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities

On **February 9, 2011**, the Board issued its **final rule** to implement the provisions of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") that grant banking entities and nonbank financial companies supervised by the Board a **period of time to conform** their activities and investments with the prohibitions and

restrictions imposed by that section on proprietary trading activities and on hedge fund and private equity funds activities.

Subsequently, the Board received a number of requests for clarification of the manner in which this conformance period would apply to various activities and investments covered by the requirements of section 619 of the Dodd-Frank Act.

The Board is issuing this interpretation to address this question.

As more fully explained in this statement, the Board confirms that banking entities by statute have two years from July 21, 2012, to conform all of their activities and investments to section 619, unless that period is extended by the Board.

During the conformance period, banking entities should engage in good-faith planning efforts, appropriate for their activities and investments, to enable them to conform their activities and investments to the requirements of section 619 and final implementing rules by no later than the end of the conformance period.

This may include complying with reporting or recordkeeping requirements if such elements are included in the final rules implementing section 619 and the agencies determine such actions are required during the conformance period.

Background

Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act (“BHC Act”) that imposes certain prohibitions and requirements on a banking entity and a nonbank financial company supervised by the Board that engages in proprietary trading and has certain interests in, or relationships with, a hedge fund or private equity fund (each a “covered fund”).

As required by section 13(b)(2) of the BHC Act, the Board, the Office of the Comptroller of the Currency (“OCC”), Federal Deposit Insurance Corporation (“FDIC”), and Securities and Exchange Commission (“SEC”) in October 2011 invited the public to comment on proposed rules implementing that section’s prohibitions and requirements. The period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012.

On January 11, 2012, the CFTC requested comment on a substantially similar proposed rule to implement section 13 of the BHC Act and invited public comment through April 16, 2012.

Section 13(c)(6) of the BHC Act required the Board, acting alone, to adopt rules regarding the conformance periods for activities and investments restricted by section 13.

The Board issued its final conformance rule (“Conformance Rule”) on February 9, 2011.

Board Guidance

After adoption by the Board of the Conformance Rule, a number of commenters on the interagency proposed rules to implement section 13 requested advice regarding the period of time a banking entity would have to conform its activities and investments to the requirements of section 13 and the implementing rules and whether certain activities would be prohibited prior to the expiration of the conformance period.

In particular, commenters sought confirmation that the Conformance Rule would allow a banking entity the full period permitted by statute to conform all of its investments and activities to section 13 and the final implementing rules.

In addition, commenters sought confirmation that activities conducted and investments made during the conformance period would not be

subjected to the requirements of the implementing rules during the conformance period.

Section 13 of the BHC Act generally provides that, unless the period for conformance is extended by the Board, a banking entity must conform its activities and investments to the prohibitions and requirements of that section and any final implementing rules no later than 2 years after the statutory effective date of section 13.

The effective date of section 13 is **July 21, 2012**.

As noted in the issuing release for the Conformance Rule and the legislative history of section 13, **the conformance period for banking entities is intended to give markets and firms an opportunity to adjust to the prohibitions and requirements of that section and any implementing rules adopted by the agencies.**

Consistent with this purpose and the statute, the Conformance Rule provides each banking entity with a period of 2 years after the effective date of section 13 (i.e., until **July 21, 2014**) in which to fully conform its activities and investments to the prohibitions and requirements of section 13 and the final implementing rules, unless that period is extended by the Board (**the “conformance period”**).

The Conformance Rule also provides a nonbank financial company supervised by the Board with 2 years after the date the company becomes a nonbank financial company supervised by the Board to comply with any applicable requirements of section 13 of the BHC Act, including any applicable capital requirements or quantitative limitations adopted thereunder, unless that period is extended by the Board.

Under the Conformance Rule, **all proprietary trading activity conducted by each banking entity must conform to the prohibitions and requirements of section 13 of the BHC Act and any final implementing rules by no later than the end of the conformance period.**

Similarly, all activities, investments and transactions with or involving a covered fund, including a covered fund organized and offered or sponsored by the banking entity, must conform to section 13 of the BHC Act and final implementing rules by no later than the end of the relevant conformance period.

During the conformance period, every banking entity that engages in an activity or holds an investment covered by section 13 is expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of section 13 of the BHC Act by no later than the end of the conformance period.

This includes evaluating the extent to which the banking entity is engaged in activities and investments that are covered by section 13 of the BHC Act, as well as developing and implementing a conformance plan that is as specific as possible about how the banking entity will fully conform all of its covered activities and investments with section 13 of the BHC Act and any final implementing rules by July 21, 2014, unless that period is extended by the Board.

These **good-faith efforts** should take account of the statutory provisions in section 13 of the BHC Act as they will apply to the activities and investments of the banking entity **at the end of the conformance period** as well as **any applicable implementing rules adopted in final by the primary financial regulatory agency for the banking entity**.

Good-faith conformance efforts may also include complying with **reporting or recordkeeping requirements** if such elements are included in the final rules implementing section 13 of the BHC Act and the agencies determine such actions are required during the conformance period.

Nothing in this guidance restricts in any way the authority of any agency to use its supervisory or other authority to limit any activity the agency determines to be unsafe or unsound or otherwise in violation of law.

Supervisory policies and bank deleveraging: a European perspective

Andrea Enria
Chairperson European Banking Authority
21st Annual Hyman P. Minsky Conference
on the State of the U.S. and World
Economies
Debt, Deficits and Financial Instability

*Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort*

Ladies and gentlemen,

This evening I would like to share with you some thoughts on the future landscape of the banking sector and discuss how policy makers could accompany the process of de-risking that banks are undertaking.

I will present my assessment of what is currently happening in the EU banking sector and what we expect may happen over the next years.

In particular, I will try to address three questions.

1. The first question is whether we are heading towards a significant deleveraging in the EU banking sector.
2. The second one is whether adequate policy measures can ensure that this process occurs without major damage to the real economy.
3. The third question is whether macroprudential supervisory tools can be designed to prevent excessive leverage to be built up again in the future and operated in a smooth fashion when applied to cross-border business.

Do EU banks need to undertake a significant deleveraging process?

The financial crisis has its roots in multiple imbalances at the global level and has been triggered by the fall of asset prices.

How a decline in asset value led to a major crisis at the global level has been vividly illustrated by Olivier Blanchard (2009)

First, the underestimation of risks and disaster myopia, something not really new in prolonged periods of benign market conditions.

Second, the difficulties to value some categories of assets and new financial products.

Third, the interconnections among financial institutions due to the growth of securitisation and globalisation.

Finally, the increase of leverage, with financial institutions financing their portfolios “with less and less capital, thus increasing the rate of return of capital”.

It is clear that the higher the leverage, the more likely it is that decline in asset values determines the depletion of capital.

In fact, extensive research in this respect demonstrates that the procyclicality of leverage acts as amplification mechanism propagating adverse shocks to the real economy.

Encouraged by a low-interest rate environment and by regulations lagging behind financial innovation, banks could boost the size of their balance sheets and activities.

This process entailed the growth of trading activities and investment banking, but also of retail lending, primarily of residential mortgages.

The main drivers of leveraging have been real estate and structured finance and, more generally, trading book activities.

For 70 of the largest EU banks, the exposures in the “held for trading” and “available for sale” portfolios increased by 68 per cent between 2005 and 2008, with a sharp 24 per cent decrease in 2009.

The different drivers were **deeply interlinked and worked together, with optimism and the underestimation of risk contributing to banks’ excessive leverage.**

Leveraging up was considered as a legitimate strategy to maximise earnings and, thus, to satisfy the search for yield of market investors.

Indeed, **until 2007, the banking sector experienced profitability levels well above any other economic sector and banks reported returns on equity exceeding their normalised earnings capacity on a risk-discounted basis.**

Since 2007, confronted with an unprecedented financial crisis, banks have shifted to liability-driven strategies: obtaining the necessary funding in the form of deposits or of market resources became the paramount strategic goal.

Both in the US and the EU, deleveraging was seen as part of a necessary adjustment to remove excess capacity and restructure balance sheets, and to set the basis for a more stable and sound banking sector.

Indeed, empirical research suggests that some deleveraging is unavoidable after a crisis: according to the BIS (2010), debt reduction followed 17 out of 20 banking crises that were preceded by a surge in credit.

However, **the response to the crisis has been diverse on the two sides of the ocean.**

While US banks have reduced their leverage and reliance on wholesale funding, until recently, European banks remained, on average, more reliant on wholesale funding and leverage levels – while decreasing – remained comparatively high.

This makes the EU banking sector more prone to structural and cyclical deleveraging pressures.

In the US, deleveraging has been significant.

The figures on the level of leverage should be interpreted with great caution.

There are in fact a few explanations for the difference between the US and the EU that are not linked to banks' behaviour but rather to the local regulations and the characteristics of the financial markets.

Let me provide some examples.

First of all, off-balance sheet exposures – that are typically excluded from the computation of traditional leverage measures – are of different size across banks, with US investment banks being typically outliers.

Moreover, and most importantly, accounting rules may hamper the comparison, as measures of leverage differ to a significant extent under US GAAP and IFRS standards.

Finally, after the freeze in the securitisation market, European banks have further developed the practice of funding mortgages through covered bonds.

Therefore, European banks keep mortgage exposures in their balance sheets, as opposed to US banks, which can securitize and easily divest their mortgage portfolio, primarily via the Government Sponsored Entities (GSEs).

Furthermore, other factors may explain why the change in banks' leverage has been more pronounced in the US than in the EU.

In the US, it is easier for banks to sell assets due to the dis-intermediated structure of the financial sector, where capital markets play a pivotal role.

Bank deleveraging is therefore structurally easier, but indebtedness is in fact transferred from banks to other players, often not subject to equally stringent regulations or not regulated at all.

Also, as the crisis kicked-in, we have been witnessing aggressive reduction in indebtedness levels by both households and businesses in the US, which, so far, has not been the case in the euro zone.

This suggests that **demand factors also matter and that they are intertwined with the debt level of the private sector at the onset of the crisis.**

On the last point, the data provides a mixed picture.

In the US, households confronted the crisis with higher debt levels than the euro-area ones.

In 2007, the debt to disposable income ratio was about 140 per cent against 110 in the euro-area.

The divide is even clearer looking at the mortgage to disposable income ratio (about 100 in the US per cent versus 60 in the euro-zone).

In 2010, notwithstanding the debt reduction in the US, the ratio was still at 120 per cent.

As for the corporate sector, in 2007, the leverage ratio (measured as the ratio of financial debt to financial debt plus capital) was about 30 per cent in the US compared to 37 in the euro-area (35 and 42 per cent respectively in 2010).

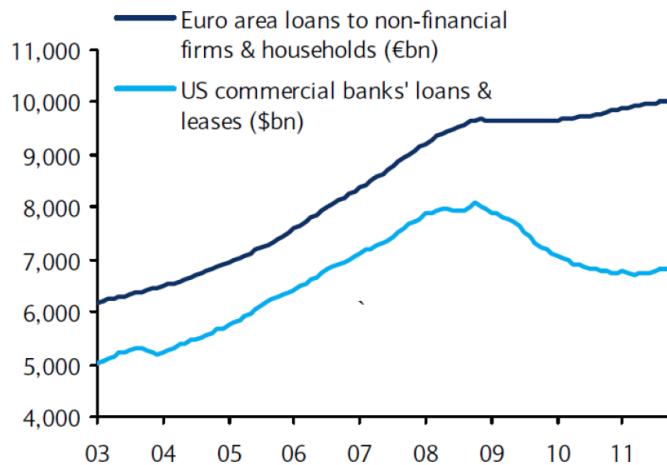
It is also fair to acknowledge that deleveraging has been prevalent at financial institutions – larger banks and brokers/dealers – that grew their balance sheets aggressively by increasing debt and assets in the upswing, a trend that has been more pronounced in the US.

All these arguments point to a complex picture in deleveraging dynamics, but a simple fact still holds true: **differently from their US peers, EU banks, until recently, had reduced their leverage almost exclusively through an increase in their capital levels**, while the size of their balance sheets had remained almost unchanged – if anything, it had grown further (Charts 1 and 2).

For the **top 10 banks**, the tangible common equity ratio (the ratio between tangible equity and tangible assets) **increased from 5.7 to 7.8 per cent between 2005 and 2011**.

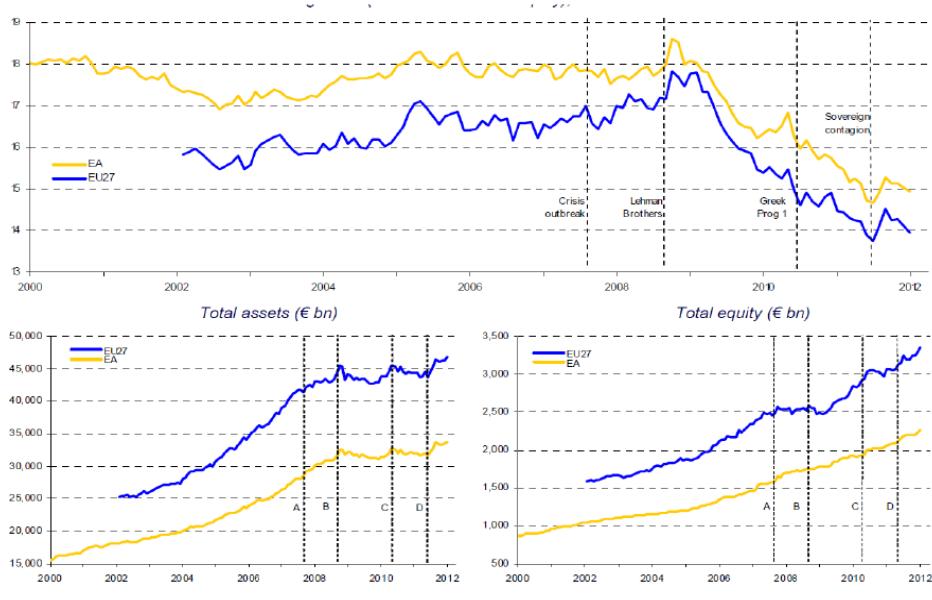
In the EU, the same ratio shifted from 3.4 to 4.5 percent for the 70 banks participating in the EBA recapitalisation exercise

Chart 1. Deleverage metrics



Source: Haver Analytics, Barclays Capital, McKinsey Global Institute

Chart 2. The drivers of deleveraging in Europe



Source: European Central Bank

All this has changed with the bursting of the sovereign debt crisis in the euro area.

Strong pressure for deleveraging emerged in Europe during the final quarter of 2011, with the freeze of the markets for medium and long term bank funding.

While this has been a source of concern, at this stage, there is no evidence that the deleveraging process has become excessive or disorderly, with disruptive consequences on the real economy.

According to the BIS (2012), European banks offered for sale a significant volume of assets, mostly those with higher risk-weights, including low-rated securitised assets, distressed bonds and commercial property.

In the last quarter of 2011, credit to non-bank private-sector borrowers in the euro-zone fell by around 0.5 per cent, while exposures towards non-euro-area residents declined by almost 4 per cent.

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The **home/regional bias** in deleveraging is partly the result of banks' deleveraging pecking order and partly of difficulties in the US dollar funding, which remained more expensive and less readily available than home-currency funding for many European banks due to the reduction of prime money market funds' exposure to euro area banks.

I would suggest some of the rationales for bank deleverage in the EU.

Funding shortages have been certainly a key driver.

We have all witnessed the **dramatic market funding freeze** during the second half of last year for EU banks, alleviated some months ago by new regulatory and policy initiatives, primarily the ECB's 3-year Long Term Refinancing Operations (LTRO), but also state guarantees for new bank bonds.

EU banks are now facing **longer-term challenges and deleveraging is the way for aligning the business model to markets' expectations and to the incentives posed by regulatory changes.**

Unquestionably, **there is a need for de-risking, bringing leverage to more conservative levels.**

Indeed, a number of European banks have not yet completed the clean-up of their balance sheets and shedding of legacy assets.

In addition, **those banks that received public support are required under EU State aid regulation to dismiss part of their business to minimize competitive distortions.**

Banks may also need to rethink their involvement in investment banking and related activities as well as attempt to reduce their dependence on less stable sources of funding – such as short-term wholesale financing – as a response to the new rules [introduced by Basel 2.5 and 3.](#)

Hence, my answer to the first question is that the EU has avoided so far a disordered deleveraging process driven by a massive funding squeeze, thanks in particular to the actions taken by the European Central Bank. But a downsizing of banks' balance sheets has started and has to take place, in order to unravel some of the processes that have triggered the financial crisis.

This is necessary to bring banks back to sounder and more stable business models.

Several estimates have been put forward by analysts on the likely dimension of this deleveraging process.

I don't think regulators should have a view on the overall size of the adjustment, but they should be aware that there is still some way to go and they should keep putting pressure on banks to complete the repair of their balance sheets.

What policy actions to avoid negative repercussions on the real economy?

A recurrent theme in the recent debate has been the claim of the banking industry that the regulatory reforms would have a major adverse impact on growth and employment.

Deleveraging has often been characterised as "bad", as implying reduced flows of lending into the real economy.

But deleveraging could be both "bad" and "good", simply because reducing the size of different components of a bank's balance sheet can have different impacts.

The point is whether we can disentangle possible trajectories for deleveraging and deploy policies that favour an orderly deleveraging process, which does not hurt growth prospects.

For example, deleveraging is welcome when it entails dismissing or writing down troubled assets accumulated by banks before the crisis.

In most post-crises periods, we have witnessed a massive deleveraging process, which often is simply reflecting the cleaning of the banks' balance sheets.

The size of banks' balance sheets shrinks simply because losses are recognised and accounting values revised downwards.

This process has no adverse real impact, as it does not change in any way the amount of loans.

On the contrary, there is a good amount of evidence that if residual credit risk is not recognised and dealt with, it is likely that the economy remains in a prolonged period of stagnation associated with a failure to address non-performing assets.

Forbearance can be a force for good where a loan has a reasonable prospect of an imminent return to performance.

However, it can be pernicious for both the borrower and the lender to maintain non-performing loans on balance sheets for prolonged periods.

When a universal bank with extensive activities in both investment and wholesale banking on the one hand, and retail and commercial banking on the other hand, decides to de-risk away from market activities, the investment banking/trading portion of the balance sheet will naturally shrink.

This may in fact be a good thing insofar as de-risking is concerned, and indeed some regulators required banks to do that at the height of the crisis.

On the other hand, indiscriminately cutting lending to the real economy may lead to an economic slowdown and possibly to a credit crunch.

And I include here not only lending to the domestic economy by the parent bank but also real economy lending in other countries where the bank has subsidiaries.

This is a very sensitive issue in the EU where, for instance, subsidiaries of Western EU banks play a major role in Central and Eastern Europe. Disentangling good and bad deleveraging is part of the usual dilemma for policy makers during a crisis.

On the one hand, there is the willingness to prevent a sharp contraction in credit supply to firms and households and, in turn, negative repercussion on economic growth.

On the other, some adjustments and repairs in banks' balance sheets are vital to restore the confidence in the financial sector and restart credit markets.

And the **Japanese experience** warns us that forbearance – late recognition of losses, delayed restructuring of balance sheets, deferred capital raising – can produce harmful consequences.

Tang and Upper (2010) remind us of this lesson: “*fix the banking system first*”.

It has been noted that “*getting rid of the non-strategic assets that normally hang around after a long merger-wave [...] is a responsibility of individual banks and their senior management, but moral persuasion from regulators and governments is also needed. Managers and directors can have a vested interest in preserving the present size, which can make it easier to extract private benefits and pursue rent-seeking behaviour*”.

In that respect, we should welcome the fact that the waterfall of deleveraging is also driven by regulation.

This leads me to the second question.

What policy actions can be set up to ensure that only good deleverage takes place?

The first element of the policy toolkit should be an incentive-compatible regulation.

If rules are properly designed, the cost in terms of capital and liquidity requirements of holding riskier assets is higher, providing the right incentives to what I called good deleveraging.

And I assume there is still agreement on the fact that certain activities have contributed more than others to the build-up of vulnerabilities in banks' balance sheets.

For example, deleveraging trading and investment assets is the consequence of a more demanding regulatory framework – **Basel 2.5 and 3 and the Dodd-Frank Act** – that affects primarily market risk and trading book exposures.

The second element is to put banks in the condition to keep granting credit to the economy.

In Europe, the initiatives for restoring market confidence have been incisive.

The operations to support liquidity approved by the European Central Bank have alleviated the pressure on bank funding, even though restoring the access to private markets for long term funds remains an important policy objective.

While easing funding pressures on banks was essential to avoid a disordered deleveraging process, policies need to be put in place that encourage banks to repair their balance sheet and strengthen their capital position.

The EBA required banks to form a capital buffer that will enable them to reach a **Core Tier 1 ratio of 9 per cent**, after a prudent valuation of the banks' sovereign exposures.

This is a temporary and exceptional buffer to address the systemic risk arising from the sovereign debt crisis.

In order to discourage banks from complying with the recommendation by simply curtailing lending, we laid down precise guidelines and asked the banks to submit plans for recapitalisation, describing the steps they intend to take in order to reach the required level of capital.

Only a limited number of measures to reduce assets are allowed to meet our request: **while it will be possible to transfer certain categories of activities to third parties – since this does not reduce the leverage of the system as a whole – reductions in lending will not determine any capital relief for banks, unless they occur within restructuring plans required by the EU and the IMF or per requested by supervisors.**

The plans submitted by banks – and currently being carried out under the scrutiny of national supervisory authorities and the EBA – are encouraging.

The actions that banks intend to put in place for reaching the target capital level focus predominately on direct capital measures – issuance of new capital, retained earnings, conversion of hybrid instruments into common equity.

Overall, **direct capital measures cover 96 per cent of the shortfall.**

In a small number of cases reductions in lending into the economy are included in the plans.

The majority of these deleveraging activities correspond to conditions laid out in EU State Aid rules or other official programmes to ensure appropriate restructuring and return to long term viability.

In practice, less than 1 per cent of the total measures will be represented by decrease in lending.

But let me turn to **another important point**.

Over the last months, there has been some dispute on the role that supervisory pressure for strengthening capital levels played in the deleveraging process, particularly in the EU.

In fact, asset deleverage has been primarily driven by a change in strategy and de-risking, reduced credit demand and funding constraints, much less by additional needs on the capital side.

In Europe, the deleveraging process began long before the EBA started to consider banks' recapitalisation needs, and it was closely linked with the difficulties banks had in collecting funds on the market at a reasonable cost.

On this, I want to be blunt: I do not believe that high levels of capital are a deterrent to new lending.

On the contrary, banks with low capital levels – or perceived by the market as being so – are those that have had problems in increasing lending.

They either face major funding difficulties – which, in turn, do not allow them to grant loans – or focus primarily on preserving their meagre capital.

Banks with large capital positions, by contrast, are less sensitive to cyclical shocks and more likely to pursue lending growth strategies. Indeed, last September, the IMF warned that "*a number of [European] banks must raise capital to help ensure the confidence on their creditor and depositors.*

Without additional capital buffers, problems in accessing funding are likely to create deleveraging pressures at banks, which will force them to cut credit to the real economy” and the European Systemic Risk Board (ESRB) emphasised the need for coordinated efforts to strengthen EU banks’ capital.

The EBA’s recommendation for temporary capital buffers is consistent with the lessons learnt from previous crises and responds to the IMF and ESRB warnings and meets market expectations for higher capital levels.

It has pushed a rebalancing of the deleveraging through a major **increase in capital (€115bn)** and, at the same time, it only allowed for good deleveraging.

Going forward, supervisors need to maintain their focus on asset quality, making sure that residual credit risk is properly addressed and losses are fully recognised.

This should also help driving market values and book values closer to each other, thus supporting the issuance of new equity.

At the same time, supervisors need to work with banks to identify pathways to new and diverse sources of funding, with less reliance on short term wholesale funding than in the past.

This rebalancing in the funding models is a necessary component of a process that will lead banks to gradually exit from the extraordinary support measures provided by their central banks.

An important component of this strategy could be supporting industry initiatives to re-establish a sound and well controlled market for securitisation.

These actions on assets and funding should help banks refocusing their business models so that their activities are sustainable and reflect their areas of comparative advantage.

Which policy tools to prevent boom and bust cycles in integrated financial markets?

The final issue I want to tackle this evening is whether policy makers can reduce the probability of future boom and bust cycles devising effective preventive tools.

The Basel 3 framework does envisage instruments that should contribute to smoothing the fluctuations in the financial sector.

At the micro-prudential level, higher requirements in terms of quantity and quality of capital should structurally reduce banks' risk-taking.

In addition, the leverage ratio will set a ceiling to non-risk-weighted exposures in buoyant economic conditions.

At the macro-prudential level, the countercyclical buffer regime will require banks to build-up capital cushions in good times – when risk is underestimated – to be deployed for covering losses when the cycle reverts and, thus, supporting the economy when this is most critical.

The effectiveness of this toolkit in preventing excessive leveraging and abrupt deleveraging is still debated at the global level and, particularly in the EU, with some jurisdictions claiming that the current steps towards strengthening prudential rules may not be sufficient.

In the EU, we are working for completing the implementation of Basel 3 in our legislation as soon as possible.

Indeed, we realise that the breadth of the regulatory reform is such that it is producing some degree of uncertainty in the market place.

Our priority is thus to reduce this uncertainty and provide an environment in which banks – and investors providing banks with the necessary funds – can again do their planning in a long term perspective.

What makes Europe – I believe – an interesting case study is the fact that we are committed to achieving a single rule-book for financial markets, that is a common set of fully harmonised rules that will be binding and directly enforceable in all EU Member States.

While the **single rule-book** remains a shared goal, there is at the same time a call for greater flexibility at the national level, in order to favour the implementation of macroprudential policies.

Undoubtedly, there are strong arguments in favour of some flexibility in the use of macroprudential instruments.

First, systemic risk may materialise in different ways and no predetermined rules could address it.

Second, since credit and economic cycles are not fully synchronised across EU countries and financial markets are still heterogeneous, Member States may necessitate some room for manoeuvre in the activation of policy measures.

Third, the development of macroprudential instruments is still at an early stage and some flexibility may contribute to the learning-by-doing process.

At the same time, the establishment of any flexible macroprudential framework in Europe should not jeopardise the Single Market.

What happened during the crisis has warned us that the integration of financial and banking markets cannot be considered a permanent accomplishment if it is not underpinned by effective harmonization of the legal framework and its consistent application throughout the Union.

We have all witnessed how the Single Market may well prosper when the economic cycle is upward, but it may well implode in downturn cycles if no coordinated responses are developed.

We are currently witnessing a major retrenchment of banking business within national borders. Cross-border banking is significantly downsizing.

The money market, which was the most integrated market since the introduction of the euro, has virtually disappeared and the limited signs of recovery in interbank transactions that materialised since the ECB's LTRO are remaining mostly within national borders.

The deleveraging process is being driven by the requests of authorities to hold significant capital and liquidity levels in domestic markets and to refinance the local economy.

At the moment, we are facing a high likelihood that the deleveraging process will occur with a segmentation of the Single Market in banking.

This might well endanger its ultimate goal: wider and deeper financial markets offering better and more financing opportunities for real economies.

This does not imply that no discretion should be left to the national authorities in shaping their macroprudential toolkit, but rather that this should happen under a coordinated approach based on strong ex-ante guidance and credible ex-post reviews of the measures adopted at the national level.

The level of flexibility to be left to the macroprudential supervisors is also linked to the objectives that macroprudential policies are expected to achieve.

And it is fair to acknowledge that there is no clear agreement on this.

According to a first viewpoint, macroprudential policy plays primarily a passive role, complementing traditional microprudential supervision, which neglects the time-dynamics of credit markets, and ensuring that capital resources are adequately allocated across time, building reserves

in good times that can be run-down when economic conditions deteriorate.

The second perspective regards macroprudential tools as an effective and wide-ranging mechanism for leaning against the wind, i.e. for reducing banks' incentives to expand credit and leverage in buoyant economic conditions, thus avoiding credit bubbles.

While the two perspectives are not necessarily mutually exclusive, they have different consequences in terms of design and use of the policy tools.

In the first case, they aim at being neutral and rule-based.

Some discretion may be left to the policy maker, but it is typically residual.

In the second case, much more discretion is needed and the policy maker is endowed with a significant degree of freedom in adapting the policies to the specific juncture.

In this case, however, **it is crucial to preserve consistency** in the activation of macroprudential tools and to avoid unintended consequences when they interact with microprudential tools. In a nutshell, greater discretion needs to be balanced with some pre-agreed principles on how discretion can (or cannot) be exercised.

The functioning of the **countercyclical buffer – a key element of the Basel 3 macroprudential toolbox** – is a good example.

As currently foreseen, **national authorities will be given the possibility to activate additional buffers reflecting the conditions of the credit cycle in their jurisdiction.**

In Europe, the ex ante guidance, to be issued by the **European Systemic Risk Board (ESRB)**, coupled with an effective ex post peer review process

should guarantee that these tools do not alter the level playing field and are compatible with the single rulebook.

The approach followed for designing such a tool could be followed also for the introduction of other components of the macroprudential suite.

My answer to the initial question is therefore **mixed**.

We have some tools – the leverage ratio and the countercyclical buffers – but we still do not have a well structured suite of macroprudential tools and specific rules of engagement for their employment.

In addition, all measures have been focusing so far on the banking sector, while a sizeable share of the leveraging up of the system in the past was driven by other financial institutions.

Looking at the implementation, we are running the risk to open a wide area for discretion in national supervisory implementation, with national policy makers – not only in Europe – potentially able to hide everything under the macroprudential umbrella.

In that respect, a constrained discretion regime for macroprudential policies – along with harmonised microprudential rules and homogenous supervisory practices – is the only avenue for ensuring that the same sources of systemic risk are addressed in a consistent way across countries, levelling the playing field and reducing spill-over from less to more conservative jurisdictions.

Systemic risk cannot anymore be contained within national borders and requires coordinated policy responses.

Conclusions

Today I tried to argue that a deleveraging process is needed in the banking sector.

It has already started, with a different pace in different areas of the global financial system.

The first step has been the increase in capital levels, long overdue and one of the cornerstones of the regulatory reforms endorsed by the G20 Leaders.

The second step implies a reduction in size of balance sheets, especially by addressing non-performing assets and de-risking in areas such as capital market activities and real estate lending, which grew too much in the run-up to the crisis.

The third step entails a refocusing of business models, especially towards more stable funding structures and the gradual exit from the extraordinary support measures put in place by central banks.

I have seen no compelling evidence supporting the industry's argument that the regulatory reforms will bring about an unwarranted deleveraging process, badly hurting the real economy.

On the contrary, I am convinced that **without an ordered deleveraging process, through a significant strengthening of capital and a selective downsizing of asset levels, we would fail addressing the fragilities that are preventing banks from performing their fundamental functions.**

A point I acknowledge in the industry's criticism is that in the path to the new equilibrium, authorities need to provide for regulatory certainty and close coordination of actions.

Supervisors and central banks have to carefully coordinate their actions to accompany this process and make sure that it occurs in an orderly fashion, without hampering the continued flow of lending into the real economy.

In particular, in deploying their armoury of tools, including the new macroprudential instruments, national authorities should avoid policies

too narrowly focused on domestic objectives: if the deleveraging process is shaped by policies aimed at maintaining domestic assets while de-risking in foreign jurisdictions, we risk triggering a segmentation of financial markets that may well hamper growth and employment.

This is particularly true in the euro area and the EU, but has a more general relevance for global financial markets.

Thank you for your attention.

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Basel 3 News, June 2012



Dear Member,

Stress testing is the most important challenge this month.



Press Releases

**Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency**

For Immediate Release

May 14, 2012

Agencies Finalize Large Bank Stress Testing Guidance

The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on Monday issued [final supervisory guidance regarding stress-testing practices at banking organizations with total consolidated assets of more than \\$10 billion.](#)

The guidance highlights the importance of stress testing at banking organizations as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks and better equips it to address a range of adverse outcomes.

The recent financial crisis underscored the need for banking organizations to [incorporate stress testing into their risk management practices](#), demonstrating that

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banking organizations unprepared for particularly adverse events and circumstances can suffer acute threats to their financial condition and viability.

This guidance **builds upon previously issued** supervisory guidance that discusses the uses and merits of stress testing in specific areas of risk management.

The guidance outlines **general principles** for a satisfactory stress testing framework and describes various stress testing **approaches** and how stress testing should be used at various levels within an organization.

The guidance also discusses the importance of stress testing in **capital and liquidity planning** and the importance of strong internal governance and controls as part of an effective stress-testing framework.

The guidance does **not** implement the stress testing requirements in the **Dodd-Frank** Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) or in the Federal Reserve Board's capital plan rule that apply to certain companies, as those requirements have been or are being implemented through **separate** proposals by the respective agencies.

However, the agencies expect that banking organizations with total consolidated assets of more than \$10 billion **would follow the principles** set forth in the guidance--as well as other relevant supervisory guidance--**when conducting stress testing in accordance with the Dodd-Frank Act**, the capital plan rule, **and other** statutory or regulatory requirements.

**DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION**

Supervisory Guidance on Stress Testing for Banking Organizations with More Than \$10 Billion In Total Consolidated Assets

AGENCIES: Board of Governors of the Federal Reserve System (“Board” or “Federal Reserve”); Federal Deposit Insurance Corporation (“FDIC”); Office of the Comptroller of the Currency, Treasury (“OCC”).

ACTION: Final supervisory guidance.

SUMMARY: The Board, FDIC and OCC, (collectively, the “agencies”) are issuing this guidance, which outlines high-level principles for stress testing practices, applicable to all Federal Reserve-supervised, FDIC-supervised, and OCC-supervised banking organizations with more than \$10 billion in total consolidated assets.

The guidance highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization’s forward-looking assessment of its risks and better equips the organization to address a range of adverse outcomes.

DATES: This guidance will become effective on July 23, 2012.

I. Background

On June 15, 2011, the agencies requested [public comment](#) on joint proposed guidance on the use of stress testing as an ongoing risk management practice by banking organizations with more than \$10 billion in total consolidated assets (the proposed guidance).

The public comment period on the proposed guidance [closed on July 29, 2011](#).

The agencies are adopting the guidance in final form with certain modifications that are discussed below (the final guidance).

As described below, this guidance does not apply to banking organizations with consolidated assets of \$10 billion or less.

All banking organizations should have the capacity to understand their risks and the potential impact of stressful events and circumstances on their financial condition.

The agencies have previously highlighted the use of stress testing as a means to better understand the range of a banking organization’s potential risk exposures.

The 2007- 2009 financial crisis further underscored the need for banking organizations to [incorporate stress testing into their risk management](#), as banking organizations unprepared for stressful events and circumstances can suffer acute threats to their financial condition and viability.

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The final guidance is intended to be consistent with sound industry practices and with international supervisory standards.

Building upon previously issued supervisory guidance that discusses the **uses and merits of stress testing in specific areas of risk management**, the final guidance provides principles that a banking organization should follow when conducting its stress testing activities.

The guidance outlines broad principles for a satisfactory stress testing framework and **describes the manner** in which stress testing should be employed as an **integral component of risk management** that is applicable at various levels of aggregation within a banking organization and that contributes to capital and liquidity planning.

While the guidance is not intended to provide detailed instructions for conducting stress testing for any particular risk or business area, the guidance describes several types of stress testing activities and how they may be most appropriately used by banking organizations subject to this guidance.

The final guidance does **not** implement the stress testing requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) on financial companies regulated by the OCC, FDIC, or Board with total consolidated assets of more than \$10 billion or by the Board's capital plan rule on U.S. bank holding companies with total consolidated assets equal to or greater than \$50 billion.

The Dodd-Frank Act's stress testing requirements are being implemented through **separate** notices of proposed rulemaking by the respective agencies.

The Board issued the final capital plan rule on November 22, 2011.

In light of these recent rulemaking efforts on stress testing, the guidance provides banking organizations with **principles** for conducting their stress testing activities to, among other things, ensure that those activities are adequately integrated into overall risk management.

The agencies expect such companies would follow the principles set forth in the guidance – as well as other relevant supervisory guidance – when conducting stress testing in accordance with statutory or regulatory requirements.

II. Discussion of Comments on the Proposed Guidance

The agencies received 17 comment letters on the proposed guidance.

Commenters included financial trade associations, bank holding companies, financial advisory firms, and individuals. Commenters generally expressed support for the proposed guidance.

However, several commenters recommended changes to, or clarification of, certain provisions of the proposed guidance, as discussed below.

In response to these comments, the agencies have clarified the principles set forth in the guidance and modified the proposed guidance in certain respects as described in this section.

A. Scope of application

The proposed guidance would have applied to all banking organizations supervised by the agencies with more than \$10 billion in total consolidated assets.

Specifically,

- **with respect to the OCC**, these banking organizations would have included national banking associations and federal branches and agencies;
- **with respect to the Board**, these banking organizations would have included state member banks, bank holding companies, and all other institutions for which the Board is the primary federal supervisor;
- **with respect to the FDIC**, these banking organizations would have included state nonmember banks and all other institutions for which the FDIC is the primary federal supervisor.

The proposed guidance indicated that a banking organization should develop and implement its stress testing framework in a manner commensurate with its size, complexity, business activities, and overall risk profile.

Some commenters supported the total consolidated asset threshold (i.e., more than \$10 billion), but others noted the importance and value of stress testing for smaller banking organizations.

Consistent with the proposed guidance, no supervised banking organization with \$10 billion or less in total consolidated assets is subject to this final guidance.

The agencies believe that \$10 billion is the appropriate threshold for the guidance based on the general complexity of firms above this size.

However, the agencies note that previously issued supervisory guidance applicable to all supervised institutions discusses the use of stress testing as a tool in certain aspects of risk management—such as for commercial real estate concentrations, liquidity risk management, and interest-rate risk management.

The agencies received two comments suggesting that the \$10 billion total consolidated asset threshold be measured over a four quarter period in order to minimize the likelihood that temporary asset fluctuations would trigger application of the guidance.

The agencies do not establish an asset calculation methodology in the final guidance; however, banking organizations with assets near the threshold should use reasonable judgment and consider, in conjunction with their primary federal supervisor as appropriate, whether they should consider preparing to follow the guidance.

Three commenters expressed concern that foreign banking organizations (FBOs) are required to follow stress testing guidelines established by their home country supervisors and suggested that the agencies give consideration to those requirements.

When developing the guidance, the agencies sought to ensure that it would not introduce inconsistencies with internationally agreed supervisory standards.

The agencies recognize that an FBO's U.S. operations are part of the FBO's global enterprise subject to requirements of its home country.

The agencies provided sufficient flexibility in the proposed guidance so that the guidance could apply to various types of organizations.

In this final guidance, the agencies clarify that certain aspects of the guidance may not apply to U.S. branches and agencies of FBOs (such as the portions related to capital stress testing) or may apply differently (such as portions related to governance and controls).

Supervisors will take these issues into consideration when evaluating the ability of U.S. offices of FBOs to meet the principles in the guidance.

Two commenters expressed concern regarding the application of the proposed guidance to savings and loan holding companies (SLHCs).

They suggested that the Board issue separate guidance for SLHCs, as these institutions would face a different set of stress testing assumptions and scenarios than banking organizations.

The Board believes that the guidance is instructive to SLHCs to the same degree it is for bank holding companies.

The Federal Reserve became the primary federal supervisor for SLHCs on July 21, 2011, after the agencies published the proposed guidance for public comment but before the end of the comment period.

While the Board recognizes that certain differences do exist between bank holding companies and SLHCs, the Board believes the guidance contains flexibility adequate to accommodate the variations in size, complexity, business activities, and overall risk profile of all banking organizations that meet the asset threshold.

Thus, the guidance anticipates that each banking organization, including each SLHC, would implement stress testing in a manner consistent with its own business and risk profile.

Similarly, one commenter advocated that the OCC propose separate guidance on stress testing specifically tailored to savings associations.

The OCC became the primary federal supervisor for federal savings associations on July 21, 2011.

While the OCC recognizes that certain differences do exist between national banks and federal savings associations, the OCC notes that the final guidance contains flexibility adequate to accommodate the variations in size, complexity, business activities, and overall risk profile of all banking organizations that meet the asset threshold.

Thus, it is also expected that each federal savings association would implement the guidance consistent with its own business and risk profile.

Several commenters requested clarification on the [linkage between the stress testing guidance and the stress testing requirements in the Dodd-Frank Act](#).

In devising the guidance, the agencies endeavored to ensure that the proposed and final guidance is consistent with the stress testing requirements under the Dodd-Frank Act and believe that **the principles set forth in the final guidance are useful when conducting the stress tests required under the Act.**

Notably, the final guidance was framed broadly to inform a banking organization's use of stress testing in overall risk management, not just stress tests required under the Dodd-Frank Act.

Dodd-Frank stress tests would generally be considered part of an organization's overall stress testing framework as described in the stress testing guidance.

B. Stress Testing Principles

As noted above, the proposed guidance identified and included a discussion of **four key principles** for a banking organization's stress testing framework and related stress test results, namely that:

- (1) A banking organization's stress testing framework should include activities and exercises that are **tailored to and sufficiently capture the banking organization's exposures, activities, and risks;**
- (2) An effective stress testing framework employs **multiple** conceptually sound stress testing activities and approaches;
- (3) An effective stress testing framework is **forward-looking and flexible;** and
- (4) Stress test results should be **clear, actionable, well supported, and inform decision-making.**

In the final guidance, the agencies have incorporated a **fifth principle** specifying that an organization's stress testing framework **should include strong governance and effective internal controls.**

The elements of the fifth principle had been set forth in section VI of the proposed guidance, and the fifth principle does not expand on this aspect of the proposed guidance.

Rather, the agencies reorganized this discussion into a fifth principle

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in order to underscore the importance of governance and controls as a key element in a banking organization's stress testing framework.

As noted above, commenters were supportive of the principles-based approach and the notion that a banking organization's stress testing framework should be implemented in a manner commensurate with factors such as the complexity and size of the organization.

With more specific regard to the proposed principles, commenters suggested that the final guidance address the standardization of stress testing through the inclusion of **common coefficients, models, or benchmarks**.

These commenters expressed concerns that banking organizations would implement the principles inconsistently and that standardization would help regulators conduct comparative analyses across firms.

Another commenter suggested that the agencies prescribe more detailed and integrated stress testing between different entities or business units within an organization.

The agencies did not modify the guidance in response to these comments.

A key aspect of the guidance is to provide organizations flexibility on how they design their individual stress testing frameworks.

Thus, each banking organization should design a specific stress testing framework to capture risks relevant to the organization.

The agencies believe that prescribing standardized stress tests in this guidance would have its own inherent limitations and may not appropriately cover a banking organization's material risks and activities.

In addition, commenters suggested that the agencies mandate public release of stress testing results through the guidance.

The agencies have considered these comments, but do not believe the final guidance is the appropriate place for such a requirement given its broader focus on banking organizations' overall stress testing frameworks.

The agencies note, however, that banking organizations may be required to disclose information about their stress tests pursuant to other statutory, regulatory, or supervisory requirements.

A few commenters stated that a banking organization should explain and justify the stress testing methodologies it utilizes to its primary federal supervisor.

The agencies note that **supervisors will examine firms' stress testing methodologies through the supervisory process.**

One commenter noted that the guidance should explicitly indicate that liabilities should be part of a banking organization's stress testing activities; the agencies intended that stress testing activities would take an organization's liabilities into account and have clarified this in the final guidance.

Three commenters suggested that operational risk be specifically referenced in the guidance.

In response, **the agencies have clarified in the final guidance that operational risk should be among the risks considered by an organization's stress testing framework.**

Another commenter expressed concern that the frequency of stress testing and communication of results might eventually desensitize senior management to them.

The agencies believe that regular review of stress test results is useful – both during periods of economic downturn and benign periods – and have clarified that such review can help a banking organization track over time the impact of ongoing business activities, changes in exposures, varying economic conditions, and market movements on its financial condition.

Aside from the inclusion of a fifth principle as described above, the agencies have otherwise adopted the proposed principles in the final guidance with only minor additional refinements.

C. Stress testing approaches and applications

The proposed guidance described **certain** stress testing approaches and applications – scenario analysis, sensitivity analysis, enterprise-wide testing, and reverse stress testing – that a banking organization could consider using within its stress testing framework, as appropriate.

The proposed guidance provided that **each banking organization should apply these approaches** and applications commensurate with its size, complexity, and business profile, and may not need to incorporate all of the details described in the guidance.

Some commenters questioned the appropriate number and types of stress test approaches an organization should utilize.

The agencies do **not believe that specifying a number** or particular types of approaches – including the number of scenarios – is appropriate in the guidance given the wide range of stress testing activities that different banking organizations may undertake.

A **banking organization should choose** the approaches that appropriately consider the unique characteristics of that particular organization and the relevant risks it faces.

The agencies expect that stress testing methodologies will evolve over time as banking organizations develop approaches that best capture their individual risk profiles.

In addition, the proposed guidance described reverse stress testing as a tool that would **allow a banking organization to assume a known adverse outcome**, such as suffering a credit loss that causes it to breach a minimum regulatory capital ratio or suffering severe liquidity constraints making it unable to meet its obligations, and then deduce the types of events that could lead to such an outcome.

This type of stress testing may help a banking organization to **consider scenarios beyond its normal business expectations and see the impact of severe systemic effects on the banking organization.**

It also would allow a banking organization to **challenge common assumptions** about its performance and expected mitigation strategies.

Three commenters expressed doubts regarding the effectiveness of reverse stress testing, as the approach could produce results of questionable value and captures unlikely, “extreme” scenarios.

The agencies reiterate the value of reverse stress testing, as it helps a banking organization **evaluate the combined effect of several types of extreme events** and circumstances that might threaten the survival of the banking organization, even if in isolation each of the effects might be manageable.

Another commenter expressed concern that the results of severe scenarios used for reverse stress testing would directly lead to a supervisory requirement to raise capital if the results of the approach were unfavorable to the organization.

In addition, some commenters sought clarification that results would not be used by regulators to criticize banking organizations.

As stated in the proposed guidance, a given stress test result will not necessarily lead to immediate action by a firm, and in some cases stress test results – including those from reverse stress tests – are most useful for the additional information they provide.

In terms of supervisory responses to an organization's stress testing activities, the agencies expect to consider a banking organization's stress test results and the appropriateness of its overall stress testing framework, along with all other relevant information, in assessing a banking organization's risk management practices, as well as its capital and liquidity adequacy.

The guidance sets forth supervisory expectations for prudent risk management practices and a firm's decision not to follow the principles in this guidance will be examined as part of the supervisory process and may be cited as evidence of unsafe and unsound practices.

D. Stress testing for assessing adequacy of capital and liquidity

Given the importance of **capital and liquidity** to a banking organization's viability, stress testing should be applied to these two areas on a regular basis.

Stress testing for capital and liquidity adequacy should be conducted in coordination with a banking organization's overall business strategy and annual planning cycles.

Results should be refreshed in the event of major strategic decisions, or other changes that can materially impact capital or liquidity.

An effective stress testing framework should explore the potential for capital and liquidity problems to arise at the same time or **exacerbate one another**.

A banking organization's liquidity stress analysis should explore situations in which the banking organization may be operating with a capital position that exceeds regulatory minimums, but **is nonetheless viewed within the financial markets or by its counterparties as being of questionable viability**.

For its capital and liquidity stress tests, a banking organization should articulate clearly its objectives for a **post-stress outcome**, for instance to remain a viable financial market participant that is able to meet its existing and prospective obligations and commitments.

In response to comments received on the planning horizon for stress tests, the agencies clarified that while capital stress tests should generally be conducted with a horizon of at least two years, organizations should recognize that the effects of certain stress conditions could extend beyond that horizon.

The agencies have also clarified, in response to comments, that consolidated stress tests should account for the fact that certain legal entities within the consolidated organization are required to meet regulatory capital requirements.

A commenter requested clarification on whether capital and liquidity stress testing should be evaluated in unified or separate stress tests.

The proposed guidance did not specify the precise manner in which capital and liquidity stress tests should be performed.

The final guidance notes that assessing the potential interaction of capital and liquidity can be challenging and may not be possible within a single stress test, so a banking organization should explore several avenues to assess that interaction.

In any case, the agencies believe that stress testing for both liquidity and capital adequacy should be an integral part of a banking organization's stress testing framework.

E. Governance and controls

As noted under the new fifth principle of the final guidance, a banking organization's stress testing framework will be effective only if it is subject to strong governance and controls to ensure that the framework functions as intended.

Strong governance and controls also help ensure that the framework contains core elements, from clearly defined stress testing objectives to recommended actions.

Importantly, strong governance provides critical review of elements of the stress testing framework, especially regarding key assumptions, uncertainties, and limitations.

A banking organization should ensure that the stress testing framework is not isolated within a banking organization's risk management function, but is firmly integrated into business lines, capital and asset-liability committees, and other decision-making bodies.

As part of their overall responsibilities, a banking organization's board and senior management should establish a comprehensive, integrated and effective stress testing framework that fits into the broader risk management of the banking organization.

Stress testing results should be used to inform the board about alignment of the banking organization's risk profile with the board's chosen risk appetite, as well as inform operating and strategic decisions.

Stress testing results should be considered directly by the board and senior management for decisions relating to capital and liquidity adequacy.

Senior management, in consultation with the board, should ensure that the stress testing framework includes a sufficient range of stress testing activities applied at the appropriate levels of the banking organization (i.e., not just one enterprise-wide stress test).

Several commenters raised concerns regarding the proposed responsibilities of a banking organization's board of directors with respect to stress tests and the framework.

One commenter believed that the board of directors should not review all stress test results, but rather only those that were expected to have a material impact on the overall organization.

Another commenter expressed the belief that the board of directors should be involved in providing direction and oversight regarding the banking organization's stress testing framework, but that the board of directors should not be expected to be involved directly in more operational aspects of the framework.

The agencies have modified the final guidance to clarify that senior management, not the board of directors, should have the primary responsibility for stress testing implementation and technical design.

However, the agencies emphasize that a banking organization's board of directors should be provided with information from senior management on stress testing developments (including the process to design tests and develop scenarios) and on stress testing results (including from individual tests, where material).

As a general matter, the board of directors is also responsible for monitoring effectiveness of the overall framework, and using the results to inform their decision making process.

In addition, the final guidance specifies that senior management should, in consultation with the board of directors, review stress testing activities and results with an appropriately critical eye to ensure that there is objective review and that the stress testing framework includes a sufficient range of stress testing activities applied at the appropriate levels of the banking organization.

Finally, in response to comments, the agencies have clarified that a banking organization's minimum annual review and assessment of the effectiveness of their stress testing framework should ensure that stress testing coverage is comprehensive, tests are relevant and current, methodologies are sound, and results are properly considered.

IV. Administrative Law Matters

A. Paperwork Reduction Act Analysis

In accordance with the Paperwork Reduction Act ("PRA") of 1995 the agencies reviewed the final guidance. The agencies may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the information collection displays a currently valid OMB control number.

While the guidance is not being adopted as a rule, the agencies determined that certain aspects of the guidance may constitute a collection of information and, therefore, believed it was helpful to publish a burden estimate with the guidance.

In particular, the aspects of the guidance that may constitute an information collection are the provisions that state a banking organization should

- (i) Have a stress testing framework that includes clearly defined objectives, well-designed scenarios tailored to the banking organization's business and risks, well-documented assumptions, conceptually sound methodologies to assess potential impact on the banking organization's financial condition, informative management reports, and recommended actions based on stress test results; and
- (ii) Have policies and procedures for a stress testing framework.

The agencies estimated that the above-described information collections included in the guidance would take respondents, on average, 260 hours each year.

The frequency of information collection is estimated to be annual. Respondents are banking organizations with more than \$10 billion in total consolidated assets, as defined in the guidance.

The agencies received three comment letters regarding the paperwork burden of the guidance, stating that implementation will require a multiple of the 260 estimated hours.

The agencies emphasize that the guidance **does not** implement the stress testing requirements imposed by the Dodd-Frank Act or the Board's capital plan rule, and **does not** otherwise impose mandatory stress testing requirements.

The **burden of information collections** associated with mandatory stress tests will be accounted for in the respective rules that implement those requirements.

In addition, the agencies believe that in some respects, **the information collection elements of this guidance augment certain expectations that already are in place relative to certain existing supervisory guidance.**

The burden estimates for this guidance take into consideration only those collections of information, such as documentation of policies and procedures and relevant reports, that are specific to this guidance.

Based on these factors, the agencies believe the burden estimates included in the proposed guidance continue to be appropriate.

V. Final supervisory guidance

The text of the final supervisory guidance is as follows:

**Office of the Comptroller of the Currency
Federal Reserve System
Federal Deposit Insurance Corporation**

Guidance on Stress Testing for Banking Organizations with Total Consolidated Assets of More Than \$10 Billion

I. Introduction

All banking organizations **should have the capacity** to understand fully their risks and the potential impact of stressful events and circumstances on their financial condition.

The U.S. federal banking agencies have previously highlighted the use of stress testing as a means to better understand the range of a banking organization's potential risk exposures.

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The 2007-2009 financial crisis underscored the **need for banking organizations to incorporate stress testing into their risk management practices**, demonstrating that banking organizations unprepared for stressful events and circumstances can suffer acute threats to their financial condition and viability.

The Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the “agencies”) are issuing this guidance to emphasize the importance of stress testing as an **ongoing risk management practice** that supports banking organizations’ forward-looking assessment of risks and better equips them to address a range of adverse outcomes.

This joint guidance is applicable to all institutions supervised by the agencies with **more than \$10 billion in total consolidated assets**.

Specifically, with respect to the OCC, these banking organizations include national banking associations, federal savings associations, and federal branches and agencies; with respect to the Board, these banking organizations include state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; with respect to the FDIC, these banking organizations include state nonmember banks, state savings associations and insured branches of foreign banks.

The guidance **does not apply to any supervised institution below the designated asset threshold**.

Certain other existing supervisory guidance that applies to all supervised institutions discusses the use of stress testing as a tool in certain aspects of risk management, such as for commercial real estate concentrations, liquidity risk management, and interest-rate risk management.

However, **no institution at or below \$10 billion in total consolidated assets is subject to this final guidance**.

Building upon previously issued supervisory guidance that discusses the uses and merits of stress testing in specific areas of risk management, this guidance provides broad principles a banking organization should follow in conducting its stress testing activities, such as ensuring that those activities fit into the organization’s overall risk management program.

The guidance outlines broad principles for a satisfactory stress testing framework and describes the manner in which stress testing should be employed as an integral component of risk management that is applicable at various levels of aggregation

within a banking organization, as well as for contributing to capital and liquidity planning.

While the guidance is not intended to provide detailed instructions for conducting stress testing for any particular risk or business area, the document describes several types of stress testing activities and how they may be most appropriately used by banking organizations.

II. Overview of Stress Testing Framework

For purposes of this guidance, **stress testing refers to exercises used to conduct a forward looking assessment of the potential impact of various adverse events and circumstances on a banking organization.**

Stress testing occurs at various levels of aggregation, including on an enterprise-wide basis.

As outlined in section IV, there are **several approaches** and applications for stress testing and a banking organization should consider the use of each in its stress testing framework.

An effective stress testing framework provides a comprehensive, integrated, and **forward looking** set of activities for a banking organization to employ along with other practices in order to assist in the identification and measurement of its material risks and vulnerabilities, including those that may manifest themselves during stressful economic or financial environments, or arise from firm-specific adverse events.

Such a framework **should supplement other quantitative risk management practices, such as those that rely primarily on statistical estimates of risk or loss estimates based on historical data, as well as qualitative practices.**

In this manner, stress testing can assist in highlighting unidentified or under-assessed risk concentrations and interrelationships and their potential impact on the banking organization during times of stress.

A banking organization should develop and implement its stress testing framework in a manner commensurate with its size, complexity, business activities, and overall risk profile.

Its stress testing framework **should include** clearly defined objectives, well-designed scenarios tailored to the banking organization's business and risks, well-documented

assumptions, sound methodologies to assess potential impact on the banking organization's financial condition, informative management reports, ongoing and effective review of stress testing processes, and recommended actions based on stress test results.

Stress testing **should incorporate the use of high-quality data and appropriate assumptions about the performance of the institution under stress to ensure that the outputs are credible and can be used to support decision-making.**

Importantly, a banking organization should have a sound governance and control infrastructure with objective, critical review to ensure the stress testing framework is functioning as intended.

A stress testing framework **should allow a banking organization to conduct consistent, repeatable exercises that focus on its material exposures, activities, risks, and strategies, and also conduct ad hoc scenarios as needed.**

The framework should consider the impact of both firm specific and systemic stress events and circumstances that are based on historical experience as well as on hypothetical occurrences that could have an adverse impact on a banking organization's operations and financial condition.

Banking organizations subject to this guidance should develop **policies** on reviewing and assessing the effectiveness of their stress testing frameworks, and use those policies at least annually to assess the effectiveness of their frameworks.

Such assessments should help to ensure that stress testing coverage is comprehensive, tests are relevant and current, methodologies are sound, and results are properly considered.

III. General Stress Testing Principles

A banking organization should develop and implement an effective stress testing framework as part of its broader risk management and governance processes.

The framework should include several activities and exercises, and not just rely on any single test or type of test, since every stress test has limitations and relies on certain assumptions.

The uses of a banking organization's stress testing framework **should include, but are not limited to,**

- augmenting risk identification and measurement;
- estimating business line revenues and losses and informing business line strategies;
- identifying vulnerabilities, assessing the potential impact from those vulnerabilities, and identifying appropriate actions;
- assessing capital adequacy and enhancing capital planning; assessing liquidity adequacy and informing contingency funding plans;
- contributing to strategic planning;
- enabling senior management to better integrate strategy, risk management, and capital and liquidity planning decisions; and assisting with recovery and resolution planning.

This section describes general principles that a banking organization should apply in implementing such a framework.

Principle 1:

A banking organization's stress testing framework should include activities and exercises that are **tailored to and sufficiently capture the banking organization's exposures, activities, and risks.**

An effective stress testing framework **covers a banking organization's full set of material exposures, activities, and risks, whether on or off the balance sheet, based on effective enterprise-wide risk identification and assessment.**

Risks addressed in a firm's stress testing framework may include (but are not limited to) credit, market, operational, interest-rate, liquidity, country, and strategic risk.

The framework should also address non-contractual sources of risks, such as those related to a banking organization's reputation.

Appropriate coverage is important as stress testing results could give a false sense of comfort if certain portfolios, exposures, liabilities, or business line activities are not included.

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Stress testing exercises should be part of a banking organization's regular risk identification and measurement activities.

For example, **in assessing credit risk a banking organization should evaluate the potential impact of adverse outcomes, such as an economic downturn or declining asset values, on the condition of its borrowers and counterparties, and on the value of any supporting collateral.**

As another example, in assessing interest-rate risk, banking organizations should analyze the effects of significant interest rate shocks or other yield-curve movements. An effective stress testing framework should be applied at various levels in the banking organization, such as business line, portfolio, and risk type, as well as on an enterprise-wide basis.

In many cases, stress testing may be more effective at business line and portfolio levels, as a higher level of aggregation may cloud or underestimate the potential impact of adverse outcomes on a banking organization's financial condition.

In some cases, stress testing can also be applied to individual exposures or instruments.

Each stress test should be tailored to the relevant level of aggregation, capturing critical risk drivers, internal and external influences, and other key considerations at the relevant level.

Stress testing should capture the interplay among different exposures, activities, and risks and their combined effects.

While stress testing several types of risks or business lines simultaneously may prove operationally challenging, a banking organization should aim to identify common risk drivers across risk types and business lines that can adversely affect its financial condition.

Accordingly, **stress tests should provide a banking organization with the ability to identify potential concentrations – including those that may not be readily observable during benign periods and whose sensitivity to a common set of factors is apparent only during times of stress – and to assess the impact of identified concentrations of exposures, activities, and risks within and across portfolios and business lines and on the organization as a whole.**

Stress testing should be tailored to the banking organization's idiosyncrasies and specific business mix and include all major business lines and significant individual counterparties.

For example, a banking organization that is geographically concentrated may determine that a certain segment of its business may be more adversely affected by shocks to economic activity at the state or local level than by a severe national recession.

On the other hand, if the banking organization has significant global operations, it should consider scenarios that have an international component and stress conditions that could affect the different aspects of its operations in different ways, as well as conditions that could adversely affect all of its operations at the same time.

A banking organization should use its stress testing framework to determine whether exposures, activities, and risks under normal and stressed conditions are aligned with the banking organization's risk appetite.

A banking organization can use stress testing to help inform decisions about its strategic direction and/or risk appetite by better understanding the risks from its exposures or of engaging in certain business practices.

For example, if a banking organization pursues a business strategy for a new or modified product, and the banking organization does not have long-standing experience with that product or lacks extensive data, the banking organization can use stress testing to identify the product's potential downsides and unanticipated risks.

Scenarios used in a banking organization's stress tests should be relevant to the direction and strategy set by its board of directors, as well as sufficiently severe to be credible to internal and external stakeholders.

Principle 2:

An effective stress testing framework employs multiple conceptually sound stress testing activities and approaches.

All measures of risk, including stress tests, have an element of uncertainty due to assumptions, limitations, and other factors associated with using past performance measures and forward-looking estimates.

Banking organizations should, therefore, use multiple stress testing activities and approaches (consistent with section IV), and ensure that each is conceptually sound.

Stress tests usually vary in design and complexity, including the number of factors employed and the degree of stress applied.

A banking organization should ensure that the complexity of any given test does not undermine its integrity, usefulness, or clarity.

In some cases, relatively simple tests can be very useful and informative.

Additionally, **effective stress testing relies on high-quality input data and information to produce credible outcomes.**

A banking organization should ensure that it has readily available data and other information for the types of stress tests it uses, including key variables that drive performance.

In addition, a banking organization **should have appropriate management information systems (MIS) and data processes** that enable it to collect, sort, aggregate, and update data and other information efficiently and reliably within business lines and across the banking organization for use in stress testing.

If certain data and information are not current or not available, or if proxies are used, **a banking organization should analyze the stress test outputs with an understanding of those data limitations.**

A banking organization should also document the assumptions used in its stress tests and note the degree of uncertainty that may be incorporated into the tools used for stress testing.

In some cases, it may be appropriate to present and analyze test results not just in terms of point estimates, but also including the potential margin of error or statistical uncertainty around the estimates.

Furthermore, almost all stress tests, including well-developed quantitative tests supported by high-quality data, employ a certain amount of expert or business judgment, and the role and impact of such judgment should be clearly documented.

In some cases, when credible data are lacking and more quantitative tests are operationally challenging or in the early stages of development, a banking

organization may choose to employ more qualitatively based tests, provided that the tests are properly documented and their assumptions are transparent.

Regardless of the type of stress tests used, a banking organization should understand and clearly document all assumptions, uncertainties, and limitations, and provide that information to users of the stress testing results.

Principle 3:

An effective stress testing framework is **forward-looking** and **flexible**.

A stress testing framework should be **sufficiently dynamic and flexible** to incorporate changes in a banking organization's **on- and off-balance-sheet activities**, portfolio composition, asset quality, operating environment, business strategy, and other risks that may arise over time from firm-specific events, macroeconomic and financial market developments, or some combination of these events.

A banking organization should also ensure that its MIS are capable of incorporating relatively rapid changes in exposures, activities, and risks.

While stress testing should utilize available historical information, a banking organization should look beyond assumptions based only on historical data and **challenge conventional assumptions**.

A banking organization should ensure that it is not constrained by past experience and that it considers multiple scenarios, even scenarios that have not occurred in the recent past or during the banking organization's history.

For example, a banking organization should not assume that if it has suffered no or minimal losses in a certain business line or product that such a pattern will continue.

Structural changes in customer, product, and financial markets can present unprecedented situations for a banking organization.

A banking organization with any type of significant concentration can be particularly vulnerable to rapid changes in economic and financial conditions and should try to identify and better understand the impact of those vulnerabilities in advance.

For example, the risks related to residential mortgages were underestimated for a number of years leading up to the 2007-2009 financial crisis by a large number of banking organizations, and those risks eventually affected the banking organizations in a variety of ways.

Effective stress testing can help a banking organization identify any such concentrations and help understand the potential impact of several key aspects of the business being exposed to common drivers.

Stress testing should be conducted over various relevant time horizons to adequately capture both conditions that may materialize in the near term and adverse situations that take longer to develop.

For example, when a banking organization stress tests a portfolio for market and credit risks simultaneously, it should consider that certain credit risk losses may take longer to materialize than market risk losses, and also that the severity and speed of mark-to-market losses may create significant vulnerabilities for the firm, even if a more fundamental analysis of how realized losses may play out over time seems to show less threatening results.

A banking organization should carefully consider the incremental and cumulative effects of stress conditions, particularly with respect to potential interactions among exposures, activities, and risks and possible second-order or “knock-on” effects. In addition to conducting formal, routine stress tests, a banking organization should have the flexibility to conduct new or ad hoc stress tests in a timely manner to address rapidly emerging risks.

These less routine tests usually can be conducted in a short amount of time and may be simpler and less extensive than a banking organization’s more formal, regular tests.

However, for its ad hoc tests a banking organization should still have the capacity to bring together approximated information on risks, exposures, and activities and assess their impact.

More broadly, a banking organization should continue updating and maintaining its stress testing framework in light of new risks, better understanding of the banking organization’s exposures and activities, new stress testing techniques, and any changes in its operating structure and environment.

A banking organization’s stress testing development should be iterative, with ongoing adjustments and refinements to better calibrate the tests to provide current and relevant information.

Banking organizations should document the ongoing development of their stress testing practices.

Principle 4:

Stress test results should be **clear, actionable, well supported, and inform decision-making.**

Stress testing should incorporate measures that adequately and effectively convey results of the impact of adverse outcomes.

Such measures may include, for example, **changes to asset values, accounting and economic profit and loss, revenue streams, liquidity levels, cash flows, regulatory capital, risk-weighted assets, the loan loss allowance, internal capital estimates, levels of problem assets, breaches in covenants or key trigger levels, or other relevant measures.**

Stress test measures should be tailored to the type of test and the particular level at which the test is applied (for example, at the business line or risk level). Some stress tests may require using a range of measures to evaluate the full impact of certain events, such as a severe systemic event.

In addition, **all stress test results should be accompanied by descriptive and qualitative information (such as key assumptions and limitations) to allow users to interpret the exercises in context.**

The analysis and the process should be well documented so that stress testing processes can be replicated if need be.

A banking organization should regularly communicate stress test results to appropriate levels within the banking organization to foster dialogue around stress testing, **keep the board of directors, management, and staff apprised, and to inform stress testing approaches, results, and decisions in other areas of the banking organization.**

A banking organization should maintain an internal summary of test results to document at a high level the range of its stress testing activities and outcomes, as well as proposed follow-up actions.

Regular review of stress test results can be an important part of a banking organization's ability over time to track the impact of ongoing business activities, changes in exposures, varying economic conditions, and market movements on its financial condition.

In addition, **management should review** stress testing activities on a regular basis to determine, among other things, the validity of the assumptions, the severity of tests,

the robustness of the estimates, the performance of any underlying models, and the stability and reasonableness of the results.

Stress test results **should inform** analysis and decision-making related to business strategies, limits, risk profile, and other aspects of risk management, consistent with the banking organization's established risk appetite.

A banking organization should review the results of its various stress tests with the strengths and limitations of each test in mind (consistent with Principle 2), determines which results should be given greater or lesser weight, analyze the combined impact of its tests, and then evaluate potential courses of action based on that analysis.

A banking organization may decide to maintain its current course based on test results; indeed, the results of highly severe stress tests need not always indicate that immediate action has to be taken.

Wherever possible, benchmarking or other comparative analysis should be used to evaluate the stress testing results relative to other tools and measures – both internal and external to the banking organization – to provide proper context and a check on results.

Principle 5:

An organization's stress testing framework **should include strong governance and effective internal controls.**

Similar to other aspects of its risk management, a banking organization's stress testing framework will be effective only if it is subject to strong governance and effective internal controls to ensure the framework is functioning as intended. Strong governance and effective internal controls help ensure that the framework contains core elements, from clearly defined stress testing objectives to recommended actions.

Importantly, strong governance provides critical review of elements of the stress testing framework, especially regarding key assumptions, uncertainties, and limitations.

A banking organization should ensure that the stress testing framework is not isolated within a banking organization's risk management function, but is firmly integrated into business lines, capital and asset-liability committees, and other decision making bodies.

Along those lines, the board of directors and senior management should play key roles in ensuring strong governance and controls.

The extent and sophistication of a banking organization's governance over its stress testing framework should align with the extent and sophistication of that framework.

Additional details regarding governance and controls of an organization's stress testing framework are outlined in section VI.

IV. Stress Testing Approaches and Applications

This section discusses some general types of stress testing approaches and applications.

For any type of stress test, banking organizations should indicate the specific purpose and the focus of the test.

Defining the scope of a given stress test is also important, whether it applies at the portfolio, business line, risk type, or enterprise-wide level, or even just for an individual exposure or counterparty.

Based on the purpose and scope of the test, different stress testing techniques are most useful.

Thus, a banking organization should employ several approaches and applications; these might include scenario analysis, sensitivity analysis, enterprise-wide stress testing, and reverse stress testing.

Consistent with Principle 1, banking organizations should apply these commensurate with their size, complexity, and business profile, and may not need to incorporate all of the details described below.

Consistent with Principle 3, banking organizations should also recognize that stress testing approaches will evolve over time and they should update their practices as needed.

Scenario Analysis

Scenario analysis refers to a type of stress testing in which a banking organization applies historical or hypothetical scenarios to assess the impact of various events and circumstances, including extreme ones.

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Scenarios usually involve some kind of coherent, logical narrative or “story” as to why certain events and circumstances can occur and in which combination and order, such as a severe recession, failure of a major counterparty, loss of major clients, natural or man-made disaster, localized economic downturn, disruptions in funding or capital markets, or a sudden change in interest rates brought about by unfavorable inflation developments.

Scenario analysis can be applied at various levels of the banking organization, such as within individual business lines to help identify factors that could harm those business lines most.

Stress scenarios should reflect a banking organization’s unique vulnerabilities to factors that affect its exposures, activities, and risks.

For example, if a banking organization is concentrated in a particular line of business, such as commercial real estate or residential mortgage lending, it would be appropriate to explore the impact of a downturn in those particular market segments.

Similarly, a banking organization with lending concentrations to oil and gas companies should include scenarios related to the energy sector.

Other relevant factors to be considered in scenario analysis relate to operational, reputational and legal risks to a banking organization, such as significant events of fraud or litigation, or a situation when a banking organization feels compelled to provide support to an affiliate or provide other types of non-contractual support to avoid reputational damage.

Scenarios should be internally consistent and portray realistic outcomes based on underlying relationships among variables, and should include only those mitigating developments that are consistent with the scenario.

Additionally, a banking organization should consider the best manner to try to capture combinations of stressful events and circumstances, including second-order and “knock-on” effects.

Ultimately, a banking organization should select and design multiple scenarios that are relevant to its profile and make intuitive sense, use enough scenarios to explore the range of potential outcomes, and ensure that the scenarios continue to be timely and relevant.

A banking organization may apply scenario analysis within the context of its existing risk measurement tools (e.g., the impact of a severe decline in market prices on a banking organization's value-at-risk (VaR) measure) or use it as an alternative, supplemental measure.

For instance, a banking organization may use scenario analysis to measure the impact of a severe financial market disturbance and compare those results to what is produced by its VaR or other measures.

This type of scenario analysis should account for known shortcomings of other risk measurement practices.

For example, market risk VaR models generally assume liquid markets with known prices.

Scenario analysis could shed light on the effects of a breakdown in liquidity and of valuation difficulties.

One of the key challenges with scenario analysis is to translate a scenario into balance sheet impact, changes in risk measures, potential losses, or other measures of adverse financial impact, which would vary depending on the test design and the type of scenario used.

For some aspects of scenario analysis, banking organizations may use econometric or similar types of analysis to estimate a relationship between some underlying factors or drivers and risk estimates or loss projections based on a given data set, and then extrapolate to see the impact of more severe inputs.

Care should be taken not to make assumptions that relationships from benign or mildly adverse times will hold during more severe times or that estimating such relationships is relatively straightforward.

For example, linear relationships between risk drivers and losses may become nonlinear during times of stress.

In addition, organizations should recognize that there can be multiple permutations of outcomes from just a few key risk drivers.

Sensitivity Analysis

Sensitivity analysis refers to a banking organization's assessment of its exposures, activities, and risks when certain variables, parameters, and inputs are "stressed" or "shocked."

A key goal of sensitivity analysis is to test the impact of assumptions on outcomes.

Generally, sensitivity analysis differs from scenario analysis in that it involves changing variables, parameters, or inputs without an explicit underlying reason or narrative, in order to explore what occurs under a range of inputs and at extreme or highly adverse levels.

In this type of analysis a banking organization may realize, for example, that a given relationship is much more difficult to estimate at extreme levels.

A banking organization may apply sensitivity analysis at various levels of aggregation to estimate the impact from a change in one or more key variables.

The results may help a banking organization better understand the range of outcomes from some of its models, such as developing a distribution of output based on a variety of extreme inputs.

For example, a banking organization may choose to calculate a range of changes to a structured security's overall value using a range of different assumptions about the performance and linkage of underlying cash flows.

Sensitivity analysis should be conducted periodically due to potential changes in a banking organization's exposures, activities, operating environment, or the relationship of variables to one another.

Sensitivity analysis can also help to assess a combined impact on a banking organization of several variables, parameters, factors, or drivers.

For example, a banking organization could better understand the impact on its credit losses from a combined increase in default rates and a decrease in collateral values.

A banking organization could also explore the impact of highly adverse capitalization rates, declines in net operating income, and reductions in collateral when evaluating its risks from commercial real estate exposures.

Sensitivity analysis can be especially useful because it is not necessarily accompanied by a particular narrative or scenario; that is, sensitivity analysis can provide banking organizations more flexibility to explore the impact of potential stresses that they may not be able to capture in designed scenarios.

Furthermore, banking organizations may decide to conduct sensitivity analysis of their scenarios, i.e., choosing different levels or paths of variables to understand the sensitivities of choices made during scenario design.

For instance, banking organizations may decide to apply a few different interest-rate paths for a given scenario.

Enterprise-Wide Stress Testing

Enterprise-wide stress testing is an application of stress testing that involves assessing the impact of certain specified scenarios on the banking organization as a whole, particularly with regard to capital and liquidity.

As is the case with scenario analysis more generally, enterprise wide stress testing involves robust scenario design and effective translation of scenarios into measures of impact.

Enterprise-wide stress tests can help a banking organization in its efforts to assess the impact of its full set of risks under adverse events and circumstances, but should be supplemented with other stress tests and other risk measurement tools given inherent limitations in capturing all risks and all adverse outcomes in one test.

Scenario design for enterprise-wide stress testing involves developing scenarios that affect the banking organization as a whole that stem from macroeconomic, market-wide, and/or firm-specific events.

These scenarios should incorporate the potential simultaneous occurrence of both firm-specific and macroeconomic and market-wide events, considering system-wide interactions and feedback effects.

For example, price shocks may lead to significant portfolio losses, rising funding gaps, a ratings downgrade, and diminished access to funding.

In general, it is a good practice to consult with a large set of individuals within the banking organization – in various business lines, research and risk areas – to gain a wide perspective on how enterprise wide scenarios should be designed and to ensure

that the scenarios capture the relevant aspects of the banking organization's business and risks.

Banking organizations should also conduct scenarios of varying severity to gauge the relative impact.

At least some scenarios should be of sufficient severity to challenge the viability of the banking organization, and should include instantaneous market shocks and stressful periods of extended duration (e.g., not just a one or two-quarter shock after which conditions return to normal).

Selection of scenario variables is important for enterprise-wide tests, because these variables generally serve as the link between the overall narrative of the scenario and tangible impact on the banking organization as a whole.

For instance, **in aiming to capture the combined impact of a severe recession and a financial market downturn, a banking organization may choose a set of variables such as changes in gross domestic product (GDP), unemployment rate, interest rates, stock market levels, or home price levels.**

However, particularly when assessing the impact on the whole banking organization, using a large number of variables can make a test more cumbersome and complicated – so a banking organization may also benefit from simpler scenarios or from those with fewer variables.

Banking organizations should balance the comprehensiveness of contributing variables and tractability of the exercise.

As with scenario analysis generally, translating scenarios into tangible effects on the banking organization as a whole presents certain challenges.

A banking organization should identify appropriate and meaningful mechanisms for translating scenarios into relevant internal risk parameters that provide a firm-wide view of risks and understanding of how these risks are translated into loss estimates.

Not all business areas are **equally affected by a given scenario, and problems in one business area can have effects on other units.**

However, for an enterprise-wide test, assumptions across business lines and risk areas should remain constant for the chosen scenario, since the objective is to see how the banking organization as a whole will be affected by a common scenario.

Reverse Stress Testing

Reverse stress testing is a tool that allows a banking organization to **assume a known adverse outcome**, such as suffering a credit loss that breaches regulatory capital ratios or suffering severe liquidity constraints that render it unable to meet its obligations, and **then deduce the types of events that could lead to such an outcome.**

This type of stress testing may help a banking organization to consider scenarios beyond its normal business expectations and see the impact of severe systemic effects on the banking organization.

It also **allows a banking organization to challenge common assumptions about its performance and expected mitigation strategies.**

Reverse stress testing helps to explore so-called “break the bank” situations, allowing a banking organization to set aside the issue of estimating the likelihood of severe events and to focus more on what kinds of events could threaten the viability of the banking organization.

This type of stress testing also **helps a banking organization evaluate the combined effect of several types of extreme events and circumstances that might threaten the survival of the banking organization, even if in isolation each of the effects might be manageable.**

For instance, reverse stress testing may help a banking organization recognize that a certain level of unemployment would have a severe impact on credit losses, that a market disturbance could create additional losses and result in rising funding costs, and that a firm-specific case of fraud would cause even further losses and reputational impact that could threaten a banking organization’s viability.

In some cases, **reverse stress tests could reveal to a banking organization that “breaking the bank” is not as remote an outcome as originally thought.**

Given the numerous potential threats to a banking organization’s viability, the organization should ensure that it focuses first on those scenarios that have the largest firm-wide impact, such as insolvency or illiquidity, but also on those that seem most imminent given the current environment.

Focusing on the most prominent vulnerabilities helps a banking organization prioritize its choice of scenarios for reverse stress testing.

However, a banking organization should also consider a wider range of possible scenarios that could jeopardize the viability of the banking organization, exploring what could represent potential blind spots.

Reverse stress testing can highlight previously unacknowledged sources of risk that could be mitigated through enhanced risk management.

V. Stress Testing for Assessing the Adequacy of Capital and Liquidity

There are many uses of stress testing within banking organizations.

Prominent among these are **stress tests designed to assess the adequacy of capital and liquidity.**

Given the importance of capital and liquidity to a banking organization's viability, stress testing should be applied in these two areas in particular, including an evaluation of the interaction between capital and liquidity and the potential for both to become impaired at the same time.

Depletions and shortages of capital or liquidity can cause a banking organization to no longer perform effectively as a financial intermediary, be viewed by its counterparties as no longer viable, become insolvent, or diminish its capacity to meet legal and financial obligations.

A banking organization's capital and liquidity stress testing should consider how losses, earnings, cash flows, capital, and liquidity would be affected in an environment in which multiple risks manifest themselves at the same time, for example, an increase in credit losses during an adverse interest-rate environment.

Additionally, **banking organizations should recognize that at the end of the time horizon considered by a given stress test, they may still have substantial residual risks or problem exposures that may continue to pressure capital and liquidity resources.**

Stress testing for capital and liquidity adequacy should be conducted in coordination with a banking organization's overall strategy and annual planning cycles.

Results should be refreshed in the event of major strategic decisions, or other decisions that can materially impact capital or liquidity.

Banking organizations should conduct stress testing for capital and liquidity adequacy periodically.

Capital Stress Testing

Capital stress testing results can serve as a useful tool to support a banking organization's capital planning and corporate governance.

They may help a banking organization better understand its vulnerabilities and evaluate the impact of adverse outcomes on its capital position and ensure that the banking organization holds adequate capital given its business model, including the complexity of its activities and its risk profile.

Capital stress testing complements a banking organization's regulatory capital analysis by providing a forward-looking assessment of capital adequacy, usually with a forecast horizon of at least two years (with the recognition that the effects of certain stress conditions could extend beyond two years for some stress tests), and highlighting the potential adverse effects on capital levels and ratios from risks not fully captured in regulatory capital requirements.

It should also be used to help a banking organization assess the quality and composition of capital and its ability to absorb losses.

Stress testing can aid capital contingency planning by helping management identify exposures or risks in advance that would need to be reduced and actions that could be taken to bolster capital levels or otherwise maintain capital adequacy, as well as actions that in times of stress might not be possible – such as raising capital.

Capital stress testing should include exercises that analyze the potential for changes in earnings, losses, reserves, and other potential effects on capital under a variety of stressful circumstances.

Such testing should also capture any potential change in risk-weighted assets, the ability of capital to absorb losses, and any resulting impact on the banking organization's capital ratios.

It should include all relevant risk types and other factors that have a potential to affect capital adequacy, whether directly or indirectly, including firm-specific ones.

A banking organization should also explore the potential for possible balance sheet expansion to put pressure on capital ratios and consider risk mitigation and capital preservation options, other than simply shrinking the balance sheet.

Capital stress testing should assess the potential impact of a banking organization's material subsidiaries suffering capital problems on their own – such as being unable to meet local country capital requirements – even if the consolidated banking organization is not encountering problems.

Where material relative to the banking organization's capital, counterparty exposures should also be included in capital stress testing.

Enterprise-wide stress testing, as described in section IV, should be an integral part of a banking organization's capital stress testing.

Such enterprise-wide testing should include proforma estimates of not only potential losses and resources available to absorb losses, but also potential planned capital actions (such as dividends or share repurchases) that would affect the banking organization's capital position, including regulatory and other capital ratios.

There should also be consideration of the impact on the banking organization's allowance for loan and lease losses and other relevant financial metrics.

Even with very effective enterprise-wide tests, banking organizations should use capital stress testing in conjunction with other internal approaches (in addition to regulatory measures) for assessing capital adequacy, such as those that rely primarily on statistical estimates of risk or loss estimates based on historical data.

Liquidity stress testing

A banking organization should also conduct stress testing for liquidity adequacy.

Through such stress testing a banking organization can work to identify vulnerabilities related to liquidity adequacy in light of both firm-specific and market-wide stress events and circumstances.

Effective stress testing helps a banking organization identify and quantify the depth, source, and degree of potential liquidity and funding strain and to analyze possible impacts on its cash flows, liquidity position, profitability, and other aspects of its financial condition over various time horizons.

For example, stress testing can be used to explore potential funding shortfalls, shortages in liquid assets, the inability to issue debt, exposure to possible deposit outflows, volatility in short-term brokered deposits, sensitivity of funding to a ratings downgrade, and the impact of reduced collateral values on borrowing capacity at the Federal Home Loan Banks, the Federal Reserve discount window, or other secured

wholesale funding sources.

Liquidity stress testing should explore the potential impact of adverse developments that may affect market and asset liquidity, including the freezing up of credit and funding markets, and the corresponding impact on the banking organization.

Such tests can also help identify the conditions under which balance sheets might expand, thus creating additional funding needs (e.g., through accelerated drawdowns on unfunded commitments).

These tests also help determine whether the banking organization has a sufficient liquidity buffer to meet various types of future liquidity demands under stressful conditions.

In this regard, liquidity stress testing should be an integral part of the development and maintenance of a banking organization's contingency funding planning.

Liquidity stress testing should include enterprise wide tests as discussed in section IV, but should also be applied, as appropriate, at lower levels of the banking organization, and in particular should account for regulatory or supervisory restrictions on inter-affiliate funding and asset transfers.

As with capital stress testing, banking organizations may need to conduct liquidity stress tests at both the consolidated and subsidiary level.

In undertaking enterprise-wide liquidity tests banking organizations should make realistic assumptions as to the implications of liquidity stresses in one part of the banking organization on other parts.

An effective stress testing framework should explore the potential for capital and liquidity problems to arise at the same time or exacerbate one another.

For example, a banking organization in a stressed liquidity position is often required to take actions that have a negative direct or indirect capital impact (e.g., selling assets at a loss or incurring funding costs at above market rates to meet funding needs).

A banking organization's liquidity stress analysis should explore situations in which the banking organization may be operating with a capital position that exceeds regulatory minimums, but is nonetheless viewed within the financial markets or by its counterparties as being of questionable viability.

Assessing the **potential interaction** of capital and liquidity can be challenging and may not be possible within a single stress test, so organizations should explore several avenues to assess that interaction.

As with other applications of stress testing, for its capital and liquidity stress tests, it is beneficial for a banking organization to articulate clearly its objectives for a post-stress outcome, for instance to remain a viable financial market participant that is able to meet its existing and prospective obligations and commitments.

In such cases, banking organizations would have to consider which measures of financial condition would need to be met on a post-stress basis to secure the confidence of counterparties and market participants.

VI. Governance and Controls

As noted under Principle 5, a banking organization's stress testing framework will be effective only if it is subject to strong governance and controls to ensure the framework is functioning as intended.

The **extent and sophistication** of a banking organization's governance over its stress testing framework should align with the extent and sophistication of that framework.

Governance over a banking organization's stress testing framework rests with the banking organization's board of directors and senior management.

As part of their overall responsibilities, a banking organization's board and senior management should establish a comprehensive, integrated and effective stress testing framework that fits into the broader risk management of the banking organization.

While the board is ultimately responsible for ensuring that the banking organization has an effective stress testing framework, senior management generally has responsibility for implementing that framework.

Senior management duties should include establishing adequate policies and procedures and ensuring compliance with those policies and procedures, assigning competent staff, overseeing stress test development and implementation, evaluating stress test results, reviewing any findings related to the functioning of stress test processes, and taking prompt remedial action where necessary.

Senior management, directly and through relevant committees, also should be

responsible for regularly reporting to the board on stress testing developments (including the process to design tests and develop scenarios) and on stress testing results (including from individual tests, where material), as well as on compliance with stress testing policy.

Board members should actively evaluate and discuss this information, ensuring that the stress testing framework is in line with the banking organization's risk appetite, overall strategy and business plans, and contingency plans, directing changes where appropriate.

A banking organization should have **written policies, approved and annually reviewed by the board, that direct and govern the implementation of the stress testing framework in a comprehensive manner**.

Policies, along with procedures to implement them, should:

- Describe the overall purpose** of stress testing activities;
- Articulate consistent and sufficiently rigorous stress testing practices** across the entire banking organization;
- Indicate stress testing roles and responsibilities**, including controls over external resources used for any part of stress testing (such as vendors and data providers);
- Describe the frequency and priority** with which stress testing activities should be conducted;
- Indicate how stress test results are used**, by whom, and outline instances in which remedial actions should be taken; and
- Be reviewed and updated** as necessary to ensure that stress testing practices remain appropriate and keep up to date with changes in market conditions, banking organization products and strategies, banking organization exposures and activities, the banking organization's established risk appetite, and industry stress testing practices.

A stress testing framework should **incorporate validation or other type of independent review to ensure the integrity of stress testing processes and results, consistent with existing supervisory expectations**.

If a banking organization engages a third party vendor to support some or all of its stress testing activities, there should be appropriate controls in place to ensure that

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those externally developed systems and processes are sound, applied correctly, and appropriate for the banking organization's risks, activities, and exposures.

Additionally, senior management should be mindful of any potential inconsistencies, contradictions, or gaps among its stress tests and assess what actions should be taken as a result.

Internal audit should also provide independent evaluation of the ongoing performance, integrity, and reliability of the stress testing framework.

A banking organization should ensure that its stress tests are documented appropriately, including a description of the types of stress tests and methodologies used, key assumptions, results, and suggested actions.

Senior management, in consultation with the board, should review stress testing activities and results with an appropriately critical eye and ensure that there is objective review of all stress testing processes.

The results of stress testing analyses should facilitate decision-making by the board and senior management.

Stress testing results should be used to inform the board about alignment of the banking organization's risk profile with the board's chosen risk appetite, as well as inform operating and strategic decisions.

Stress testing results should be considered directly by the board and senior management for decisions relating to capital and liquidity adequacy, including capital contingency plans and contingency funding plans.

Senior management, in consultation with the board, should ensure that the stress testing framework includes a sufficient range of stress testing activities applied at the appropriate levels of the banking organization (i.e., not just one enterprise-wide stress test).

Sound governance also includes using stress testing to consider the effectiveness of a banking organization's risk mitigation techniques for various risk types over their respective time horizons, such as to explore what could occur if expected mitigation techniques break down during stressful periods.

VII. Conclusion

A banking organization should use the principles laid out in this guidance to develop,

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implement, and maintain an effective stress testing framework.

Such a framework should be **adequately tailored to the banking organization's size, complexity, risks, exposures, and activities.**

A key purpose of stress testing is to explore various types of possible outcomes, including rare and extreme events and circumstances, assess their impact on the banking organization, and then evaluate the boundaries up to which the banking organization plans to be able to withstand such outcomes.

Stress testing **may be particularly valuable during benign periods when other measures may not indicate emerging risks.**

While stress testing can provide valuable information regarding potential future outcomes, similar to any other risk management tool it has limitations and cannot provide absolute certainty regarding the implications of assumed events and impacts.

Furthermore, **management should ensure that stress testing activities are not constrained to reflect past experiences, but instead consider a broad range of possibilities.**

No single stress test can accurately estimate the impact of all stressful events and circumstances; therefore, a banking organization should understand and account for stress testing limitations and uncertainties, and use stress tests in combination with other risk management tools to make informed risk management and business decisions.



Guidelines on Stressed Value-At-Risk (Stressed VaR) and on the Incremental Default and Migration Risk Charge (IRC)

16 May 2012

The EBA published today two sets of Guidelines on **Stressed Value-At-Risk (Stressed VaR)** and on the **Incremental Default and Migration Risk Charge (IRC)** modelling approaches employed by credit institutions using the Internal Model Approach (IMA).

These Guidelines are seen as an important means of **addressing weaknesses** in the regulatory capital framework and in the risk management of financial institutions.

Their objective is to contribute to a **level playing field** and to enhance convergence of supervisory practices across the EU.

National competent authorities are expected to implement the provisions set out in the Guidelines **within six months** after their publication.

After that date, the competent authorities must ensure that institutions comply with the Guidelines effectively.

Guidelines on Stressed Value-At-Risk (Stressed VaR)

These Guidelines include provisions on Stressed VaR modelling by credit institutions using the **Internal Model Approach** for the calculation of the required capital for market risk in the trading book.

The main provisions of the Guidelines relate to:

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- The identification and the review of the stressed period;
- The Stressed VaR methodology;
- The Use test.

Guidelines on the Incremental Default and Migration Risk Charge (IRC)

These Guidelines include provisions on the IRC modelling approaches employed by credit institutions **using the Internal Model Approach ('IMA')** for the calculation of the required capital for specific **interest risk in the trading book**.

The incremental risk charge is intended to complement additional standards being applied to the value-at-risk (VaR) modelling framework in the trading book.

The main provisions of the Guidelines relate to:

- The scope of application; Individual modelling of all aspects of the IRC approach
- The interdependence between default and migration events;
- The profit and losses (P&L) valuation including how ratings changes impact on market prices and on the computation of P&L;
- The liquidity horizons;
- The validation and use test for IRC models.

Notes

1) According to the **amendments of the Capital Requirements Directive** by Directive 2010/76/EU, entered into force on 31 December 2011, the EBA is tasked with monitoring the range of practices in the area of **Stressed Value-at-Risk (Stressed VaR)** and **Incremental Default and Migration Risk Charge (IRC)** in the trading book.

The EBA shall draw up guidelines in order to ensure convergence of supervisory practices.

2) In accordance with Article 16(3) of the EBA Regulation, Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area.

Competent authorities and financial market participants must make every effort to comply with the guidelines.

Before the deadline indicated in the Guidelines, i.e **6 months from the date of publication**, Competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance.

The notifications shall be published on the EBA website.

EBA Guidelines on Stressed Value At Risk (Stressed VaR)

16.05.2012

I. Executive Summary

The amendments to the Capital Requirements Directive¹ by Directive 2010/76/EU (CRD III) relate, among others, to **Stressed Value-at-Risk (Stressed VaR) in the trading book**.

According to these amendments, the predecessor of the EBA, the Committee of European Banking Supervisors (CEBS) is tasked with monitoring the range of practices in this area and drawing up guidelines in order to ensure convergence of supervisory practices.

The amendments to the Capital Requirements Directive by Directive 2010/76/EU (CRD III) **entered into force on 31 December 2011**.

Providing guidance on Stressed VaR modelling by credit institutions using the **Internal Model Approach ('IMA')** for the calculation of the required capital for market risk in the trading book, is seen as an important means of addressing weaknesses in the regulatory capital framework and in the risk management of financial institutions that contributed to the turmoil in global financial markets.

It is also expected to **reduce reliance on cyclical VaR-based capital estimates as well as to contribute to the development of a more robust financial system**.

The first chapter, on ‘Identification and validation of the stressed period’, elaborates on the value-at-risk model inputs calibrated to historical data from a continuous 12-month period of significant financial stress relevant to an institution’s portfolio and deals with

- i) The **length** of the stressed period,
- ii) The **number** of stressed periods to use for calibration,
- iii) The **approach** to identify the appropriate historical period and
- iv) The **required documentation** to support the approach used to identify the stressed period.

The second chapter, on ‘**Review of the stressed period**’ provides guidance on the frequency and monitoring of a stressed period.

The third chapter on ‘**Stressed VaR methodology**’ deals with

- i) **Consistency** issues between the VaR and Stressed VaR methodologies and
- ii) The **use and validation** of proxies in Stressed VaR modelling.

The fourth and final chapter, entitled ‘**Use tests**’ specifies use test requirements.

The Guidelines on Stressed VaR are expected to contribute to a level playing field among institutions and to enhance convergence of supervisory practices among the competent authorities across the EU.

It is expected that the national competent authorities around the EU will implement the Guidelines by incorporating them within their supervisory procedures within six months after publication of the final guidelines.

After that date, the competent authorities must ensure that institutions comply with the Guidelines effectively.

II. Background and Rationale

The CRD III trading book amendments, **including the requirement of Stressed Value at Risk (VaR) modelling** for the calculation of the regulatory capital for market risk in the trading book, are the result of widespread international (**G20, Basel, FSF**)

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recognition in 2008 that further regulatory reform was needed to address weaknesses in the current regulatory capital framework and in the risk management of financial institutions that contributed to the turmoil in global financial markets.

In **January 2009**, the Basel Committee on Banking Supervision (BCBS) proposed supplementing the current VaR-based trading book framework with, among other measures, an incremental risk capital charge (IRC), which includes default risk as well as migration risk for unsecuritised credit products and a stressed value-at-risk requirement.

As observed losses in banks' trading books during the financial crisis have been significantly higher than the minimum capital requirements under the Pillar 1 market risk rules, the BCBS proposed to enhance the framework through requiring banks to calculate, in addition to the current VaR, a stressed VaR taking into account a one-year observation period relating to significant losses.

The **additional stressed VaR requirement is expected to help reduce the pro-cyclicality of the minimum capital requirements for market risk.**

In the process of refining capital requirements for market risk, the BCBS conducted a quantitative impact study.

In the **summer of 2009**, the Trading Book Group (TBG) investigated the impact of the provisions of the 'Revisions to the Basel II market risk framework' and of the 'Guidelines for computing capital for incremental risk in the trading book' consultation papers published in **January 2009**, focusing (generally) on big internationally-active banks with extensive trading activities.

The amendments to the Capital Requirements Directive by Directive 2010/76/EU (CRD III) relating to Stressed VaR in the trading book are a direct transposition of the proposals from the BCBS in the EU context.

The European Banking Authority is requested to monitor the range of practices in this area and to provide guidelines on Stressed VaR models.

The objectives of these Guidelines on Stressed VaR are:

I. To achieve a **common understanding** among the competent authorities across the EU on Stressed VaR modelling in order to enhance convergence of supervisory practices;

II. To create more transparency for institutions when implementing Stressed VaR into the calculation of the required capital for market risk in the trading book and into their risk management practices; and

III. To create a level playing field among institutions in this area.

The guidelines presented in this paper do not aim to be a comprehensive set of rules, but rather to complement the new CRD provisions relating to Stressed VaR where additional guidance by the EBA was deemed necessary or appropriate.

Given that the Guidelines discussed in this paper do not go beyond the provisions of the CRD but rather clarify how the rules are to be applied in practice a detailed assessment of the costs and benefits associated with them is not required.

These costs and benefits are unlikely to be incremental to those identified in the EU Commission's Impact Assessment accompanying its CRDIII proposal.

III. EBA Guidelines on Stressed VaR Status of these Guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC ('the EBA Regulation').

In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial market participants must make every effort to comply with the guidelines.

2. Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area.

The EBA therefore expects all competent authorities and financial market participants to whom guidelines are addressed to comply.

Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory rules and/or guidance or supervisory processes), including where particular guidelines are directed primarily at institutions.

Notification Requirements

3. According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by 16.07.2012.

In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant.

Notifications should be sent by submitting the form provided at Section V to compliance@eba.europa.eu with the reference 'EBA/GL/2012/2'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

4. The notification of competent authorities mentioned in the previous paragraph shall be published on the EBA website, as per article 16 of EBA Regulation.

Title I – Subject matter, Scope and Definitions

1. Subject matter

These guidelines aim at achieving a common understanding among the competent authorities across the EU on Stressed Value at Risk (VaR) models in order to enhance convergence of supervisory practices in line with Annex V of Directive 2006/49/EC, as amended by Directive 2010/76/EU.

2. Scope and level of application

1. Competent authorities should require institutions to comply with the provisions laid down in these Guidelines on Stressed VaR.

2. These guidelines should apply to institutions using an Internal Model Approach (IMA) for the purpose of calculating the capital requirement for market risk in the trading book.

3. The guidelines apply to institutions at the level (solo and/or consolidated) on which the model is authorised to be used by the relevant competent authority, unless stated otherwise in these Guidelines.

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3. Definitions

In these guidelines the following definitions should apply:

- a. The term **institutions** should mean credit institutions and investment firms as set out in Directives 2006/48/EC and 2006/49/EC.
- b. The term **antithetic data** under point 6 of these Guidelines should mean price movements which are considered relevant irrespective of their direction.
- c. The term **de-meaning** under point 10 of these Guidelines should mean a quantitative process to remove a trend from historical data.

Depending on the positions and the size of the trend, not removing the drift from the historical data to simulate the price variations could generate mainly profitable scenarios and very few and limited losses.

- d. The term **proxy** under point 11 of these Guidelines should mean an observable variable or price taken from a liquid market that is used to substitute a variable that cannot be observed (or whose hypothetical price does not reflect real transactions from a deep two-way market) and thus cannot be accurately measured. Institutions use proxies both for valuation and risk measurement purposes.

From a theoretical perspective three types of proxies can be identified: those applied in the valuation of instruments (which would affect the adequacy of VaR and Stressed VaR as capital measures); those used for

VaR calculations (which would also be present in Stressed VaR metrics); and those affecting solely the Stressed VaR calculation.

Title II – Requirements regarding institutions' Stressed VaR modelling - A. Identification and validation of the stressed period

4. Length of the stressed period

1. The requirement set out in the CRD that the historical data used to **calibrate the Stressed VaR measure** have to cover a continuous 12-month period, applies also where

institutions identify a period which is shorter than 12 months but which is considered to be a significant stress event relevant to an institution's portfolio.

2. The approach to be applied to identify the stressed period in order to meet the requirement of Paragraph 10a of Annex 5 of Directive 2006/49/EC as amended by Directive 2010/76/EU, to calculate a Stressed VaR measure calibrated to a continuous 12-month period of financial stress relevant to an institution's portfolio, is the most material element determining the output of the model and is therefore subject to approval by the competent authorities.

5. Number of stressed periods to use for calibration

1. For the purposes of approval of the choice of the stressed period by institutions, a competent authority is the competent authority responsible for the exercise of supervision on a consolidated basis of this EU institution and, in the case of an internal model also recognised at a subsidiary's level, the competent authority responsible for the exercise of supervision of this EU institution's subsidiary.
2. When the competent authorities **approve** the stressed period defined at group level according to Article 37(2) of Directive 2006/49/EC referring to Article 129 of Directive 2006/48/EC, a single stressed period should only be required to be defined at group level.
3. As an **exception** from the above, the competent authorities should require an EU institution to determine a different stressed period at a subsidiary's level if the stressed period defined for the group is not considered relevant to the subsidiary's portfolio.

Where a single group-wide stressed period is used in an institution that has a subsidiary with a locally approved VaR model, institutions should provide proof that this group-wide stressed period is relevant to the subsidiary's portfolio.

6. The approach for identifying the appropriate historical period

1. In order to choose a historical period for calibration purposes, institutions should formulate a methodology for identifying a stressed period relevant to their current portfolios, based on one of the following two ways:
 - i. judgement-based approaches; or
 - ii. formulaic approaches.

2. A judgement-based approach is one that does not use a detailed quantitative analysis to identify the precise period to use for calibration, but rather relies on a high-level analysis of the risks inherent in an institution's current portfolio and past periods of stress related to those risk factors.

Where this judgement-based approach is used by institutions, it should include quantitative elements of analysis.

3. A formulaic approach instead is one that applies, in addition to expert judgement, a more systematic quantitative analysis to identify the historical period representing a significant stress for an institution's current portfolio.

This more systematic approach could be employed in a number of ways:

i. A risk-factor based approach: an institution identifies a restricted number of risk factors which are considered to be a relevant proxy for the movement in value of its portfolio.

The historical data for these risk factors can then be fully analysed to identify the most stressed period (for example, through identification of the period of highest volatility of the risk factors), in the historical data window.

ii. A VaR based approach: the historical period is identified by running either the full VaR model or an approximation over a historical period to identify the 12-month period which produces the highest resulting measure for the current portfolio.

4. This approach should be employed to determine a historical period that would provide a conservative capital outcome rather than just selecting the period of highest volatility.

5. While either approach may be used by institutions, the use of the formulaic approach, where possible, should be preferred for the identification of the historical period.

6. Institutions may also combine the above two approaches to limit the computational burden of the formulaic approach.

This can be done by using the judgement-based approach to restrict the historical data periods to be considered in the formulaic approach.

7. Irrespective of the approach used, institutions should provide evidence that the stressed period is relevant for their current portfolio and that they have considered a range of potential historical periods in their analyses.

The institutions should also have to **prove** that the portfolio on which the identification of the stressed periods is based is representative of the institutions' current portfolio, e.g. by applying the approach to identify the stressed period to other typical or previous portfolios.

As an example, for many portfolios, a **12-month period** relating to significant losses in 2007/2008 would adequately reflect a period of such stress, but, in addition to that, other periods relevant to the current portfolio should also be considered by institutions.

8. In all cases no weighting of historical data should be applied when **determining the relevant historical period** or when calibrating the Stressed VaR model, as the weighting of data in a stressed period would not result in a true reflection of the potential stressed losses that could occur for an institution's portfolio.

9. Finally, competent authorities may require institutions to use antithetic data when calibrating the Stressed VaR model, especially where an institution's portfolio is characterized by frequent position changes.

7. Documentation to support the approach used to identify the stressed period

1. Irrespective of the approach applied, institutions must produce robust documentation justifying the choice of approach made.

This should in all cases include quantitative assessments to support the current choice of the historical period and its relevance for the current portfolio.

This should also include documentation of the modelling of risk factors' returns.

2. Where institutions apply a formulaic approach to identify the stressed period the following issues should, as a minimum, be addressed in the related documentation:

- i. **Justification for the choice of risk factors** used if a risk-factor based approach is applied and where fewer than the modelled risk factors are selected.
- ii. **Justification of any simplifications** where a simplified VaR model is used to identify the historical period.

3. Where a **formulaic approach** is applied, which is **based on a simplified VaR model**, an institution should also provide adequate evidence that the simplified measure gives

directionally the same VaR results as the full VaR model (and therefore is accurate in determining the most stressed period).

This evidence should include empirical analysis.

4. Where a **formulaic approach** is applied, which aims at identifying the most volatile period for a set of risk factors, an institution should provide adequate evidence that a period of high volatility is a suitable proxy for a period in which the VaR measure would be high and that the lack of inclusion of correlations or other factors that would be reflected in the VaR measure does not result in rendering this proxy unsuitable.

B. Review of the stressed period

8. Frequency

1. The requirement of the CRD, for the review of the identified 12-month period of significant stress to be performed at least yearly by institutions, means that different circumstances, including a very high turnover in the trading book or specific trading strategies, may require a review of the stressed period with a higher frequency.

2. Any changes to the choice of the historical period following the outcome of the review of the stressed period should be communicated to the competent authority before the intended implementation date of the proposed changes.

9. Monitoring the stressed period

1. In addition to the above-mentioned regular review, an institution should have in place **procedures which ensure, on an on-going basis, that the specified stressed period remains representative, including when market conditions or portfolio compositions have been subject to significant change.**

2. In order to put in place sound procedures for the ongoing monitoring of the relevance of a stressed period, an institution should document the soundness of the implemented approach.

Monitoring may be based on a variety of factors which may differ among institutions.

Factors to be considered **include changes in market conditions, in trading strategies or also in portfolio composition.**

These factors may be analysed by comparing them to changes in the allocation of market values or notional, in risk factor loadings, in the level of VaR or sensitivities, in the repartition of VaR or sensitivities over portfolios and risk categories, in the P&L and back-testing results or also by the impact of newly approved products on the risk profile.

3. In addition to the above-mentioned procedures, monitoring of Stressed VaR relative to VaR should be performed on an **on-going basis**, because, while in theory, due to differences in parameterisation, Stressed VaR can exceptionally be smaller than VaR, also at inception, this should not structurally be the case.

The **ratio** between Stressed VaR and VaR at the moment of identification of the relevant stressed period should be used as a reference value for ongoing monitoring. Significant decreases in the ratio should be considered as indications for a potential need for review of a stressed period.

A ratio between Stressed VaR and VaR below one should be considered as a warning signal triggering a review of the stressed period.

C. Stressed VaR methodology

10. Consistency with VaR methodology

1. The Stressed VaR methodology should be based on the current VaR methodology, with specific techniques required, where applicable, in order to adjust the current VaR model into one that delivers a Stressed VaR measure. Any risk factor occurring in the VaR model should therefore be reflected in the Stressed VaR model.

2. With respect to standards used in both measures, and further to the ones prescribed by the Directive (e.g. the **99% confidence level**), institutions may consider the use of ‘square root of time’ scaling to calculate a 10-day Stressed VaR measure.

Nevertheless, given some known limitations of the scaling factor, an analysis to demonstrate that the assumptions underlying the use of the ‘square root of time’ rule are appropriate, should form part of the internal model validation process.

3. While the Stressed VaR model should share some of the current VaR standards, others may diverge due to explicit Directive requirements or to methodological incompatibilities related to the Stressed VaR concept.

In particular, this is the case in the following areas:

(i) Length of the stressed Period

Given the length of the stressed period must be 12 months, any action to reduce or increase the stated stressed period based on the need for consistency between VaR and Stressed VaR should not be permitted.

(ii) Back-testing requirement

The multiplication factor m_s used for capital requirements should be at least 3 and be increased by an addend between 0 and 1 depending on the VaR backtesting results.

Nevertheless, backtesting is not a requirement in itself for determining the Stressed VaR measure.

(iii) Periodicity of the Stressed VaR calculation

As the CRD provides that the calculation of the Stressed VaR should be at least weekly, institutions may choose to compute the measure more frequently, for instance, daily, to coincide with the VaR periodicity.

If, for example, institutions decide on a weekly Stressed VaR computation, and assuming a one-day Stressed VaR scaled up to 10 days, for the daily calculation of capital requirements based on internal models the following would apply:

- a) The same **Stressed VaR number** would be used for **5 subsequent business days** following the running of the Stressed VaR model;
- b) With respect to the calculation of the average Stressed VaR numbers during the preceding sixty business days, institutions should use the previous **12 Stressed VaR numbers** to compute that average;
- c) An institution should be able to prove that, on the day of the week chosen for Stressed VaR calculation, its portfolio is representative of the portfolio held during the week and that the chosen portfolio does not lead to a systematical underestimation of the Stressed VaR numbers when computed weekly.

For example, proof that the VaR is not systematically lower on the day of the week chosen for Stressed VaR calculation could be considered sufficient.

4. Stressed VaR standards may diverge from VaR standards in other circumstances where there could be methodological incompatibilities between the current VaR and the Stressed VaR model.

One example includes **changes in the current VaR methodology that cannot be translated into the Stressed VaR measure and the use of local valuation (sensitivity analysis/proxies) as opposed to full revaluation, which is the preferred approach for Stressed VaR.**

5. As a general rule, changes in an institution's VaR model or VaR methodology should be reflected in changes to the model/methodology used to calculate the Stressed VaR charge.

6. Under **exceptional circumstances**, if an institution can demonstrate that it cannot incorporate enhancements to the current VaR methodology in the Stressed VaR, such situations should be documented and the institution should be able to demonstrate that the impact (for example, in terms of VaR or capital requirements) resulting from the current VaR developments which are not implemented in the Stressed VaR measure is limited.

7. Where **sensitivities rather than full revaluation** are used within a VaR model, the institution concerned should demonstrate that this approach is still appropriate for Stressed VaR where larger shocks are applied.

A sensitivity-based approach for Stressed VaR may require that higher order derivatives/convexity are factored in.

8. Any revaluation ladders or spot/volatility matrices employed should be reviewed and extended to include the wider shocks in risk factors that occur in stressful scenarios.

It is preferable that **full revaluation be used for Stressed VaR with shocks applied simultaneously to all risk factors.**

9. In terms of calibration to market data, the process of 'de-meaning' is not considered necessary for Stressed VaR. If there is a significant drift in market data, the use of antithetic data is preferable to 'de-meaning'.

10. The table below summarises the main issues described above concerning the level of consistency between the methodological aspects of the current VaR and Stressed VaR measure.

Is consistency between VaR and Stressed VaR required?		
Yes for...	No for...	Subject to verification
Confidence level	Weighting scheme	Changes to models
Holding period	Back-testing Length of historical observation period Frequency of computation	Use of Taylor series approximations Scaling method

11. Estimation of proxies for Stressed VaR

- Given that the **data constraints** that make necessary the use of proxies for VaR, become even more relevant for Stressed VaR and that it is expected that any proxies used in VaR will also be necessary for Stressed VaR, while additional ones may also be needed, whereas any new risk factor not present in the historical data should naturally require the use of a proxy for VaR calculation, but only on a ‘temporary’ basis (e.g. after one year there would be enough real information to complete a 12-month data series), the same proxy should be more ‘permanent’ for Stressed VaR purposes (due to the more constant nature of the historical time series).
- If a risk factor is missing in the stressed period because it was not observable during that period (for example for a newly listed equity) the institution may use another risk factor (in this example, another equity from the same sector and with a similar risk and business profile) for which there is information available and for which a highly correlated behaviour with the factor that the institution is trying to capture can be demonstrated.

Where these proxies are used, institutions should consider whether an assumption of 100% correlation between the risk factor and its proxy is appropriate.

3. Institutions may alternatively map the missing factor to another one similar in terms of volatility (though not necessarily correlated). If this approach is used, institutions should demonstrate that it is conservative and appropriate.

4. If a VaR model is **enhanced by incorporating a risk factor**, an institution should also incorporate it into its Stressed VaR calculations.

In certain cases, this may mean reviewing the historical data series for the risk factors and introducing an appropriate proxy.

For example where a new risk factor used for valuation purposes is incorporated into the VaR model as required under Annex V point 12 first Paragraph of Directive 2006/49/EC as amended by Directive 2010/76/EU.

5. In all cases, the use of these proxies, including simplifications and any omissions made, will only be acceptable provided they are well documented and their limitations are taken into account and addressed in the institution's capital assessment.

12. Validation of proxies

1. Whereas **validation of a proxy** should be broadly performed in the same way for VaR and Stressed VaR, any proxy validated for the day-to-day VaR is not automatically acceptable for Stressed VaR.

Proxies in use should be reviewed periodically to assess their adequacy and ensure that they provide a conservative outcome.

2. Regarding those proxies which might be used for Stressed VaR purposes only (for instance, due to lack of data in the selected period), an institution should ensure that the risk factor used as proxy is conservative.

13. Validation of model inputs/outputs

1. **All qualitative standards** defined for the control of consistency, accuracy and reliability of data sources of VaR also apply to Stressed VaR.
2. Underlyings for which institutions do not have a **history of data** complete enough to cover the reference period, should be shocked by **approximation**, using closely related underlyings (same market, similar structure and characteristics).

Following the same process that has been approved for the institutions' internal models, in order to ensure the quality of historical data used for the reference period, institutions should document the methodology followed for identifying and for proxying missing data.

Institutions should also perform tests of the potential impact of the use of these proxies.

3. With a view to **preserving arbitrage inequalities**, institutions may need to apply data cleaning for Stressed VaR.

Where this is the case, the removal of outliers from historical data series should be appropriately justified and documented, as it should not end up decreasing the magnitude of extreme events.

4. As **Stressed VaR entails**, by definition, the application of highly stressed scenarios to current market parameters, which may lead to incoherent market conditions (e.g. negative forward rates) more frequently than within a VaR computation, institutions should monitor the calibration failures that may materialise.

Institutions using full revaluation when estimating their Stressed VaR may be more frequently confronted with those calibration failures than institutions not using full revaluation, not because failures will not happen, but because their methodology will not enable them to spot these calibration failures when they occur.

D. Use test

14. Use test

1. The Stressed VaR model should be subject to a use test through use of Stressed VaR output in risk management decisions.

Stressed VaR output should be in place as a supplement to the risk management analysis based on the day-to-day output of a VaR model.

The results of Stressed VaR should be monitored and reviewed periodically by senior management.

2. Where Stressed VaR outputs reveal particular vulnerability to a given set of circumstances, prompt steps should be taken to manage those risks appropriately.

Title III – Final Provisions and Implementation

15. Date of application

Competent authorities should implement these Guidelines by incorporating them within their supervisory procedures within six months after publication of the final Guidelines.

Thereafter, competent authorities should ensure that institutions comply with them effectively.

IV. Accompanying documents

a. Feedback on the public consultation and on the opinion of the BSG

1. The European Banking Authority (EBA) officially came into being on 1 January 2011 and has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS).

2. On 16 November 2011, the draft Guidelines on Stressed VaR were presented to the EBA's Banking Stakeholder Group (BSG).

The BSG provided broad comments and suggestions, to be considered by the EBA, when finalizing the Guidelines.

3. On 30 November 2011, the EBA submitted the draft Guidelines on Stressed Value at Risk (Stressed VaR) for public consultation.

The consultation period ended on 15 January 2012.

Ten responses were received.

In addition, a public hearing was held on 13 December 2011 at the EBA's premises in London, to allow interested parties to share their views with the EBA.

4. The responses to the consultation paper were generally positive and supportive of EBA's work and required only some clarification; however, on some paragraphs in the

consultation paper, the majority of the respondents disagreed or requested significant clarification.

5. A detailed account of the comments received and the EBA's responses to them is provided in the feedback table below.

The feedback table is divided between general remarks and specific comments received from respondents and includes a section with EBA's point of view on them and the changes made in the final guidelines to address them.

6. In some cases, several respondents made similar comments.

In such cases, the comments, and EBA's analysis of them are included in the section of the detailed part of this paper where EBA considers them most appropriate.



BANK FOR INTERNATIONAL SETTLEMENTS

Models and tools for macroprudential analysis BCBS Working Papers No 21, May 2012

The Basel Committee's Research Task Force Transmission Channel project aimed at generating **new research** on various aspects of the credit channel linkages in the monetary transmission mechanism.

Under the credit channel view, financial intermediaries play a critical role in the allocation of credit in the economy.

They are the **primary source of credit for consumers and businesses that do not have direct access to capital markets.**

Among more traditional macroeconomic modelling approaches, the credit view is unique in its emphasis on the health of the financial sector as a critically important determinant of the efficacy of monetary policy.

The final products of the project are two working papers that summarise the findings of the many individual research projects that were undertaken and discussed in the course of the project.

The first working paper, Basel Committee Working Paper No 20, "**The policy implications of transmission channels between the financial system and the real economy**", analyses the link between the real economy and the financial sector, and channels through which the financial system may transmit instability to the real economy.

The second working paper, Basel Committee Working Paper No 21, "**Models and tools for macroprudential analysis**", focuses on the methodological progress and modelling advancements aimed at improving financial stability monitoring and the identification of systemic risk potential.

Because both working papers are summaries, they touch only briefly on the results and methods of the individual research papers that were developed during the course of the project.

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Each working paper includes comprehensive references with information that will allow the interested reader to contact any of the individual authors and acquire the most up-to-date version of the research that was summarised in each of these working papers.

The Research Task Force Transmission Channels Project

The Research Task Force Transmission Channel (RTF-TC) project was conceived before the onset of the recent global financial crisis.

From the beginning, RTF-TC was intended to be a long-term project that would involve many RTF member institutions.

The primary goal was to generate new research on various aspects of the credit channel linkages in the monetary transmission mechanism.

Under the credit channel view, financial intermediaries play a critical role in the allocation of credit in the economy.

They are the primary source of credit for consumers and businesses that do not have direct access to capital markets.

Among more traditional macroeconomic modelling approaches, the credit view is unique in its emphasis on the health of the financial sector as a critically important determinant of the efficacy of monetary policy.

Subsequent to the start of the RTF-TC, the onset of the global financial crisis focused policymakers' attention on the health of the financial sector.

While the RTF-TC did not anticipate the financial crisis, its work did progress as the financial crisis unfolded.

Many of the research papers produced in this project made use of new data and insights gained from the work that many RTF member institutions undertook during the course of the financial crisis.

Six workshops hosted by the Bank of Italy, by the Bank of France and the French Prudential Supervisory Authority, by the UK Financial Services Authority, by the Bank of Canada and the Canadian Office of the Superintendent of Financial Institutions, by the US Office of the Comptroller of the Currency, and by the Central Bank of Norway provided venues to present innovative research studies, but also, importantly, to receive feedback from RTF member institution colleagues.

The research papers and findings produced by the RTF-TC are in most cases preliminary and still undergoing revision and refinement.

Still, RTF-TC research has produced many new insights and analysis that help us to better understand the linkages between the financial sector and real economy.

The work of the RTF-TC included detailed econometric analysis of credit data from many RTF member countries, theoretical modelling contributions, dynamic stochastic general equilibrium calibration exercises and experiments, and the investigation of new analytical approaches for financial stability monitoring and systemic risk analysis.

The results of these projects **should help to inform macroprudential policy development.**

The final products of the RTF-TC project are two working papers that summarise the findings of the many individual research projects that were undertaken and discussed in the course of the project.

The first working paper, Basel Committee Working Paper No 20, “**The policy implications of transmission channels between the financial system and the real economy**”, analyses the link between the real economy and the financial sector, and channels through which the financial system may transmit instability to the real economy.

The second working paper, Basel Committee Working Paper No 21, “**Models and tools for macroprudential analysis**”, focuses on the methodological progress and modelling advancements aimed at improving financial stability monitoring and the identification of systemic risk potential.

Because both working papers are summaries, they touch only briefly on the results and methods of the individual research papers that were developed during the course of the project.

Each working paper includes comprehensive references with information that will allow the interested reader to contact any of the individual authors and acquire the most up-to-date version of the research that was summarised in each of these working papers.

Paul Kupiec, FDIC and Chairman of the Basel Committee Research Task Force

Models and tools for macroprudential analysis

Introduction

The findings of the Research Task Force Transmission Channel (RTF-TC) project are reported in two summary papers.

The role that the financial system played in transmitting instability to the real sector of the economy is examined in the first report of the RTF-TC (Basel Committee Working Paper No 20).

This report **focuses on the methodological progress and modelling advancements** useful for improving the existing financial stability analytical framework – that is the framework to identify, assess and monitor systemic risk.

Systemic risk is defined as the risk of disruptions in the provision of key financial services that can have serious consequences for the real economy.

The RTF-TC contributing member institutions conducted new research that was presented at international workshops organised by the group. This research allowed the group to study the interactions between the financial system and the real economy and, more generally, those interactions that have the potential for producing systemic risk.

The workshops facilitated communication among member institution researchers.

In summarising the findings of the group, this report acknowledges the joint contribution of the members of the group and of all the other participants at the workshops (both authors and discussants).

The Appendix lists the papers presented and the workshop participants.

We caution that this document is not a comprehensive literature review, but reflects the specific contributions and insights of the RTF-TC members.

This summary of the RTF-TC's findings is **organised into four sections**.

Section 1 discusses analytical methods used to measure the impact of macro-financial shocks on the real economy.

This section includes studies that use dynamic stochastic general equilibrium models (Section 1.1) as well as studies that use more traditional macro stress testing methods (Section 1.2).

Section 2 discusses developments in modelling financial sector liquidity risk including the potential for contagion.

Section 3 discusses methods for measuring the potential for systemic risk.

Section 4 summarises RTF-TC studies that quantify bank behavioural responses to changing central bank and macroprudential policies and macroeconomic conditions.

Each section includes a summary of the remaining gaps in the literature.

1. What are the impacts of a macro-financial shock on the financial sector and the real economy?

How should the transmission of a macro-financial shock on the banking sector, the macroeconomy, and the possible feedback between the two sectors be measured?

The recent global financial crisis highlighted some key features that need to be incorporated into operational macroprudential models.

One feature models must take into account is the importance of the credit and maturity transformation mechanism that lies at the heart of banking. In normal times, banks fund themselves with short-term liquid contracts and invest in illiquid credit instruments with longer maturity duration.

Financial sector shocks have the potential to disrupt the normal credit intermediation process and may result in a widespread curtailment of credit to bank dependent customers.

A second important modelling feature identified by the crisis is the ability to account for interdependencies (both linear and non-linear) among key financial and macroeconomic variables and for feedback effects between the financial and real sectors.

Models should also account for the fact that, for a set of interconnected, highly leveraged financial institutions, systematic risk is likely to play a more important role than idiosyncratic risk.

These two modelling features, in addition to the lessons learned from the recent crisis, emphasised the need to build a model that can incorporate out-of-equilibrium dynamics, learning, herding behaviour, and contagion.

The RTF-TC research included studies using two different methods for macroprudential modelling that encompasses those aspects: dynamic stochastic general equilibrium (DSGE) models and traditional econometric macro stress testing models.

DSGE models are computable general equilibrium models built from microeconomic-consistent foundations.

These models are calibrated to mimic historical data patterns but are not estimated in the traditional econometric sense.

While DSGE models can be designed to include interesting behavioural features in their representative agents, they do not generate time-series forecasts.

DSGE models are instead designed to answer comparative static or “what if” exercises.

In contrast, traditional macroprudential stress testing methods rely on reduced form econometric model specifications that are estimated using historical data.

These models need not be linked to an underlying model of a rational optimising representative agent.

The ideal macro-financial model would incorporate features of both of these approaches, but the development of operational hybrid models is unlikely in the near term.

Additionally, an important challenge is that this ideal model cannot be overly complex.

Model results must be intuitive and their logic accessible for financial stability authorities to better understand the most important features of the transmission channels between the financial sector and the real economy during periods of extreme widespread stress.

At present, there is no single “best” approach for macroprudential modelling; the approach must be tailored to the data available and to the question at hand.

1.1 Are dynamic stochastic general equilibrium (DSGE) models useful for understanding the channels of transmission of financial sector shocks?

Can they be used to quantify the impact of a financial sector shock on the real economy?

Can DSGE models help identify whether macro prudential regulations will attenuate or amplify a shock?

How do monetary and macroprudential policies interact?

Can DSGE models be used to optimise macro prudential regulation?

DSGE models are complex, non-linear systems of equations.

Initially, DSGE models were developed in the Real Business Cycle literature.

Enhanced DSGE models that included market imperfections and nominal rigidities were developed in the so-called New Neoclassical Synthesis which created models in which monetary policy is no longer neutral in the short run.

DSGE models have **three distinguishing features**.

First, they are constructed from microeconomic foundations assuming rational forward-looking optimising behaviour of individual economic agents.

Secondly, DSGE models are constructed to be internally-consistent with their assumptions and can capture the behavioural interactions between households, firms, and policymakers.

As such, DSGE models assume the existence of a stable equilibrium and the risks in these models are purely exogenous shocks that drive the economy temporarily away from the steady state to which it dynamically converges according to the optimising behaviour of the different agents.

Thirdly, typical DSGE methods cannot easily incorporate irrationality, inefficient markets, and the formation of asset price bubbles.

DSGE models can be used to analyse and understand the mechanisms through which exogenous shocks are transmitted to the real economy as the real economy adjusts towards a new equilibrium.

In this capacity, DSGE models have been used to explain:

- (i) How macro variables react to aggregate shocks, either real (eg productivity, exogenous demand, etc) or monetary shocks,
- (ii) The transmission channels of different economic policies, and
- (iii) The role of different real and nominal rigidities that may be sources of the observed dynamics of the macroeconomy.

In this context, systemic risk is represented by macroeconomic instability, which is originated either by a real or a financial exogenous shock, and is propagated through excessive lending and excessive GDP growth in booms, and vice versa in downturns.

In the aftermath of the recent global financial crisis, DSGE models have been criticised for relying too heavily on the assumption of a perfectly competitive capital market.

Indeed, under this assumption, the Modigliani-Miller (M-M) theorem holds, and models are incapable of capturing credit channel effects.

Because these models lacked a realistic financial sector, they were of little use during the crisis.

In this section, we discuss RTF-TC research efforts to attempt to include an accurate financial sector into a DSGE framework and how this research has made DSGE models more useful in answering questions regarding financial sector shocks and regulation.

The original models of banking activities are **too simplistic to use for policy analysis on the effects of capital regulation on credit intermediation.**

RTF-TC studies have attempted to improve existing models by developing a stylised model of the banking sector that recognises financial frictions on the borrowing and lending side and thereby including a role for bank capital.

Micro-founded financial frictions are modelled by assuming imperfect information between lenders (interbank market or depositors) and borrowers (financial intermediaries).

Credit contracts in the funding market for banks are not perfect, due to the possibility for banks to be impacted by shocks and the impossibility for their creditors to fully observe these shocks.

In some cases, the modelling approach allows for banks to default in equilibrium, as well.

Once the model includes financial frictions, there is a natural economic role for bank capital. Several papers analyse how frictions in the financial sector can influence the bank balance sheet and endogenously create an optimal bank capital structure.

RTF-TC research uses bank capital to mitigate asymmetric information frictions between lenders and borrowers (financial intermediaries).

This **endogenous resolution** of the agency problem results in constraints on banks' leverage ratios and implies that equilibrium credit flows will depend on the banks' equity positions.

Any **unexpected movement** in asset prices – either endogenously, via demand for investment, or exogenously via a financial shock – will affect the banks' balance sheet and risk premium.

The shock will endogenously alter the demand for bank capital to attenuate the risk premium and the set of feedbacks that augment the initial change in investment and asset prices.

Banks' **endogenous demand** for capital also interacts with the interbank market in determining loan supply.

In these models, the introduction of a binding regulatory constraint has important implications for the dynamics of the macroeconomic variables, because a costly trade-off arises between equity issuance and a decrease in lending.

With these enhancements, DSGE models are **better able to address fundamental policy issues**, such as the overall importance of financial sector shocks in explaining the business cycle and the role of monetary policy and/ or prudential regulation to avoid or mitigate financial crises.

For example, one RTF-TC study shows that, in the presence of financial frictions, aggressive interest rate cuts are required to offset adverse financial shocks.

Another RTF-TC study uses an enhanced DSGE model to assess the interaction between monetary and macroprudential policies and the design of an optimal mix of these policies.

A [comparison of the effects of countercyclical capital requirements](#), maximum loan-to-value ratios, and maximum leverage ratios with traditional monetary policy instruments shows that countercyclical financial-sector regulation may prove useful in mitigating the business-cycle fluctuations in the aftermath of a technological or a monetary shock, but might as well have an amplification effect if the banks' capital unexpectedly drops.

Even though DSGE models cannot be used to examine the endogenous creation of bubbles, an RTF-TC study attempts to model how the economy is affected by the life cycle of bubbles.

The results suggest that [ownership of the over-valued asset is an important issue](#).

The boom-bust cycle is strongly amplified when the asset experiencing the price bubble is held by banks, but the economy is much less affected if the bubble asset is held by unleveraged agents.

Such research may help develop early warning indicators of dangerous bubbles, discussed further in Section 3, and an evaluation of credit conditions that may produce such bubbles.

The findings of many of the RTF-TC DSGE studies are preliminary and subject to further refinement.

The studies tend to each focus on a particular financial shock in isolation (eg a shock affecting borrowers' net worth, asset prices, or banks' capital).

Depending on the type of financial shock considered, its consequences and the transmission mechanism can be very different.

Second, and perhaps more fundamentally, the work of the RTF-TC group has highlighted a key issue that macroprudential analysts must resolve when using DSGE models for policy analysis: they must strike a balance between simplicity and transparency on the one hand, and reality and completeness on the other hand.

Perhaps, the answer lies in the specific purpose for which the model is used in a given instance.

In fact, when the focus is on the quantification of the impact of shocks and the role played by banking regulation, a rich framework is needed in order to incorporate meaningful behaviour of the financial system and feedback effects to the macroeconomy.

Some of the research conducted by RTF-TC introduced a banking sector in a complicated manner which makes it difficult to fully understand the forces driving the interaction between the real and financial sectors.

In contrast, if the aim is to understand the transmission channels between the real and the financial sectors, then simpler models appear to be more desirable.

While the DSGE model findings reported in this summary are informative, further research and analysis is required.

Since DSGE models assume forward-looking rational expectations equilibria, they must be modified to include some type of market or information imperfection before they can accommodate fads, bubbles or the market pricing imperfections that should be considered when analysing financial stability.

Since the root causes of investment fads and market inefficiencies remain a mystery for the most part, there are potentially many ways that these features might be introduced into DSGE models and in some cases there is little empirical basis for the mechanism used to generate the financial sector inefficiency.

More generally, such studies and the corresponding models, both theoretical and empirical, are but one input into regulatory (and monetary) policymaking, in conjunction with qualitative judgements and analysing trends in a broad range of data.

The RTF-TC group has also highlighted several directions for future research on DSGE models:

Appropriately enhanced, models can potentially be used to help assess the interactions (and the possible trade-offs) between macroprudential, monetary and fiscal policies, since all policies have a bearing on financial stability.

There is a need for a formal normative (welfare) analysis.

What are the costs of a macroprudential policy (eg increased bank capital requirements) and how are they distributed among different agents?

Can we compare the transition costs with the potential benefits in terms of decreased swings in the business cycle?

Do we need to consider the accompanying fiscal policy?

- The very **nature of financial intermediation** is to assume financial risk due to balance sheet mismatch between assets and liabilities.

The research of the RTF-TC group has modified and created models to incorporate a more accurate picture of the financial sector.

However, maturity mismatch and the effects of market valuation on assets still need to be satisfactorily incorporated, especially since they represent an important aspect of the recent financial crisis.

More generally, future research needs to focus on endogenising the systemic-risk exposures of banks.

- DSGE models can be **useful for understanding the bank capital channel, but they are limited by their solution method**. DSGE models equilibria are approximated around the model's steady state and such solutions may become inaccurate when considering large deviations from the steady path.

These models also require a unique equilibrium and thereby cannot encompass models with multiple equilibria that allow movements between equilibria.

It is an open issue whether local solution methods are useful for studying financial (in)stability and whether they are capable of producing reliable quantitative information in case of financial turmoil.

- **Disaggregated models of the economy that include different degrees of borrower riskiness** could help address questions such as: At any given moment, which sectors are at risk?

How interdependent are the sectors (in other words, what is the correlation among sectors)?

By contrast, current DSGE models only consider the net worth of the borrowers independently of the sector to which the borrowers belong and individual risks they might face.

Several research papers of the RTF-TC group represent early attempts at including sectoral diversification and matching different degrees of riskiness in capital requirements.

More generally, there are a number of features that could potentially be useful to add to DSGE models (diversity of entities in the system and their interactions, risk appetite and expectations) that could help policymakers understand complex quantitative questions.

Still, more research is needed in this area.

1.2 How can traditional macro stress testing models (those using a suite-of-models approach) be improved to better measure the transmission and the lasting effects of a macro-financial shock?

Macro stress testing refers to a range of analytical models and tools that are used by central banks and supervisory agencies to assess financial sector vulnerabilities to severe but plausible scenarios of widespread exogenous shocks.

For many central banks and supervisors, the practice of macro stress testing was introduced as part of the Financial Sector Assessment Programs conducted by the IMF and the World Bank.

As such, macro stress tests can provide valuable information on the potential negative effects on the financial sector that are imposed by severe real sector shocks, and thus help policymakers assess the soundness of the financial system.

Ideally, macro stress tests could allow bank supervisors to identify institutions whose current financial condition poses risks under alternative macroeconomic scenarios.

Central banks and supervisors typically use a suite of models and tools in a multi-stage process to conduct macro stress testing of credit risk.

The first stage involves projecting the dynamic paths of key macroeconomic indicators (such as GDP, interest rates, and house prices) under a certain stress scenario.

The projections normally use some combination of structural macroeconometric models, VAR models and vector error correction models, or some other statistical approach.

In the second stage, a credit risk satellite model is estimated using either loan performance data (such as non-performing loans, loan loss provisions, or historical default rates) or micro-level data related to the default risk of the household and/or corporate sector.

The satellite or auxiliary model is then used to link a measure of credit risk to the variables from the macroeconomic model and to map the external macroeconomic shocks to a bank's asset quality shocks.

Finally, the last stage involves estimating the impact of the asset quality shocks on a bank's earnings and/or capital.

One of the main limitations of traditional stress testing is that the satellite models that are used treat the macroeconomic variables as exogenous and ignore the feedback effects from a situation of distress in the banking system to the macroeconomy.

In conducting macro stress tests, the statistical relationship between macroeconomic variables and indicators of the banks' financial condition can change dramatically under stressed conditions.

Therefore, if the focus is only on the conditional mean of a risk measure (as is typical of a traditional stress testing exercise), it can be an inadequate approach in assessing the impact of an aggregate shock.

During periods of extreme stress, it is **especially important to focus on unexpected losses in order to assess the tails of the loss distributions**.

The research of the RTF-TC group focused on the quantile regression (QR) method to address this issue. The QR approach focuses on the tail events of conditional risk indicator distributions.

It allows for the possibility of extreme events leading to changes in the statistical relationships between the risk indicators and macroeconomic variables across the quantiles of the distribution of a given stress indicator and by doing so, provides a more complete picture of covariate effects.

For example, **a covariates relationship with a stress factor can differ substantially at lower and upper quantiles of a dependent variable compared to its relationship at its mean or median values.**

RTF-TC research showed that the QR approach is robust to extreme events and can also be used to construct density estimates and forecasts of real activity and financial stress and expected shortfall measures of systemic real risk and systemic financial risk.

The QR approach produced more conservative results when compared with other approaches to modelling the macro-credit risk link.

The method is very flexible and could have a variety of additional applications in the area of stress testing, such as forecasting interest income, fee income, profits, or loan loss provisions; or on probability of default (PD) estimates and loss-given-default (LGD) estimates which influence risk-weighted assets and capital adequacy ratios.

To read the paper:

http://www.bis.org/publ/bcbs_wp21.htm



BANK FOR INTERNATIONAL SETTLEMENTS

The policy implications of transmission channels between the financial system and the real economy BCBS Working Papers No 20, May 2012

The Basel Committee's Research Task Force Transmission Channel project aimed at generating new research on various aspects of the credit channel linkages in the monetary transmission mechanism.

Under the credit channel view, financial intermediaries play a critical role in the allocation of credit in the economy.

They are the primary source of credit for consumers and businesses that do not have direct access to capital markets.

Among more traditional macroeconomic modelling approaches, the credit view is unique in its emphasis on the health of the financial sector as a critically important determinant of the efficacy of monetary policy.

The final products of the project are two working papers that summarise the findings of the many individual research projects that were undertaken and discussed in the course of the project.

The first working paper, Basel Committee Working Paper No 20, "The policy implications of transmission channels between the financial system and the real economy", analyses the link between the real economy and the financial sector, and channels through which the financial system may transmit instability to the real economy.

The second working paper, Basel Committee Working Paper No 21, "Models and tools for macroprudential analysis", focuses on the methodological progress and modelling advancements aimed at improving financial stability monitoring and the identification of systemic risk potential.

Because both working papers are summaries, they touch only briefly on the results and methods of the individual research papers that were developed during the course of the project.

Each working paper includes comprehensive references with information that will allow the interested reader to contact any of the individual authors and acquire the most up-to-date version of the research that was summarised in each of these working papers.

The policy implications of transmission channels between the financial system and the real economy

Introduction

The recent global financial crisis was a catalyst for regulatory change.

Policymakers have **strengthened existing micro-prudential tools**, such as bank-specific capital and liquidity requirements, and introduced new macro-prudential tools, such as countercyclical capital requirements, capital surcharges for systemically-important financial institutions, and loan-to-value caps to promote financial stability.

In addition, **stress testing has taken on new importance both as a means for helping policymakers decide on a course of action and as a tool for communication.**

At the same time, data emerging from the crisis provides new information about transmission channels between the financial system and the real economy.

For example, **it is now obvious that economic models and analysis must account for the state of the financial system when forecasting the evolution of the macroeconomy.**

Moreover, the crisis has shown that linear approximations based on data from normal economic times fail in periods of financial sector stress.

Such issues highlight the need to improve our understanding of the role of the financial sector in the monetary transmission channel.

Over the past two years, a subgroup of the Research Task Force, the Transmission Channels (RTF-TC) project, has worked to produce original research that addresses questions and outstanding issues regarding the role the financial sector plays, both for economic growth and as a source of economic instability.

During this period, research has been presented by the contributing institutions at several international workshops.

These workshops have facilitated the communication of ideas and the interaction of researchers working on the relevant topics.

Many significant contributions have been made during this time.

This document summarises the group's findings.

It is important to remember that most of this research is preliminary, and individual authors will continue to refine their analysis and conclusions.

So while we offer this summary of the group's findings, we stress their preliminary nature, and caution against using these results to formulate policy without further research and supporting analysis.

Moreover, we caution that this document is not a comprehensive literature review, but reflects the specific contributions and insights of the RTF-TC members.

This report is designed as a reference document for policymakers, bank supervisors, and researchers alike and is organised around four topics:

- (1) The interactions between bank credit, monetary policy and growth in the real economy;
- (2) Costs and benefits of bank capital and liquidity regulation;
- (3) Bank risk taking and monetary policy;
- (4) Asset price bubbles and cyclical properties of regulation.

For each of these topics, several key questions have been identified for discussion.

We conclude each section by highlighting the new issues and questions that have arisen and identify some remaining gaps in the literature.

1. The interactions between bank credit, monetary policy and growth in the real economy

Brief summary of literature

Basel iii Compliance Professionals Association (BiiiCPA)
www.basel-iii-association.com



This section focuses on the interactions between credit, economic growth, the banking sector and the real economy.

It is well-known that monetary policy affects the supply of bank credit.

Halvorsen and Jacobsen (2009), Hammerlstrand and Traee (2010) and Tabak et al (2010) all confirm that tighter monetary policy has a negative impact on bank lending.

Moreover, this effect reflects at least in part a reduction in loan supply as shown by Ciccarelli et al (2010), Black and Rosen (2009), Jimenez et al (2010), Havro and Vale (2011) and Jimbocean and Messonier (2010).

The transmission channel of loan supply to the real economy is investigated in Hirataka et al (2010), Dedola and Lombardo (2009), Jimenez et al (2010), de Haas and van Horen (2010) and Black and Rosen (2009).

These papers **find that bank balance sheet conditions greatly influence the transmission of shocks to the real economy as the health of bank balance sheets affects bank lending and the credit available to bank dependent borrowers.**

The efficacy of monetary policy may depend on market conditions. Havro and Vale (2011), Ciccarelli et al (2010), de Haas and van Horen (2010) and Boissay (2011) show that a drop in market liquidity weakens the credit channel of monetary policy and leads to a negative contribution to GDP.

Monnin and Jokipii (2010) find a positive link between measures of banking sector soundness and growth in the real economy.

Some RTF-TC research focused on understanding the impact of leverage and liquidity on the provision of credit. The evidence appears to be mixed.

Some authors do not find a clear direct effect of leverage on lending (Havro and Vale (2011)), while others provide evidence that better capitalised banks, to a varying degree, are more willing to lend (Berrospide and Edge (2010); Foglia et al (2010)).

Further evidence of the importance of bank health is provided by Francis and Osborne (2009) who show that banks with capital in excess of their own capital target lend more than their peers.

The impact of liquidity on the provision of credit appears to be similar. Banks with more liquid portfolios appear more willing to lend (Havro and Vale (2011)).

Based on findings by the RTF-TC, this section of the report addresses the following questions:

- (1) How does monetary policy impact the credit channel?
- (2) Do financial market conditions impact the credit channel?
- (3) What is the relative importance of the bank lending and borrower balance sheet channels in the financial transmission mechanism?
- (4) How do higher capital standards impact economic growth, credit availability and financial stability?

(1) How does monetary policy impact the credit channel?

Empirical studies have found **evidence** that increases in the central bank policy rate have a negative impact on bank lending.

Examples of such papers using macroeconomic data include Halvorsen and Jacobsen (2009) and Hammerlslund and Traee (2010) which study both the UK and the Norwegian economies.

Similarly, at the micro (bank) level, Tabak et al (2010) find that bank lending is reduced in response to an increase in the central bank policy rate in Brazil.

While such an effect is consistent with the existence of credit channel influences on credit supply, these studies do not prove that credit channel effects are present since they do not identify whether the amount of credit changes because of a shift in credit supply or a change in credit demand.

Several papers have tried to solve this identification problem.

Ciccarelli et al (2010) use the confidential euro area Bank Lending Survey and the publicly-available US Senior Loan Officer Survey to disentangle the effects of loan supply from loan demand.

They find loan supply to be more sensitive to monetary policy shocks than loan demand.

Black and Rosen (2009) use bank-level data on extensions of business credit to examine how monetary policy affects aggregate loan supply.

They examine the distribution of loans across firms of different sizes, the maturity structure of loan originations and the supply of loans from small and large banks.

They find monetary policy affects aggregate loan supply by causing variation in the maturities of new originations, with the impact being at least as strong for large banks as for small banks.

Jiménez et al (2010) use disaggregated data for analysing the bank lending channel and conclude that the provision of loans is significantly affected by tighter monetary policy.

Havro and Vale (2011) as well as Jimboorean and Mésonnier (2010) provide further evidence using Norwegian and French data, respectively.

The empirical findings highlighted above suggest that at least part of the effect on bank lending from tighter monetary policy is supply driven, ie there is a bank lending channel for monetary policy.

(2) Do financial market conditions impact the credit channel?

Financial market conditions appear to affect the strength of the credit channel.

More specifically, a decrease in market liquidity weakens the credit channel of monetary policy and results in slower GDP growth for any given level of the policy rate.

Even in the presence of very low interest rates, when market liquidity conditions are poor, credit availability is subdued as banks tighten lending standards, especially for uncollateralised borrowers.

Recent theoretical models have considered the optimal policy responses to adverse financial shocks; such models suggest that aggressive easing of monetary policy is appropriate and that higher capitalised banking systems can attenuate this liquidity effect.

Norwegian banks were not exposed to subprime-related assets, but they were affected by global market liquidity conditions.

Havro and Vale (2011) regard the aftermath of the Lehman crisis as an exogenous liquidity shock for the Norwegian banking system.

They find that, following the Lehman bankruptcy shock, Norwegian banks' loan supply curve became considerably steeper and the traditional bank lending channel of monetary policy may not have been working in the crisis period.

In a related study, Ciccarelli et al (2010) show that during the recent financial crisis, liquidity problems had a strong negative impact on GDP growth by reducing loan supply to businesses.

The wholesale market plays a central role in determining market liquidity conditions.

Boissay (2011) argues theoretically that the wholesale financial market improves the allocation of liquidity inside the banking sector, but becomes fragile when available liquidity exceeds the liquidity absorption capacity of the economy.

This leads to a "crisis time" equilibrium that is characterised by deleveraging.

Monetary policies may have to adapt to reflect the condition of the financial sector.

De Fiore and Tristani (2009) develop a model that relaxes the assumption of frictionless financial markets and show that an aggressive easing of policy is an optimal response to adverse financial market shocks.

Similarly, using dynamic stochastic general equilibrium (DSGE) models with financial frictions, Dib (2010) finds that higher capital requirements can attenuate the real impact of financial shocks on the macroeconomy; and Tomura (2010) demonstrates that liquidity mismatches in bank balance sheets lead to an endogenous demand for bank capital to prevent bank runs.

In a financial crisis, bank behaviour can offset monetary policy stimulus. De Haas and van Horen (2010) examine how the global financial crisis prompted banks to tighten lending standards despite very low policy interest rates.

Using data on syndicated loans made to private borrowers in 65 countries over the period 2005–2009, they find tighter lending standards for uncollateralised loans, for loans to first-time borrowers and for financial-sector borrowers in developed countries.

Increases in borrower screening and monitoring were less evident for rated borrowers and for loans structured by well-known arrangers.

Analysis of counterparty exposures may help anticipate bank crisis behaviour.

Castrén and Kavonius (2009) use euro area flow-of-funds data to construct a sector-level network of bilateral balance sheet exposures, which they extend to risk-based balance sheets.

They find that bilateral cross-sector exposures are important channels through which financial intermediaries affect borrowers in other sectors including the transmission of financial sector shocks.

(3) What is the relative importance of the bank lending and borrower balance sheet channels in the financial transmission mechanism?

The evidence of the importance of bank capital positions for sustaining bank loan growth is mixed but the data supports the importance of household balance sheets as a factor limiting credit.

Some studies find that well capitalised banks are more likely to grant credit and are less likely to limit credit.

However, **other studies find banks that are holding less capital are more willing to lend.**

On the borrower side of the equation, research shows that balance sheet conditions are the dominant credit channel affecting households.

Households with weak balance sheets and credit performance are less likely to obtain credit from a bank.

Bank capital conditions can affect the strength of the credit channel. Foglia et al (2010) use bank loan- and firm-level data to separate bank lending effects from borrower balance sheet effects in order to quantify how loan supply constraints affected real investment spending following the collapse of Lehman Brothers in 2008.

They find that well capitalised banks with balanced maturity structures were less likely to ration credit.

Moreover, **after the Lehman crisis, rationed firms tended to reduce investment spending by a greater amount than non-rationed firms.**

Jiménez et al (2010) use an extensive dataset of business loan applications and originations to examine how lending is related to the balance sheet conditions of both the banks as well as the firms seeking credit.

They find that both of these balance sheets (banks' and business') play an important role in determining how changes in economic activity or short-term interest rates affect the extension of credit.

Unsurprisingly, well-capitalised firms were more likely to be granted credit than their more poorly-capitalised counterparts.

However, banks with less capital or liquidity (ie riskier banks) were more, not less, likely to make loans.

Avery et al (2010) use localised measures for bank health and household debt performance to examine how bank and borrower balance sheets affect local economic activity.

On the local level, **bank capital had a stronger direct link to economic activity (unemployment rates) during the housing boom and bust period than during the previous decade.**

However, this capital channel does not appear to operate through expanded household lending, a finding that may reflect that national lenders dominate US mortgage and consumer credit markets.

This is consistent with the idea that balance sheet conditions are the dominant credit channel affecting households and suggests that, at least at the local level, banks matter mainly for business spending, through commercial and industrial lending.

Theoretical models may help to explain the interaction between bank lending and borrower balance sheet channels that we observe in the data. Hirakata et al (2011) develop a DSGE model where financial intermediaries invest household savings with entrepreneurs.

In this model, shocks to borrower creditworthiness are propagated to the real economy through the revisions of credit contracts.

When the model is estimated using US data, the authors find that adverse shocks to financial intermediaries cause larger economic downturns than do shocks to entrepreneurs.

In another theoretical paper, Dedola and Lombardo (2009) model a two-country economic system with a financial accelerator and an endogenous portfolio choice to show how foreign exposures in the balance sheets of leveraged investors can propagate shocks across countries.

In this framework, financial sector shocks can cause large real sector shocks even with minimal balance sheet exposure to foreign risky assets (so long as asset market integration across borders generates an equalisation of external finance premia faced by leveraged investors).

In this scenario, a global flight to quality will yield similar (de-)leveraging, financial and macroeconomic dynamics across countries.

Bank lending shocks have important effects on real sector growth and volatility.

Halvorsen and Jacobsen (2009) find that bank lending shocks explain a substantial share of output gap variability in Norway and the UK from 1988 through 2009.

This period includes both the Norwegian banking crisis (1988–1993) and the more recent financial crisis in the UK.

Using data for 18 OECD countries from 1981 through 2008, Monnin and Jokipii (2010) examine the relationship between banking sector stability and the real economy.

Using country-level indicators of financial sector health, they find a relationship between banking sector stability and the performance of the real economy.

In a related study, Jimborean and Mésonnier (2010) link French bank balance sheet characteristics to macroeconomic fluctuations and find that banking sector conditions matter more for real sector performance during crisis periods.

Moreover, since the results show that feedback effects tend to be largely driven by periods of instability, there are likely to be real economic benefits from well-executed macroprudential supervision.

Together these studies suggest several important ways through which financial sector problems magnified real sector volatility.

Bank capital and liquidity problems had adverse real consequences through reductions in credit supplied to businesses.

At the same time, the severe impairment of households' balance sheets and the deterioration of their credit performance reduced the willingness of even healthy banks to lend to the household sector.

(4) How do higher capital standards impact economic growth, credit availability, and financial stability?

Since the financial crisis, policymakers have focused on regulatory enhancements aimed at preventing future crises.

Bank capital regulation has been at the forefront of discussions as a means to ensure the resilience of the global financial system.

Despite the obvious benefits of increasing required capital, critics argue that stronger capital and liquidity regulations will reduce bank credit, stifle economic growth and reduce financial stability.

In this section, we discuss the RTF-TC's findings regarding bank capital, economic growth, credit availability, and financial stability.

(a) Bank capital and economic growth

Bank capital and liquidity regulations must strike a balance between costs and benefits. Several papers presented at the RTF-TC workshops compare the costs and benefits associated with higher capital and/or liquidity requirements.

For example, Francis and Osborne (2010) model the costs of additional capital as an increase in the wedge between lending and deposit rates and estimate the net economic benefits associated with a range of changes in prudential standards.

In a related study, Kato et al (2010) show that the optimal level of bank capital varies considerably depending on the level of banks' liquidity as well as macroeconomic conditions.

The optimal level of bank capital may not be constant over the business cycle.

In addition to comparing costs and benefits associated with tighter regulations, Kato et al (2010) highlight the need for a countercyclical buffer to better prepare for prospective distress.

Repullo et al (2010) offer a specific proposal for a countercyclical capital buffer.

Christensen et al (2011) show that absent regulation, bank leverage fluctuates as the macroeconomic environment changes to accommodate the economy's requirements for lending with the natural inertia in bank capital.

Regulation that limits, or directs, movements in leverage can thus importantly affect the propagating impact of bank capital.

(b) Bank capital and credit availability

When a bank faces a capital shock from losses or a change in regulation, it must consider the trade-off between the marginal costs of issuing equity and the marginal cost of cutting back on lending.

Kiley and Sim (2010) model this trade-off. Banks respond to a shock through a mix of financial disintermediation and recapitalisation.

Agur (2010) analyses the trade-off between financial stability and credit rationing that arises when capital requirements are increased and shows that with greater use of wholesale finance, capital requirements have a stronger impact on the real economy.

This impact results from feedback effects between loan rates and funding rates.

Since uninsured financiers – who represent wholesale investors – care about the risk of the bank they are lending to, higher loan rates lead to higher funding rates, which amplifies the impact of capital requirements.

The empirical evidence on the effects of capital shocks on lending supports the theory.

Francis and Osborne (2010) use data on UK banks and show that better capitalised banks are more willing to supply loans.

This feature is especially true in times of crisis (Foglia et al (2010)). Coffinet et al (2010) use micro data on French banks to show that bank capital behaves in a procyclical manner especially when better quality capital is considered.

Darracq et al (2010) assess the effects of introducing risk-sensitive and more stringent capital requirements.

They show that a bank capital shock results in an increase in bank leverage which, in order for banks to re-establish their target leverage ratio, leads to an increase in banks' loan-deposit margins.

This is mainly driven by higher lending rates, which in turn lower loan demand and real activity.

They conclude that if banks have more time to adjust their activities and balance sheets to a new environment, they will tend to smooth the impact of the shock.

(c) Bank capital and financial stability

In the aftermath of the recent financial crisis, much debate has been focused on new regulations that were introduced to preserve financial stability.

In addition to the need to increase individual bank resilience, a consensus has emerged regarding the need to consider financial stability from a systemic perspective.

Some papers studied by the working group estimate models of bank default probabilities as well as the probability of a financial crisis more generally.

Osborne et al (2010) and Kato et al (2010) estimate probit/logit models of the probability of a financial crisis occurring.

Capital and liquidity ratios are key determinants of the likelihood of a crisis with higher ratios being associated with a reduced probability.

Higher capital and liquidity standards lower the probability of a crisis.

Capital regulations may need to consider the potential for contagion. Gauthier, Lehar and Souissi (2010) estimate overall systemic risk by explicitly incorporating contagion externalities present in the financial system.

They show that systemic capital allocations can differ substantially and are not directly related to bank size or individual bank default probability.

Systemic capital allocation mechanisms are estimated to reduce default probabilities of individual banks as well as the probability of a systemic crisis by about 25%.

Their results suggest that financial stability can be enhanced by implementing a systemic perspective on bank regulation.

New questions and issues that have arisen

In assessing this strand of literature, some new questions and issues have arisen.

What roles do the structures of the bank and the non-bank sectors play in the longer-term development of real estate booms?

Evidence suggests that low interest rates were one of the key factors contributing to the leverage build up; however, competition between the un-regulated and regulated financial sectors may have contributed to risk taking in extending credit to riskier borrowers.

How have credit market developments that increase the degree of lending beyond the banking sector affected linkages between the banking system and the real economy?

Similarly, how do secular trends in bank credit extensions – such as shifts to asset-based lending in real estate boom periods – affect linkages between banks and the real economy during bust periods?

Finally, an important dimension of the bank lending channel is the potential for a misallocation of resources in the real economy.

Is there some way to quantify the real effects of bank lending in terms of types of investment spending occurring in the real sector of an economy and the attendant misallocation of resources associated with overbuilding in the residential real estate sector?

Remaining gaps in the literature

Several important gaps remain in the literature studying the interaction between credit, growth, the banking sector and the real economy.

Evidence on the role of financial markets in the credit transmission channel of monetary policy remains scarce, while the role of market funding and securitisation should also be further researched.

In addition, in light of the vast amount of public funds injected into the financial system during the course of the financial crisis, the efficacy of public (vs private or market-based) capital injections remains relatively unexplored.

Such evidence could perhaps inform on the macroeconomic implications of loss absorbency that is provided using contingent capital or bail-in debt instruments to systemically important institutions.

Moreover, another interesting question is whether new regulations should account for government shareholders in the bank.

From a methodological point of view – regardless of the methodology used (ie VAR-type models, DSGE models, or theoretical models) – limited attention has been paid to nonlinearities and structural breaks.

For instance, **the effect of Basel II inception or the specificity of downturn periods has only been scarcely investigated.**

In light of the recent financial crisis, nonlinearities in relationships in crisis and non-crisis periods have emerged as a key gap in the research. More work is needed to understand differences between how credit channels work in both good and bad times.

In addition, there is little evidence on how the financial environment prior to a crisis affects the economic significance of a particular credit channel for economic activity.

Further work on these issues would also be fruitful.

Additionally, more work needs to be done to identify shocks to loan supply that are due to changes in loan demand generated by future profit expectations.

Credit demand reflects expectations about future investment opportunities as asset values are inherently forward looking.

Thus lower asset values can change credit demand by affecting the balance sheets of banks and borrowers, but they may also signal lower expected future returns from holding the asset which may itself reduce the demand for credit.

Finally, more research is needed to understand how linkages between banking sector conditions and real sector activity are related to specific institutional and regulatory features of an economy.

2. Costs and benefits of bank capital and liquidity regulation

Brief summary of literature

Higher capital and liquidity requirements may generate social benefits by reducing the frequency and severity of banking crises and the accompanying loss of economic output, and may generate costs by impacting the price and availability of credit and other financial services, and thereby altering the level of investment and output in the economy.

Schanz (2009), Schanz et al (2011), Barrell et al (2009) and Kato et al (2010) aim to quantify the overall costs and benefits of higher capital and/or liquidity standards.

The results of these studies are broadly similar, although there are some quantitative differences, reflecting different assumptions about departures from the Modigliani-Miller (M-M) theorem, among other factors.

In terms of the benefits that would result from tighter regulation, Barrell et al (2009) and Kato et al (2010) both find that higher standards should lower the probability of a financial crisis.

In contrast, Schanz et al (2011) concludes that the results vary depending on the specific assumptions that are made in the model.

The thrust of the literature on the role of bank capital and liquidity is that more capital and liquidity will smooth credit availability over financial cycles, although whether this outcome can be achieved by imposing fixed requirements remains somewhat less clear.

This section considers the following questions:

- (1) What are the costs and benefits of higher capital and liquidity requirements?
- (2) What are the key differences between studies on the costs of increased capital requirements?
- (3) What are the implications of these liquidity and credit supply findings for the Basel liquidity standards?
- (4) Is it possible to quantify the benefits of tighter regulation?

(1) What are the costs and benefits of higher capital and liquidity requirements?

Following the recent financial crisis, it has been widely recognised that in order to reduce the risk of future financial crises, both capital and liquidity buffers are needed to withstand shocks.

Several papers shed light on the costs and benefits of stricter capital and liquidity regulations and provide significant insight into the new standards.

The costs of higher capital and liquidity requirements are generated by the impact that higher requirements have on the price and the availability of credit, and the effect that this has on the level of investment and output in the economy.

One of the benefits of higher capital and liquidity standards is a lower probability of a financial crisis and the associated reduction in the expected cost of such a crisis in terms of lost output.

The studies reviewed (Schanz et al (2011), Barrell et al (2009) and Kato et al (2010)) make varying assumptions about each of these elements, leading to somewhat different results in terms of the overall costs and benefits of the more robust standards.

Osborne et al (2010) enhance the UK Financial Services Authority/National Institute of Economic and Social Research (FSA/NIESR) modelling framework by including micro-foundations that generate individual bank responses to changes in prudential standards.

They also include alternative parameterisations of the macroeconomic costs and benefits used in the framework.

Macroeconomic costs associated with liquidity are refined using market and regulatory data (between 1999 and 2007) and integrated into the National Institute Global Econometric Model (NiGEM) framework and the model is modified to account for changes in the composition of regulatory capital.

The improved model has fewer type 1 errors (ie the failure to identify an observed crisis) and fewer type 2 errors (ie the false identification of a crisis).

This finding suggests that capital and liquidity requirements are both important for reducing the probability of and macroeconomic costs of a crisis.

(2) What are the key differences between studies on the costs of increased capital requirements?

Bank capital is costly because of frictions in financial markets that lead to deviations from M-M, which would otherwise predict that higher equity capital would not increase banks' funding costs.

In the calculation of the costs, banks are assumed to pass on the extra funding costs from higher capital to borrowers by raising lending rates. This reduces the activities of borrowers, thereby resulting in a loss in GDP.

The papers reviewed differ from each other in the assumptions that they adopt regarding the magnitude of the deviations from M-M, resulting in different estimates of the costs of higher capital requirements.

To estimate the effects of costly bank capital, Schanz et al (2011) applies a range of assumptions about deviations from M-M to data on the cost of equity and debt in the UK.

The paper concludes that the curve showing the marginal benefits of higher capital ratios is quite steep at the intersection with all of the (horizontal) marginal cost estimates, so estimates of the "optimal" capital ratio do not vary much in the cost estimates.

Due to the challenges associated with achieving a definitive parameterisation of the relationship between capital ratios and the cost of credit, Barrell et al (2009) take an empirical approach using an estimate of the long-run relationship between the capital ratio and the cost of credit for the economy of the UK.

The parameters they estimate result in an impact of a one percentage point increase in the capital ratio of around 12–15 basis points.

Compared to the Schanz et al (2011) results, these represent a relatively conservative parameterisation.

The study by Kato et al (2010) uses a formula for welfare loss associated with capital requirements taken from van den Heuvel (2008).

Changes in the cost of bank credit will translate into changes in investment, consumption and GDP.

Schanz et al (2011) calculates the long-term impact of the increase in loan rates on GDP using a CES production function with increased firms' cost of capital due to higher loan rates, whereas Kato et al (2010) and Barrell et al (2009) use in-house macroeconomic models for this element of the modelling.

The cost of higher liquidity is calculated by a “cost of carry” that is equal to the increase in the cost of credit required to offset the impact of holding a higher proportion of liquid assets with lower yield, such as cash and government bonds, on either return on equity (ROE) or return on assets (ROA).

(3) What are the implications of these liquidity and credit supply findings for the Basel liquidity standards?

The effects of liquidity requirements may depend on monetary conditions.

Much of the research considering the impact of higher liquidity standards on financial stability has been limited to empirical models of the probability of a financial crisis.

Several recent studies have examined how liquidity conditions affect credit supply under tight monetary conditions.

Among these, Jimenez et al (2011) finds that banks with more liquid assets tend to be more resilient to tight monetary policy and deteriorating economic conditions, while weaker banks tend to contract credit supply.

These results may be explained by banks with stronger balance sheets being better able to raise funds during tight monetary conditions, consistent with the finding that higher liquidity is associated with a lower probability of a crisis (and, in the case of Schanz et al (2011), lower probability of individual banks defaulting).

These findings are largely consistent with the traditional view of the bank lending channel.

Banks with stronger liquidity positions are more likely to maintain lending, but this may not provide accurate guidance as to the potential impact of minimum liquidity standards.

The beneficial impact of higher liquidity during stressed market conditions, together with the already existing literature on the bank lending channel seem to suggest that higher liquidity standards will smooth credit supply over financial cycles.

However, we should be cautious about drawing conclusions about liquidity requirements from results on the effect of liquidity conditions.

There are other factors which could explain the results with respect to liquidity conditions.

For example, banks that anticipate strong loan demand in the near future, or banks that have a lot of outstanding loan commitments may optimally decide to hold more liquid assets today in order to be ready for the moment the lending opportunities materialise, as in the traditional “pecking order” theory of corporate finance.

This could explain the observed correlation, but it does not mean that if banks are required to hold more liquid assets then they will automatically lend more, as they will not have the same investment opportunities.

Indeed, requiring higher liquid assets could reduce the supply of credit if it reduces the net present value of lending opportunities.

Consider as well the issue that a bank subjected to a regulatory requirement to hold a specified level of liquid assets may not be able to absorb shocks as well as one not subject to the requirement.

The former may be unable to sell its liquid assets because it would fall below the liquidity requirement.

In this manner, liquidity held by choice is distinct from liquidity held because of a requirement.

Another possibility recognises that banks may adjust their loans and liquidity to maintain a preferred balance.

Suppose exogenous factors could push liquid assets above banks' desired level.

The bank may respond by expanding credit to regain its desired balance with liquid assets.

Hence, the correlation between liquid asset holdings and credit supply could be just a short-run phenomenon (eg Francis and Osborne (2009) or Berrospide and Edge (2010)).

According to this view, higher liquidity standards could reduce credit supply by reducing the amount of excess liquid assets.

This view suggests that studies need to closely examine the reasons why some banks have higher liquidity ratios than others in order to be able to understand the effect of higher liquidity standards.

(4) Is it possible to quantify the benefits of tighter regulation?

Estimates of the benefits of tighter regulation depend on whether empirical models incorporate non-linear terms to account for the potential imperfect substitutability between liquidity and capital.

Papers by Barrell et al (2009) and Kato et al (2010) model the probability of a financial crisis based on historical data and using capital and liquidity measures as regressors.

There are two significant differences between the studies. Barrell et al (2009) model only linear effects for the capital ratio and the liquidity ratio and this assumption can lead to corner solutions where it is optimal to hold either capital or liquidity, but not both.

Kato et al (2010) identifies non-linear effects of capital and liquidity, which implies that capital and liquidity may be imperfect substitutes for each other, in the sense that higher capital is more effective in reducing the probability of a crisis if liquidity is high as well.

The finding that capital and liquidity are mutually reinforcing may be interpreted as providing support for the introduction of international liquidity standards as a supplement to capital standards.

Another important distinction is the use of different measures of liquidity. Whereas Barrell et al (2009) find a role for the ratio of liquid assets-to-total assets, Kato et al (2010) have the same finding but also find that higher liability-side liquidity (ie the extent to which firms rely on long-term debt) is also a key mitigant of the probability of crisis.

Calculating the net benefits of higher standards means combining the estimates of the reduction in the likelihood of a crisis by the estimated cost of a financial crisis.

The difficulties for doing this are well described by Schanz et al (2011) who show both that a wide range of estimates are available, and that very different results can be obtained by varying the assumption of whether financial crises result in a permanent reduction in growth.

New questions and issues that have arisen

The introduction of Basel III has generated substantial interest in understanding the economic consequences of enhanced prudential standards.

Many of the costs and benefits associated with the new rules have been addressed in the literature discussed above.

However, several new questions and issues have emerged.

The studies have looked at the potential impact of liquidity standards, which are now based on an internationally agreed standard.

While the research suggests that banks with greater liquidity can better maintain lending over the cycle, there is a need for further research on how banks react to liquidity standards, the potential costs of such standards, and the potential impact on banks' risk-taking.

Analytical input will be needed to monitor and investigate how the new standards (the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR)) work in practice to reduce the risk inherent in a bank and the banking sector.

What are the likely behavioural effects of new capital and liquidity standards?

In particular, what impact will higher standards have on banks' risk-taking?

Could the substantial increase in standards seen in Basel III result in a migration of risk to the nonbank sector, and if so, how can this be addressed?

How do the costs and benefits of higher standards vary depending on economic and financial conditions?

The papers by Schanz et al (2011) and Kato et al (2010) showed that variations in initial conditions had a large effect on the results in terms of optimal calibration of prudential policy and thus it will be important to understand what drives these differences, particularly in light of the increased focus on "macroprudential" policies.

Indeed, the net benefits associated with Basel III implementation in each jurisdiction will likely depend on the economic and financial conditions before and during the transition period, which of course can vary across jurisdictions.

How should feedback effects from the macroeconomy be evaluated, both in the context of whether there are steady-state or transitional costs of higher standards, and how shocks can be amplified by an undercapitalised banking system when standards are in some sense too low?

Remaining gaps in the literature

Together, the papers discussed above provide a useful clarification of the issues relating to bank capital and liquidity regulations, but several gaps in the literature remain.

More work is needed to understand the nature of the costs of a financial crisis.

In particular, is the effect on economic growth temporary or permanent?

Is the loss due to the occurrence of a crisis recoverable?

What determines the magnitude of a loss?

Do output loss estimates need to be adjusted for the possibility that a financial crisis could potentially be caused by a slowdown of the economy, rather than the other way around?

Moreover, it is still unclear how the probability of a crisis occurring would change when banks with different levels of capital and liquidity – even if the average of the banking sector as a whole is still the same – are interconnected within a certain jurisdiction and across jurisdictions.

In addition, the extent to which banks would pass on the costs from stricter regulation to their borrowers remains unclear.

To what extent would the effect come from increasing loan rates and to what extent by credit rationing?

How does the impact change depending on the economic environment, the degree of competition in financial service markets, financial structure (the importance of indirect finance), and the size of the borrowers?

Finally, even though a leverage ratio has been introduced as part of the Basel III package, most of the studies reviewed focus on risk-weighted capital ratios.

In this context, it may be useful to further examine how and when these two different capital regulations might complement or contradict each other for reducing the risks posed to the financial system and the real economy.

To read more:

http://www.bis.org/publ/bcbs_wp20.htm

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Joint Consultation Paper on the proposed response to the European Commission's Call for Advice on the Fundamental Review of Financial Conglomerates Directive

14 May 2012

The Joint Committee of the European Supervisory Authorities (EBA, EIOPA and ESMA) is launching today a **three-month public consultation** on the proposed response to the call for technical advice from the European Commission on the fundamental review of the Financial Conglomerates Directive ("the FICOD").

This consultation covers three broad areas where advice is sought by the European Commission: the scope of application, the group wide internal governance requirements and sanctions and supervisory empowerments under the FICOD.

In its proposed response, the Joint Committee issues a series of recommendations for the review of the FICOD, including the **widening of the scope of supervision, addressing requirements and responsibilities to a designated entity within the financial conglomerate and the framework of supervisory powers provided by the FICOD**.

Moreover, the Joint Committee will be providing later this year, a supervisory contribution to the wider fundamental review of the FICOD, which is being carried out by the European Commission.



JOINT COMMITTEE OF THE EUROPEAN SUPERVISORY AUTHORITIES

EBA, EIOPA and ESMA's Joint Consultation Paper on its proposed response to the European Commission's Call for Advice on the Fundamental Review of the Financial Conglomerates Directive

London, Frankfurt, Paris, 14 May 2012

1. Responding to this Consultation

The three European Supervisory Authorities, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) invite comments on all matters in this.

Comments are most helpful if they:

- Respond to the question stated;
- Indicate the specific question to which the comment relates;
- Contain a clear rationale;
- Provide evidence to support the views expressed/ rationale proposed; and
- Describe any alternative regulatory choices EBA/EIOPA/ESMA should consider.

2. Executive Summary

1. The Joint Committee of the European Supervisory Authorities' Sub Committee on Financial Conglomerates (JCFC) received a Call for Advice from the European Commission in April 2011 to look at the

(A) scope of application, especially the inclusion of nonregulated entities

(B) internal governance requirements and sanctions, and

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(C) supervisory empowerment of Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (FICOD).

This advice shall contribute to the European Commission's fundamental review of the FICOD, following the short technical review, resulting in Directive 2011/89/EU (hereafter FICOD12).

2. As a result of its analysis, the EBA, EIOPA and ESMA, hereinafter the ESAs, propose the following answers to the questions risen by the Commission in its fourth Call for Advice (hereinafter CfA):

Question 1 CfA: What should be the perimeter of supervision, when a financial conglomerate is supervised on a group wide basis?

3. Recommendation 1:

The Perimeter of supervision should be enlarged to ensure a more thorough group wide supervision and avoid possible regulatory arbitrage, by enhancing the groups of entities that can be included in the identification of a financial conglomerate.

Accordingly the ESAs suggest to allow for a more consistent and broader identification of financial conglomerates to modify the definition of "financial sector" [according to Article 2 (8) FICOD] and/or the definition of "regulated entities" [according to Article 2 (4) FICOD]. Therefore, the definition of financial sector [Article 2 (8) FICOD] should be enlarged to include insurance ancillary services undertakings and all special purpose vehicles/entities to enable a broader identification of financial conglomerates, and to enable that the risks are appropriately captured.

4. The ESAs have assessed whether Institutions for occupational retirement provision (IORPs) should be included as part of a financial conglomerate and are mindful of the national specificities of IORPs.

The ESAs welcome the views of the stakeholders on the following options:

Option 1:

Include IORPs within the definition of "financial sector", in a similar manner to the inclusion of Alternative Investment Fund Managers (AIFM) and Asset Management Companies (AMC) within FICOD, e.g. by enlarging the definition of a regulated

entity according to Article 2 (4) FICOD and by amending Article 3 FICOD respectively.

Option 2:

Maintain the status quo; such that IORPs would not be included within group wide supervision at cross-sectoral level, given that prudential risks posed by IORPs to financial conglomerates have not been demonstrated.

However, this might imply that relevant financial activities of IORPs might not be taken into account when identifying a financial conglomerate and applying supplementary supervision.

5. Recommendation 2:

Mixed financial holding companies (MFHCs), even if unregulated, should be made subject to supplementary supervision or any type of requirements that are proposed below.

Accordingly, MFHCs should be included together with regulated entities as the legal addressee of supplementary supervision.

6. Recommendation 3:

Companies undertaking solely industrial activities (with no financial services activity at all), such as industrial conglomerates, should not be subject to direct financial supervision as the supervisory focus might be diverted from financial undertakings.

Mixed activity holding companies (MAHCs) and mixed activity insurance holding companies (MAIHCs) should not become direct addressees of FICOD, but the supervisor should have the ability to access relevant information from such MAHC and MAIHC within its supervisory tool kit.

The following supervisory tools are not mutually exclusive and the ESAs welcome the views of the stakeholders in order to assess the implication of this recommendation further.

7. Supervisors should be empowered:

Tool 1 –

To require the creation of an intermediate financial holding which is responsible for all the entities (or at least, all the regulated entities) carrying out financial activities subject to supplementary supervision and which will be the “addressee” for supervision.

Tool 2 –

To designate one single “point of entry” at the top of the unregulated entities in place of a formal ‘common chapeau’ of the financial entities in the group.

This point of entry is not a legal person, but a simple reference for the supervisors (e.g. a specific team or division or a member of the Board of the parent entity).

Tool 3 –

To designate a specified regulated entity as point of entry which does not necessarily need to be the top entity of the entire financial conglomerate.

This option has merit if the enforcement requirements and sanctioning measures addressed to the top entity cannot be adequately enforced by the supervisors.

Question 2 CfA: Given your experience and expertise, which legal entity in a conglomerate should be responsible and qualify for compliance with group wide requirements, i.e. which legal entity should be the responsible parent entity?

8. Recommendation 4:

The European Commission should identify and define an ultimate responsible entity for the financial conglomerate according to the following minimum criteria: control, the dominant entity from the market’s perspective (market listed entity) and the ability to fulfil specific duties towards its subsidiaries and its supervisor.

Question 3 CfA: Given your supervisory experience and expertise, which requirements should be imposed on this qualified parent entity in the context of group wide supervision?

9. Recommendation 5:

This ultimate responsible entity should be responsible for compliance with group wide requirements.

The European Commission should explicitly require the ultimate responsible entity to have a coordinating and directing role over the other entities of the conglomerate.

Moreover, some existing requirements for regulated entities and requirements that can be derived from the ESAs' guidelines on Internal Controls should also be applicable for the top parent entity, whether the regulated entity is a Holding Company or a Financial Holding Company (FHC), Insurance Holding Company (IHC) or a MFHC.

Question 4 CfA6: Given your supervisory experience and expertise, which incentives (special benefits or sanctions) would make the enforcement of the group wide requirements more credible?

10. Recommendation 6:

In order to ensure that the group wide requirements are enforceable, the European Commission should develop an enforcement regime towards the ultimate responsible entity and its subsidiaries.

This would imply a dual approach with enforcement powers towards the top entity for groupwide risks and towards the individual entities for their respective responsibilities.

Corrective measures should be directed towards the entity that is responsible for the respective breach.

11. Recommendation 7:

In any case, the supervisor should have a minimum set of measures, consisting of informative and investigative measures, at hand (see Recommendation 3).

Supervisors should be able to administer sanction measures addressed at the MAHC or MAIHC, where this entity does not provide the requested information.

Moreover, when (under Tool 1, Recommendation 3) an intermediate financial holding company has been established, supervisors should be able to administer sanction measures at this intermediate financial holding company.

Question 5 CfA: When reflecting upon this advice, would supervisors in Europe need other or additional empowerment in their jurisdictions?

12. Recommendation 8:

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Whilst the FICOD provides the ESAs and the supervisors with a large supervisory tool kit, supervisor's actual use of this tool kit should be enhanced.

Further a minimum set of enforcement measures that national supervisors should have at their disposal towards the group (Article 16 FICOD), should be achieved by the ESAs developing guidelines or by being asked to develop binding technical standards for a common reporting scheme on risk concentrations and intra group transactions, (including the possible development of guidelines for quantitative limits under Article 7 (3) and 8 (3) FICOD).

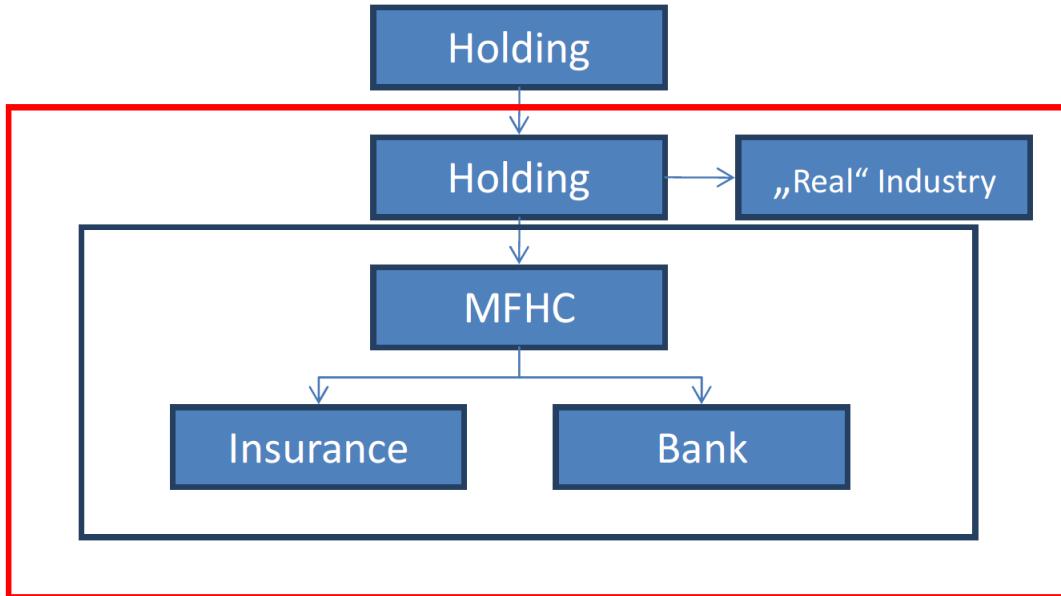
This also implies creating a minimum set of sanctioning measures that should be applied towards the group in case of a breach of group wide requirements.

In addition, the European Commission should take into account sectoral differences that may arise between CRD IV and Solvency II.

Structures of a financial conglomerate

The following example illustrates that there are some group structures that make it very difficult to identify a financial conglomerate:

In some cases a subgroup within a large complex group (hereafter LCG) qualifies as a financial conglomerate. But after calculating the threshold for the entire group (including the “real” industry) this group does not fulfil the FICOD’s 40% threshold and, therefore, the whole group will not be subject to supplementary supervision.



This situation may also be a way of avoiding supplementary supervision.

By setting up a chain of holding companies with subsidiaries of “real” industry the 40% threshold will not be fulfilled after a certain point.

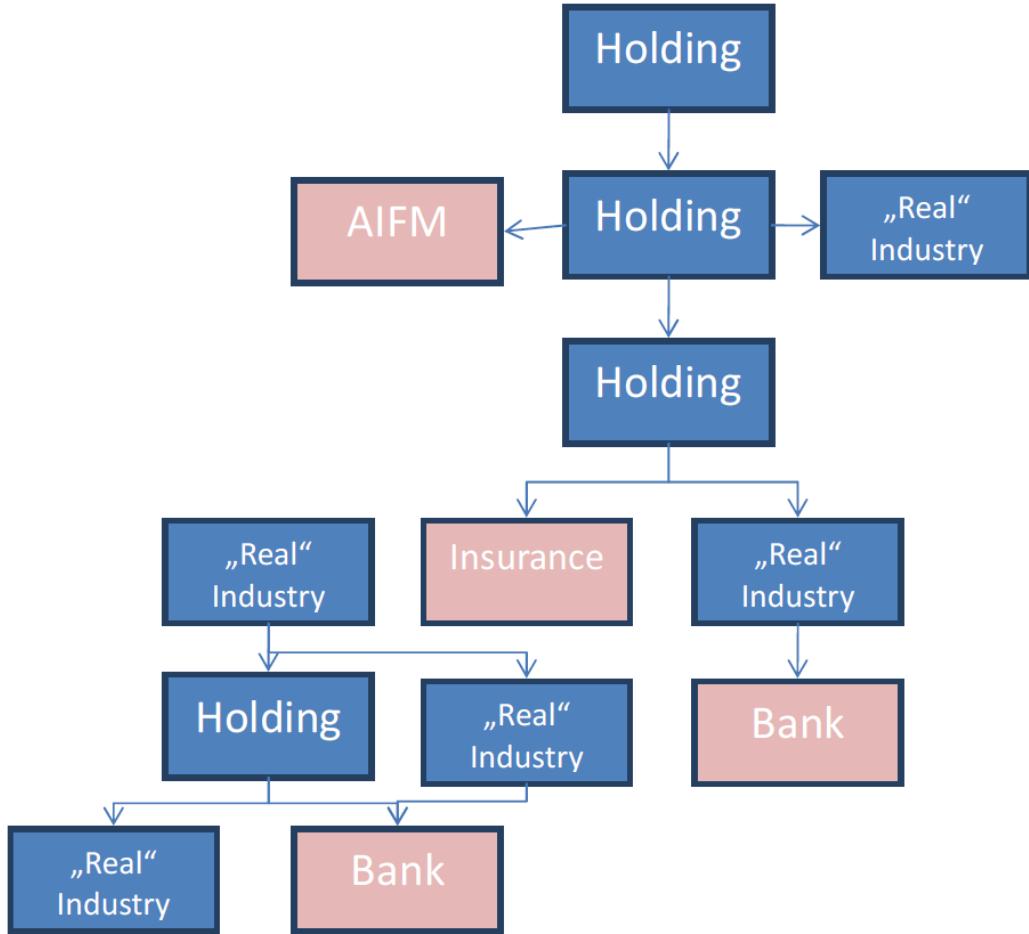
Currently, the supervisor is only allowed to address the regulated entity (e.g. in order to get information).

The regulated entity has to cooperate with its parent entity (and is responsible for the delivered information to the supervisor) but has (under company law) no powers to get necessary information.

Therefore the possibility to address supervisory issues concerning information and sanctions to holding companies should be strengthened.

In addition, there might be structures which are even more complex.

In these cases industrial groups may have many different regulated entities which are not held by one parent entity but are spread over the group.



In this case, it is almost impossible for supervisors to identify the holding company which may qualify as MAHC or MAIHC.

Further, supervisors might not be able to supervise the group on a groupwide level to avoid double gearing; but the regulated entities of the banking and insurance sector are all supervised on a solo level.

The potential negative effects (arising from intragroup transactions or risk concentrations) are scarcely visible.

This may lead to spillover effects (either from the industrial part to the financial part or vice versa).

Consequently, supplementary supervision on a group wide level would help (if this group does not qualify as a financial conglomerate according to Article 3 FICOD).

Thus, introducing a responsible entity within the group as an addressee for supervisory actions would lead to more clarity from a supervisory point of view.

To learn more:

<http://www.eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2012/JC%2001/JC-CP-2012-01--ESAs-Joint-CP----EC-call-for-advice-on-fundamental-FICOD-review-.pdf>



Market entry criteria revised for banking sector in Hong Kong

The Banking Ordinance (Amendment of Seventh Schedule) Notice 2012, which seeks to **update certain market entry criteria for the banking sector** in Hong Kong, will be gazetted on Friday, 18 May 2012.

A spokesman for the Financial Services and the Treasury Bureau said, “These amendments seek to **remove from the Banking Ordinance certain licensing criteria for banks**, which have become unnecessarily restrictive and put Hong Kong at a disadvantage when compared with other international financial centres.

These licensing criteria to be repealed may **restrict** well-managed and reputable domestic and overseas institutions from establishing a presence in Hong Kong.”

The Notice seeks to remove the present licensing requirement under which **an applicant for a bank licence must have total customer deposits of not less than HK\$3 billion and total assets of not less than HK\$4 billion**.

The Notice also seeks to remove some present impediments which **restrict foreign banks** from entering the Hong Kong market through the establishment of a locally incorporated subsidiary.

A spokesman for the Hong Kong Monetary Authority said, “Some international financial institutions do not take deposits as part of their **normal business**. The proposed revisions will **allow a broader range of qualified domestic and international institutions to participate in our financial markets, without compromising the stability of Hong Kong's banking system**.”

The proposed amendments arose from a review last year by the Hong Kong Monetary Authority, which concluded that some licensing conditions under the Banking Ordinance applying to Hong Kong are not found in other major financial markets such as the United Kingdom, the US, Germany, Switzerland, Australia and Singapore.

These conditions are also not part of the international standards for banking supervision and regulation.

The Notice will be tabled before the Legislative Council on Wednesday, 23 May 2012.

Subject to the negative vetting of the Notice by the Legislative Council, the amendments will take effect on July 12, 2012.

Hong Kong Monetary Authority
16 May 2012

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The fit and proper requirements...



Tribunal upholds FSA decision to ban and fine former UBS advisers £1.3m for not being fit and proper in relation to an unauthorised trading scheme

21 May 2012

The Upper Tribunal (Tax and Chancery Chamber) has directed the Financial Services Authority (FSA) to **fine Sachin Karpe £1.25 million and Laila Karan £75,000** and ban them both from performing any role in regulated financial services for **failing to act with integrity, in breach of Principle 1 of the FSA's Statements of Principles and Code of Conduct for Approved Persons ("APER")** and for **not being fit and proper persons.**

Between January 2006 to January 2008, **Karpe** was Desk Head of the Asia II Desk at UBS AG (UBS) international wealth management business in London.

Between February 2007 and January 2008, **Karan** worked as a Client Advisor on the Asia II Desk, **reporting directly to Karpe**.

The Asia II Desk provided services to customers resident in India, or of Indian origin.

Karpe

During the relevant period Karpe carried out **substantial unauthorised trading**, predominantly in FX instruments, with **a gross value of billions of pounds across 39 customer accounts**.

He also made **unauthorised transfers and loans** between client accounts in order to conceal losses arising from the unauthorised trading.

He directed others (including Karan) to assist him in arranging the transfers and loans, and creating **false documentation** for the unauthorised trading.

His scheme resulted in **substantial losses for 21 customers**.

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UBS has since paid compensation to the affected customers in excess of US\$42 million.

Karpe also established an investment structure to enable a major (Indian resident) customer (via an investment fund incorporated in Mauritius) to breach Indian law in clear contravention of UBS guidelines.

Ultimately, the customer invested over US\$250 million in the fund.

Karpe deliberately and repeatedly misled compliance in order to accommodate his customer.

Karpe also misled UBS and senior management about paying compensation to a customer using monies from another customer account.

The Tribunal found that:

“Mr Karpe induced others serving on his desk to participate in what was an obviously dishonest course of conduct...we infer that the whole motivation was to benefit him indirectly and in the long term by obtaining new clients through his apparent prestige, increasing funds under management and thereby advancing his career and increasing his bonuses.”

The Tribunal accepted that the compliance failings at UBS might have created an environment within which staff could “get away with” misconduct – however, this was no excuse for Karpe’s sustained dishonesty.

Karan

Karan did not instigate the unauthorised trading; however, she was aware that unauthorised activity was occurring on some customer accounts for which she was responsible.

Between February 2007 and January 2008, rather than escalating this knowledge, Karan assisted Karpe in concealing the unauthorised activity.

In particular, Karan prepared false, handwritten telephone attendance notes purporting to record customer instructions she had received when she had taken no such instructions; routed transactions through a suspense account in order to conceal their origin and destination; signed a number of UBS documents recording the

approval of transactions on the accounts without having received instructions or authorisation from the customers; and failed to escalate her knowledge of unauthorised loans between customers.

Ms Karan also failed to escalate her knowledge that Mr Karpe had misled UBS and senior management about paying compensation to a customer using monies from another customer account.

The Tribunal noted that:

“We recognise that Ms Karan had been placed in an extremely awkward situation through the manipulation of Mr Karpe.

The fact, however, is that over and over again she chose to go along with and, on occasions, to facilitate Mr Karpe’s wrongdoing.”

Tracey McDermott, acting director of enforcement and financial crime, said:

“Karpe exploited and abused his position of trust, and persuaded more junior employees to engage in misconduct to assist him.

Such behaviour is in breach of his obligations to his employer, his clients and his colleagues as well as to the regulator.

It has no place in the financial services industry.

We welcome the Tribunal’s confirmation that as well as banning Karpe, a significant financial penalty should also be imposed.

This sends a clear message of the consequences of such behaviour.

“Karan sought to categorise herself as a victim in this matter. The Tribunal (as had the FSA) recognised that she did not initiate the misconduct, and was placed in a difficult position by Karpe.

However, the findings and the resulting sanctions send a clear message that **an approved person must take responsibility for their own actions.**

Where an approved person is aware that colleagues are engaging in misconduct, we expect them to blow the whistle, not to become involved themselves.

“Those who take on the responsibility of being an approved person should be in no doubt about our commitment to **take the strongest action to tackle behaviour which falls below the high standards we expect.**”

In **November 2009** the FSA fined UBS £8million for systems and controls failures in relation to the unauthorised activity which occurred on the Asia II Desk.

In **December 2011** Jaspreet Singh Ahuja and in November 2009 Andrew Cumming, both former Asia II Desk client advisers, were banned and fined £150,000 and £35,000 respectively.



Speech by Andrea Enria, Chairperson of the European Banking Authority

Financial integration and stability in Europe: the role of the European Banking Authority

23 May 2012, at the 15th China Beijing International High Tech Expo China Financial Summit 2012

Dear CHITEC host, Ladies and Gentlemen,

It is a pleasure to have been invited to address you this morning at the China Financial Summit 2012.



Given the very difficult environment we are facing in the financial markets, and especially in the European banking sector, this conference provides an excellent opportunity to give this international gathering **some insight into the recently established European Banking Authority, the EBA, including the role it plays in tackling the crisis, and in strengthening the regulatory framework for European banks.**

While the immediate challenges are dominating our thoughts at present, it is also important that we continue to develop the structural changes necessary to deliver a more secure and stable banking environment for the long term.

The extent of the problems which have beset the global financial system over the last five years are **unprecedented** in modern times and have exposed serious weaknesses in financial regulation and supervision.

In his February 2009 report, **Jacques de Larosière pointed to the belief that in the run up to the commencement of the crisis in 2007, financial regulation and supervision had been too weak and provided the wrong incentives.**

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Lack of adequate **macro-prudential** supervision, ineffective **early warning mechanisms**, lack of **frankness and cooperation** between supervisors and lack of **common decision making process** were among the key lessons learned from the crisis.

We had a Single Market, closely integrated especially after the introduction of the euro, but the regulatory and supervisory environment has remained very diverse, notwithstanding the efforts for harmonisation.

A key component of the European response to addressing these deficiencies was the establishment of the European System of Financial Supervision on 1 January 2011.

This includes the **European Systemic Risk Board (ESRB)**, in charge of macroprudential supervision, and the three European supervisory authorities, the EBA for banking, ESMA for securities and markets and EIOPA for insurance and occupational pensions.

The EBA has been given a wide-ranging mandate. **In the field of supervision, while the day-to-day oversight of banks' safety and soundness remains a responsibility of national authorities, the EBA has been entrusted with key responsibilities.**

These include the **regular conduct of risk assessments**, which should also lead to the establishment of a risk dashboard, and of area-wide stress tests, aimed at ensuring the resilience of European banks in front of adverse shocks.

The EBA also fosters cooperation between home and host authorities and actively participates in and oversees the work of supervisory colleges for cross-border groups.

Additional tasks are envisaged in the area of **crisis management** where the EBA is in charge of coordinating recovery and resolution plans for the major European banking groups.

In the area of rule making, the EBA plays a major role in the establishment of the so-called Single Rulebook – i.e. technical rules truly uniform throughout the European Union, adopted through legal instruments that are directly binding in all the 27 Member States of the Union.

Last but not least, **we have been entrusted with the responsibility for monitoring and tackling consumer issues.**

Let me first give you an overview of the EBA's role and activities in relation to micro prudential supervision, and namely to the Authority's efforts in tackling the financial crisis.

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The EBA's efforts in tackling the crisis

The EBA's initial priorities were centered on the challenges raised by the deterioration of the financial market environment.

In the first part of 2011, we conducted a stress test exercise, aimed at assessing the capital adequacy of the largest European banks in front of adverse macroeconomic developments.

The exercise focused on credit and market risks and also, in recognition of the risks that subsequently crystallised, incorporated sensitivity to movements in funding costs.

Banks were required also to assess the credit risk in their sovereign portfolios.

In many respects, I believe the exercise was successful: in order to achieve the tougher capital threshold, anticipating many aspects of the new Basel standards, banks raised €50bn in fresh capital in the first four months of the year; we set up a comprehensive peer review exercise, which ensured consistency of the results across the European Single Market, notwithstanding the many differences in national regulatory frameworks; the exercise included an unprecedented disclosure of data (more than 3200 data points for each bank), including, amongst other things, detailed information on sovereign holdings.

However, the progress of the stress test was tracked by a significant further deterioration in the external environment.

The main objective of restoring confidence in the European banking sector was not achieved, as the sovereign debt crisis extended to more countries, thus reinforcing the pernicious linkage between sovereigns and banks.

Soon after the completion of the stress test, most EU banks, especially in countries under stress, experienced significant funding challenges.

In this context, the IMF and the European Systemic Risk Board (ESRB), called for coordinated supervisory actions to strengthen the EU banks' capital positions.

The EBA assessment was that without policy responses, the freeze in bank funding would have led to an abrupt deleveraging process, which would have hurt growth prospects and fuelled further concerns on the fiscal position of some sovereigns, in a negative feedback loop.

We then called for coordinated action on both the funding and the capitalisation side.

While advising the establishment of an EU-wide funding guarantee scheme, the EBA focused its own efforts on those areas where it had control, primarily bank capitalisation.

To this end, the EBA's Board of Supervisors, comprising the heads of all 27 national supervisory authorities, discussed and agreed that a further recapitalisation effort was required as part of a suite of coordinated EU policy measures.

This resulted in the EBA issuing a Recommendation that identified a temporary buffer to address potential concerns over EU sovereign debt holdings and **required banks to reach 9% Core Tier 1**.

The total shortfall identified was €115 bn.

The measure, agreed in October 2011 and enacted in December 2011, seeks that Supervisory Authorities should require those banks covered by its Recommendation to strengthen their capital positions by end of June 2012.

The Recommendation was swiftly followed by the ECB's **long term refinancing operations (LTROs)**, arguably the key "game changer" in this context.

The LTROs allowed banks to satisfy their funding needs in front of a significant amount of liabilities to roll over in 2012, thus preventing a massive credit crunch.

The recapitalisation was a **necessary complementary measure**: while banks needed unlimited liquidity support, to keep supporting the real economy, they had to be asked to accelerate their action to repair balance sheets and strengthen capital positions.

When the process is completed, European banks will be in a much stronger position, also vis-à-vis their main peers at the global level.

The EBA is, in general, satisfied with the progress made in the fulfilment of this Recommendation and notes that the actions taken by the bulk of banks include capital strengthening and adequate recognition of losses.

In addition, three banks identified as having weaknesses have subsequently undergone restructuring processes and will no longer exist in the same form as at the moment of the stress test.

We have put a lot of efforts to avoid that banks reached the target ratio by cutting asset levels instead of raising capital, thus reducing credit availability for corporates, especially small and medium enterprises and households.

However, a **deleveraging process is needed in the banking sector.**

It has already started, with a different pace in different areas of the global financial system and needs to be accomplished in an ordered fashion.

The first step has been the increase in capital levels, long overdue and one of the cornerstones of the regulatory reforms endorsed by the G20 Leaders.

The second step requires a reduction in size of balance sheets, especially by addressing non-performing assets and de-risking in areas such as capital market activities and real estate lending, which grew too much in the run-up to the crisis.

The third step entails a refocusing of business models, especially towards more stable funding structures and the gradual exit from the extraordinary support measures put in place by central banks.

I am convinced that without an ordered deleveraging process, through a significant strengthening of capital and a selective downsizing of asset levels, we would fail addressing the fragilities that are preventing banks from performing their fundamental functions.

Supervisory Colleges

The misalignment between the international nature of the major banking groups and a national system of supervision has been a contentious subject for many years.

In the years preceding the crisis and in an effort to improve supervision, colleges of supervisors were established, to varying extents, for major banking groups.

However, as the financial stresses developed in 2008, these structures did not work effectively in a large number of cases.

The already difficult situation was compounded by the lack of dialogue and information exchange between supervisory authorities, as national priorities took precedence in the decision making process.

Given the problems which this lack of cooperation presented, there was a clear need to radically overhaul the voluntary structures which existed.

This need has manifested itself in legislative **changes to the Capital Requirements Directive (CRD)**, the primary European legislation that implements the Basel accord for banking in the EU, and in specific provisions incorporated into the mandate of the EBA.

Supervisory colleges are now required for all cross border banking groups operating in the European Economic Area and the EBA has been granted full participation rights as a competent authority.

The EBA staff are attending supervisory colleges of the **major systemically important groups in Europe** and go to these meetings with a clearly defined goal of promoting and monitoring the efficient, effective and consistent functioning of colleges as well as fostering the coherent application of the EU law by supervisors.

Also, since 2011, European colleges are the forum in which the consolidating supervisor and the competent authorities responsible for the supervision of subsidiaries are required to reach a joint decision on the capital of the group and the relevant subsidiaries.

The formal system of joint risk assessments, which underpins this process, and the drive to make the core supervisory decision on capital, represents a major step forward in the coordination of cross border supervisory processes.

I am glad to say that in many of these meetings for banking groups which have operations outside the European Union, **consolidating supervisors will often invite supervisors from countries outside the EU so that they can give a first hand account of the risks being run in the entities they oversee.**

The EBA strongly believes the work to implement these arrangements has to be strengthened in order to improve the effectiveness of supervision for cross-border groups.

Good progress has been made in many quarters.

For instance, national authorities are coming to their joint decisions on the capital of a banking group using the common structures and templates set out in guidelines issued by the EBA.

However, there is still a long way to go to enhance consistency in supervisory outcomes and to achieve adequate levels of information exchange and cooperation.

Crisis Management

It is at these times of intense challenge, that structures and relationships are most tested, and we actually see how well coordination of supervision works at an international level- and see most clearly where fault lines continue to exist.

Before I give you some views on what is happening within the EU regulatory community, I need to forcefully make the point that primary responsibility to enhance preparedness for a crisis situation lies with the banks themselves.

Banks must learn the lessons of the crisis and materially improve their risk management processes.

They must embed into their processes the capacity to perform real stress tests and make sure they are well equipped to withstand severe adverse market developments. Part of this process will involve the development of effective **Recovery and Resolution Plans (RRPs)** and the identification of the steps to be taken when the viability of the firm is at risk.

The guidance of the Financial Stability Board is a key benchmark in this area.

For cross-border groups in the European Union, **colleges of supervisors will develop plans for the coordination of supervisory action in emergency situations.**

Colleges are supplemented by the Cross-Border Stability Groups (or “crisis colleges”), which bring together fiscal authorities, central banks and supervisors.

But the lesson of the crisis is that **voluntary cooperation arrangements are not enough.**

Stronger legal and institutional underpinnings are needed to enforce effective crisis management and resolution tools in the European Single Market.

An important step has already been taken to strengthen the European institutional setting with the provisions set out in our founding Regulation, which gives the EBA responsibilities in areas such as the monitoring of colleges, the development of Recovery and Resolution Plans and the conduct of EU-wide stress tests.

In addition, **when an emergency situation is declared by the European Council, the EBA has been given the power to address specific recommendations to national supervisory authorities with a view to coordinating their actions and, if necessary, apply European decisions directly to individual institutions in case of inaction by national authorities.**

Nonetheless, the structures are not complete and a more formal role for the EBA in crisis management will depend on the outcome of the European Commission's work on new legislation for bank recovery and resolution, due out soon.

The legal underpinning for crisis resolution needs to be fully harmonised in order to allow for an integrated process, with close cooperation between the authorities involved.

This should allow interconnecting national resolution procedures so as to ensure an integrated approach for cross-border firms, ensuring an equitable treatment of creditors in all jurisdictions.

At the same time, mechanisms should be in place to constrain the actions of national authorities and drive towards coordinated, firm-wide solutions.

Over time, the EBA's role in this area is likely to grow substantially, including its role in mediating between conflicting interests of national authorities as serious problems emerge.

Rule Making and the Single Rulebook

As proposed by [de Larosière in his report](#), the EBA now has the capacity to draft directly applicable rules, by means of regulatory and implementing standards that will then be adopted by the European Commission as EU Regulations and thereby become directly binding in the whole EU, without the need for national implementation.

This process will help [eliminate many of the inconsistencies](#) which have arisen from options, national discretions, and the different interpretations adopted when previous rules were transposed into national legislation by the 27 EU Member States.

[Materially reducing the fragmentation](#) in the EU regulatory regime will provide greater certainty to market participants and stronger foundations for convergence in supervisory practices.

Based upon the current legislative proposals for the implementation of Basel 3, about 200 deliverables will be expected from the EBA, including proposals for around 100 Technical Standards such as on the definition of capital, capital buffers, liquidity, remuneration, and the leverage ratio.

This will be essential to [ensure level playing field and avoid in the future that the regulatory lever is used to attract business in national market places or to favour](#)

national champions, a process that has played a great role in the relaxation of regulatory standards in the run up to the crisis.

The EBA can also issue Guidelines and Recommendations which are not legally binding, albeit the EU national supervisory authorities need to indicate publicly whether they intend to comply, and if this is not the case they will need to publicly explain the reasons.

The EBA can also conduct peer reviews in order to make sure that the common standards and guidelines are effectively applied in a consistent and effective fashion.

Conclusions

Ladies and gentlemen,

Today I tried to convey to you an overview on the difficult challenges the EBA is facing.

In our first 16 months of activity, we have already done a huge effort to strengthen the capital position of EU banks and to restore confidence in their resilience.

The work is not over in this area.

The liquidity support provided by the ECB avoided an abrupt deleveraging process, but banks are still in the process of repairing and downsizing their balance sheets and of refocusing their core business.

We, as supervisors, need to accompany this process and do our utmost to ensure that it occurs in an ordered fashion, without adverse consequences on the financing of the real economy.

In the coming months we have to complete the preparation for the implementation of the reforms agreed by the G20 Leaders, in particular Basel 3.

It is a major challenge for regulators across the world and the EBA is establishing close contacts with fellow supervisors in other countries, including China, to ensure that there is always an open dialogue and a common commitment to strengthening the safety and soundness of banks.

In the EU, this challenge is compounded with our resolve to set up a much more uniform regulatory setting for all the banks operating in the Single Market, with the so called Single Rulebook.

Strengthening regulation is not enough if it is not coupled with more effective supervision, especially for those large and complex groups that are active on a cross-border basis and may generate systemic risks across jurisdictions.

This requires identifying best supervisory practices and ensuring convergence towards these benchmarks, as well as strengthening cooperation within colleges of supervisors.

This has surely a strong European dimension, due to the relevance of cross-border business within the Single Market, but requires also close cooperation with supervisors in other regions.

We are surely committed to bringing our contribution to the success of this endeavour.

We have a very interesting paper from the Bank of international Settlements that clarifies issues of the Basel ii / iii frameworks.

**Fundamental review of the trading book - consultative document
May 2012**

This consultative document sets out a **revised market risk framework** and proposes a number of specific measures to improve trading book capital requirements.

These proposals reflect the Committee's **increased focus** on achieving a regulatory framework that can be implemented **consistently** by supervisors and which achieves comparable levels of capital across jurisdictions.



Key elements of the proposals include:

- A more objective **boundary** between the trading book and the banking book that materially reduces the scope for regulatory arbitrage - feedback is sought on two alternative approaches;
- Moving from value-at-risk to expected shortfall, a risk measure that better captures "**tail risk**";
- Calibrating the revised framework in both the standardised and internal models-based approaches to a period of significant financial stress, consistent with the **stressed value-at-risk** approach adopted in Basel 2.5;
- Comprehensively incorporating the risk of **market illiquidity**, again consistent with the direction taken in Basel 2.5;
- Measures to reduce **model risk** in the internal models-based approach, including a more granular models approval process and constraints on diversification; and
- A **revised standardised approach** that is intended to be more risk-sensitive and act as a credible fallback to internal models.

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The Committee is also proposing to strengthen the relationship between the models-based and standardised approaches by establishing a closer link between the calibration of the two approaches, requiring mandatory calculation of the standardised approach by all banks, and considering the merits of introducing the standardised approach as a floor or surcharge to the models-based approach.

Furthermore, the treatment of **hedging and diversification** will be more closely aligned between the two approaches.

Comments on this consultative document should be submitted by Friday 7 September 2012 by e-mail to baselcommittee@bis.org.

Alternatively, comments may be sent by post to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland.

All comments will be published on the Bank for International Settlements's website unless a commenter specifically requests confidential treatment.

Once the Committee has reviewed responses, it intends to release for comment a more detailed set of proposals to amend the Basel III framework.

In line with its normal process, the Committee will also subject such proposals to a thorough Quantitative Impact Study.

Abbreviations

CDS Credit default swap

CRM Comprehensive risk measure

CTP Correlation trading portfolio

CVA Credit valuation adjustment

ES Expected shortfall

GAAP Generally Accepted Accounting Principles

IFRS International Financial Reporting Standards

IRC Incremental risk charge

MTM Mark-to-market

OTC Over-the-counter

P&L Profit and loss

PVBP Present value of a basis point

RWA Risk-weighted assets

SDR Special drawing rights

SMM Standardised measurement method

VaR Value-at-risk

Fundamental review of the trading book Executive summary

This consultative document presents the initial policy proposals emerging from the Basel Committee's ("the Committee") fundamental review of trading book capital requirements.

These proposals will **strengthen capital standards for market risk**, and thereby contribute to a more resilient banking sector.

The policy directions set out in this paper form part of the Committee's broader agenda of **reforming bank regulatory standards to address the lessons of the financial crisis**.

These initial proposals build on the series of important reforms that the Committee has already delivered through Basel III and set out the key approaches under consideration by the Committee to revise the market risk framework.

These proposals also reflect the Committee's increased focus on achieving a regulatory framework that can be implemented consistently by supervisors and which achieves comparable levels of capital across jurisdictions.

The Committee's policy orientations with regard to the trading book are a **vital element of the objective to achieve comparability** of capital outcomes across banks, particularly those which are most systemically important.

Background

The financial crisis exposed material weaknesses in the overall design of the framework for capitalising trading activities and the level of capital requirements for trading activities proved insufficient to absorb losses.

As an important response to the crisis, **the Committee introduced a set of revisions to the market risk framework in July 2009** (part of the "Basel 2.5" rules).

These sought to reduce the cyclical nature of the market risk framework and

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increase the overall level of capital, with particular focus on instruments exposed to credit risk (including securitisations), where the previous regime had been found especially lacking.

However, the Committee recognised at the time that the Basel 2.5 revisions did not fully address the shortcomings of the framework.

As a result, the Committee initiated a fundamental review of the trading book regime, beginning with an assessment of “what went wrong”.

The fundamental review seeks to address shortcomings in the overall design of the regime as well as weaknesses in risk measurement under both the internal models-based and standardised approaches.

This consultative paper sets out the direction the Committee intends to take in tackling the structural weaknesses of the regime, in order to solicit stakeholders’ comments before proposing more concrete revisions to the market risk capital framework.

Key areas of Committee focus

The Committee has focused on the following key areas in its review:

The trading book/banking book boundary

The Committee believes that its definition of the regulatory boundary has been a source of weakness in the design of the current regime.

A key determinant of the boundary is banks' intent to trade, an inherently subjective criterion that has proved difficult to police and insufficiently restrictive from a prudential perspective in some jurisdictions.

Coupled with large differences in capital requirements against similar types of risk on either side of the boundary, the overall capital framework proved susceptible to arbitrage.

While the Committee considered the possibility of removing the boundary altogether, it concluded that a boundary will likely have to be retained for practical reasons.

The Committee is now putting forth for consideration two alternative boundary definitions:

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“Trading evidence”- based boundary:

Under this approach the boundary would be defined not only by banks’ intent, but also by evidence of their ability to trade and risk manage the instrument on a trading desk.

Any item included in the regulatory trading book would need to be marked to market daily with changes in fair value recognised in earnings. Stricter, more objective requirements would be used to ensure robust and consistent enforcement.

Tight limits to banks’ ability to shift instruments across the boundary following initial classification would also be introduced.

Fundamental to this proposal is a view that a bank’s intention to trade – backed up by evidence of this intent and a regulatory requirement to keep items in the regulatory trading book once they are placed there – is the relevant characteristic for determining capital requirements.

In some jurisdictions, application of this type of definition of the boundary could result in regulatory trading books that are considerably narrower than at present.

Valuation-based boundary:

This proposal would move away from the concept of “trading intent” and construct a boundary that seeks to align the design and structure of regulatory capital requirements with the risks posed to a bank’s regulatory capital resources.

Fundamental to this proposal is a view that capital requirements for market risk should apply when changes in the fair value of financial instruments, whether recognised in earnings or flowing directly to equity, pose risks to the regulatory and accounting solvency of banks.

This definition of the boundary would likely result in a larger regulatory trading book, but not necessarily in a much wider scope of application for market risk models or necessarily lower capital requirements.

Stressed calibration

The Committee recognises the importance of ensuring that regulatory capital is sufficient in periods of significant market stress.

As the crisis showed, it is precisely during stress periods that capital is most critical to absorb losses.

Furthermore, a reduction in the cyclical nature of market risk capital charges remains a key objective of the Committee.

Consistent with the direction taken in Basel 2.5, the Committee intends to address both issues by moving to a capital framework that is calibrated to a period of significant financial stress in both the internal models-based and standardised approaches.

Moving from value-at-risk to expected shortfall

A number of weaknesses have been identified with using value-at-risk (VaR) for determining regulatory capital requirements, including its inability to capture “tail risk”.

For this reason, the Committee has considered alternative risk metrics, in particular expected shortfall (ES).

ES measures the riskiness of a position by considering both the size and the likelihood of losses above a certain confidence level.

In other words, it is the expected value of those losses beyond a given confidence level.

The Committee recognises that moving to ES could entail certain operational challenges; nonetheless it believes that these are outweighed by the benefits of replacing VaR with a measure that better captures tail risk.

Accordingly, the Committee is proposing the use of ES for the internal models-based approach and also intends to determine risk weights for the standardised approach using an ES methodology.

A comprehensive incorporation of the risk of market illiquidity

The Committee recognises the importance of incorporating the risk of market illiquidity as a key consideration in banks' regulatory capital requirements for trading portfolios.

Before the introduction of the Basel 2.5 changes, the entire market risk framework was based on an assumption that trading book risk positions were liquid, ie that **banks could exit or hedge these positions over a 10-day horizon.**

The recent crisis proved this assumption to be false.

As liquidity conditions deteriorated during the crisis, **banks were forced to hold risk positions for much longer** than originally expected and incurred large losses due to fluctuations in liquidity premia and associated changes in market prices.

Basel 2.5 partly incorporated the risk of market illiquidity into modelling requirements for default and credit migration risk through the **incremental risk charge (IRC)** and the **comprehensive risk measure (CRM).**

The Committee's proposed approach to factor in market liquidity risk comprehensively in the revised market risk regime consists of three elements:

- **First**, operationalising an assessment of market liquidity for regulatory capital purposes.

The Committee proposes that this assessment be based on the concept of "liquidity horizons", defined as the time required to exit or hedge a risk position in a stressed market environment without materially affecting market prices.

Banks' exposures would be assigned into **five** liquidity horizon categories, ranging **from 10 days to one year**.

- **Second**, incorporating varying liquidity horizons in the regulatory market risk metric to capitalise the risk that banks might be unable to exit or hedge risk positions over a short time period (the assumption embedded in the 10-day VaR treatment for market risk).
- **Third**, incorporating capital add-ons for jumps in liquidity premia, which would apply only if certain criteria were met.

These criteria would seek to **identify the set of instruments that could become particularly illiquid**, but where the market risk metric, even with extended liquidity horizons, would not sufficiently capture the risk to solvency from large fluctuations in liquidity premia.

Additionally, the Committee is consulting on two possible options for **incorporating the "endogenous" aspect of market liquidity**.

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Endogenous liquidity is the component that relates to bank-specific portfolio characteristics, such as particularly large or concentrated exposures relative to the market.

The main approach under consideration by the Committee to incorporate this risk would be further extension of liquidity horizons; an alternative could be application of prudent valuation adjustments specifically targeted to account for endogenous liquidity.

Treatment of hedging and diversification

Hedging and diversification are intrinsic to the active management of trading portfolios.

Hedging, while generally risk reducing, also gives rise to basis risk that must be measured and capitalised.

In addition, portfolio diversification benefits, whilst seemingly risk-reducing, can disappear in times of stress.

Currently, banks using the internal models-based approach are allowed large latitude to recognise the risk-reducing benefits of hedging and diversification, while recognition of such benefits is strictly limited under the standardized approach.

The Committee is proposing to more closely align the treatment of hedging and diversification between the two approaches.

In part, this will be achieved by constraining diversification benefits in the internal models-based approach to address the Committee's concerns that such models may significantly overestimate portfolio diversification benefits that do not materialise in times of stress.

Relationship between internal models-based and standardised approaches

The Committee considers the **current** regulatory capital framework for the trading book to have become **too reliant on banks' internal models that reflect a private view of risk**.

In addition, the potential for very large differences between standardised and internal models based capital requirements for a given portfolio is a major level playing field concern and **can also leave supervisors without a credible option of removing model permission when model performance is poor.**

To strengthen the relationship between the models-based and standardised approaches the Committee is consulting on three proposals:

- **First**, establishing a closer link between the calibration of the two approaches;
- **Second**, requiring mandatory calculation of the standardised approach by all banks;
- **Third**, considering the merits of introducing the standardised approach as a floor or surcharge to the models-based approach.

Revised models-based approach

The Committee has identified a number of weaknesses with risk measurement under the models-based approach.

In seeking to address these problems, the Committee intends to

- (i) Strengthen requirements for defining the **scope of portfolios that will be eligible for internal models treatment; and**
- (ii) Strengthen the internal model standards to ensure that the **output of such models reflects the full extent of trading book risk that is relevant from a regulatory capital perspective.**

To strengthen the criteria that banks must meet before regulatory capital can be calculated using internal models, the Committee is proposing to break the model approval process into smaller, more discrete steps, including at the trading desk level.

This will allow *****model approval to be “turned-off” more easily***** than at present for specific trading desks that do not meet the requirements.

At the trading desk level, where the bank naturally has an internal profit and loss (P&L) available, model performance can be verified more robustly.

The Committee is considering **two quantitative tools to measure the performance of models.**

First, a P&L attribution process that provides an assessment of how well a desk's risk management model captures risk factors that drive its P&L.

Second, an enhanced daily backtesting framework for reconciling forecasted losses from the market risk metric with actual losses.

Although the market risk regime has always required backtesting of model performance, the Committee is proposing to apply it at a more granular trading desk level in the future.

Where a trading desk does not achieve acceptable P&L attribution or backtesting results, the bank would be required to calculate capital requirements for that desk using the standardised approach.

To strengthen model standards, the Committee is consulting on limiting diversification benefits, moving to an expected shortfall metric and calibrating to a period of market stress.

In addition, it is consulting on introducing a more robust process for **assessing whether individual risk factors would be deemed as “modellable” by a particular bank.**

This would be a systematic process for identifying, recording and calculating regulatory capital against risk factors deemed not to be amenable to market risk modelling.

Revised standardised approach

The Committee has identified a number of important shortcomings with the current standardised approach.

A standardised approach serves two main purposes.

Firstly, it provides a method for calculating capital requirements for banks with business models that do not require sophisticated measurement of market risk.

This is especially relevant to **smaller banks** with limited trading activities.

Secondly, it provides a fallback in the event that a bank's internal market risk model is deemed inadequate as a whole or for specific trading desks or risk factors.

This second purpose is of particular importance for larger or more systemically important banks.

In addition, the standardised approach could allow for a harmonised reporting of risk positions in a format that is consistent across banks and jurisdictions.

Apart from allowing for greater comparability across banks and jurisdictions, this could also allow for aggregation of risk positions across the banking system to obtain a macroprudential view of market risks.

With those objectives in mind the Committee has adopted the following principles for the design of the revised standardised approach:

simplicity, transparency and consistency, as well as improved risk sensitivity; a credible calibration; limited model reliance; and a credible fallback to internal models.

In seeking to meet these objectives, the Committee proposes a “partial risk factor” approach as a revised standardised approach.

The Committee also invites feedback on a “fuller risk factor” approach as an alternative.

More specifically:

(a) Partial risk factor approach:

Instruments that exhibit similar risk characteristics would be grouped in buckets and Committee-specified risk weights would be applied to their market value.

The number of buckets would be approximately 20 across five broad classes of instruments, though the exact number would be determined empirically.

Hedging and diversification benefits would be better captured than at present by using regulatory correlation parameters.

To improve risk sensitivity, instruments exposed to “cross-cutting” risk factors that are pervasive across the trading book (eg FX and interest rate risk) would be assigned to more than one bucket.

For example, a foreign-currency equity would be assigned to the appropriate equity bucket and to a cross-cutting FX bucket.

(b) Fuller risk factor approach:

This alternative approach would map instruments to a set of prescribed regulatory risk factors to which **shocks would be applied to calculate a capital charge for the individual risk factors.**

The bank would have to use a pricing model (likely its own) to determine the size of the risk positions for each instrument with respect to the applicable risk factors.

Hedging would be recognized for more “systematic” risk factors at the risk factor level.

The capital charge would be generated by subjecting the overall risk positions to a simplified regulatory aggregation algorithm.

The appropriate treatment of credit

A particular area of Committee focus has been the treatment of positions subject to credit risk in the trading book.

Credit risk has continuous (credit spread) and discrete (default and migration) components.

This has implications for the types of models that are appropriate for capturing credit risk.

In practice, including default and migration risk within an integrated market risk framework **introduces particular challenges** and potentially makes consistent capital charges for credit risk in the banking and trading books more difficult to achieve.

The Committee is therefore considering whether, under a future framework, there should continue to be a separate model for default and migration risk in the trading book.

Areas outside the scope of these proposals

The Committee thinks it is important to note that there are two particular areas that it has considered, but are not subject to any detailed proposals in this consultative document.

Interest rate risk in the banking book

Although the Committee has determined that removing the boundary between the banking book and the trading book may be impractical, it is concerned about the possibility of arbitrage across the banking book / trading book boundary.

A major contributor to arbitrage opportunities are different capital treatments for the same risks on either side of the boundary.

One example is interest rate risk, which is explicitly captured in the trading book under a Pillar 1 capital regime, but subject to Pillar 2 requirements in the banking book.

The Committee has therefore undertaken some preliminary work on the key issues that would be associated with applying a Pillar 1 capital charge for interest rate risk in the banking book.

The Committee intends to consider the timing and scope of further work in this area later in 2012.

Interaction of market and counterparty risk

Basel III introduced a new set of capital charges to capture the risk of changes to credit valuation adjustments (CVA).

This is known as the CVA risk capital charge and will be implemented as a “stand alone” capital charge under Basel III, with a coordinated start date of 1 January 2013.

The Committee is aware that some industry participants believe that CVA risk, as the market component of credit risk, should be captured in an integrated fashion with other forms of market risk within the market risk framework.

The Committee has agreed to consider this question, but remains cautious of the degree to which these risks can be effectively captured in a single integrated modelling approach.

It observes that there is no clear market standard for the treatment of CVA risk in banks' internal capital.

Occasionally, even within individual banks, different treatments for CVA risk seem to exist.

For the time being, the Committee anticipates that open questions regarding the practicality of integrated modelling of CVA and market risk could constrain moving towards such integration.

In the meantime, the industry should focus on ensuring a high-quality implementation of the new stand-alone charge on 1 January 2013.

This is consistent with the Committee's broader concerns over the degree of reliance on internal models and the over-estimation of diversification benefits.

For this reason, this consultative document sets out initial proposals on revisions to the capital framework for capturing market risk and does not offer specific proposals for dealing with CVA risk.

Nonetheless, stakeholders may wish to provide their views on whether CVA risk should be incorporated into the market risk framework and, if so, how this could be achieved in the context of the emerging revisions to the market risk framework presented in this paper.

Next steps

The Committee welcomes comments from the public on all aspects of this consultative document and in particular on the questions in the text (summarised at the end of this document) by 7 September 2012 by e-mail to baselcommittee@bis.org.

Alternatively, comments may be sent by post to: Basel Committee on Banking Supervision, Bank for International Settlements, Centralbahnplatz 2, CH-4002 Basel, Switzerland

All comments will be published on the Bank for International Settlements' website unless a commenter specifically requests confidential treatment.

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Once the Committee has reviewed responses, it intends to release for comment a more detailed set of proposals to amend the Basel III framework.

As is its normal process, the Committee will subject such proposals to a thorough Quantitative Impact Study.

Annex

Lessons from the academic literature and banks' risk management practices

In its deliberations on revising the prudential regime for trading activities, the Trading Book Group has drawn on lessons both from the academic literature and banks' current and emerging risk management practices.

1. Messages from the academic literature on risk measurement in the trading book

Selected lessons on VaR implementation:

(a) There is **no unique solution** to the problem of the appropriate time horizon for risk measurement.

The horizon **depends** on characteristics of the portfolio and the economic purpose of measuring its risk.

(b) Commonly used **square-root-of-time VaR scaling rules** (which **ignore future changes** in the portfolio) have been found to be an inaccurate approximation in many studies.

That said, **no widely accepted alternative has emerged**.

(c) There are limitations of VaR models that rely on the use of **continuous stochastic processes** with **only deterministic volatility assumptions**.

Introducing either stochastic volatility assumptions or stochastic jump process into modelling of risk factors will help to overcome these shortcomings.

(d) Backtesting procedures that only focus on the **number** of VaR violations are **insufficient to determine the appropriateness of the model assumptions**.

The use of conditional backtesting procedures or other techniques (like the timing of violations or the magnitude of the VaR exceptions) can improve the backtesting process.

(e) No consensus has yet emerged on the relative benefits of using actual or hypothetical results (ie P&L) to conduct backtesting exercises.

Incorporating market liquidity risk:

The literature distinguishes, *first*, between exogenous and endogenous market liquidity risks; and, *second*, between normal (or current) liquidity risk and extreme (or stressed) liquidity risk.

Portfolios may be subject to significant endogenous liquidity costs under all market conditions, depending on their size or on the risk positions of other market participants.

According to accounting standards, endogenous liquidity costs are not taken into account in the valuation of the trading books.

A first step to incorporating this risk in a VaR measure would be to take it into account in the valuation method.

In practice, the time it takes to liquidate a risk position varies, depending on its transaction costs, the size of the risk position in the market, the trade execution strategy, and market conditions.

Some studies suggest that, for some portfolios, this aspect of liquidity risk could also be addressed by extending the VaR risk measurement horizon.

Risk measures:

VaR has been criticised in the literature for lacking subadditivity. A prominent alternative to VaR is ES, which is subadditive.

Despite criticism focused on the complexity, computational burden, and backtesting issues associated with ES, the recent literature suggests that many issues have been resolved or have been identified as less severe than originally expected. Spectral risk measures are a promising generalisation of ES that is cited in the literature.

Stress testing practices for market risk:

Stress testing often was implemented as an ad hoc exercise **without any estimate of scenario probability or use of a bank's VaR risk measurement framework.**

More recent research advocates the integration of stress testing into the risk modelling framework.

This would **overcome the drawbacks of reconciling standalone stress test results with standard VaR model output.**

Progress has also been achieved in theoretical research on the selection of stress scenarios.

The regulatory stressed VaR approach has not been analysed in the academic literature.

Unified versus compartmentalised risk measurement:

Recently, attention has shifted towards **unified** approaches to risk measurement that consider all risk categories jointly.

Theoretically, an integrated approach is needed to **capture potential compounding effects that are ignored in traditional** compartmentalised risk measurement approaches (eg separate measures for interest rate, market, credit and operational risk).

These might underestimate risk if a portfolio cannot be cleanly divided into sub-portfolios along risk categories.

Irrespective of the separation of assets into “books”, it is not always true that calculating different risks for the same portfolio in a compartmentalised fashion and adding up the compartmentalised measures will be a conservative estimate of the true risk.

This insight is particularly important for “back-fitting packages”, such as the IRC.

Risk management and VaR in a systemic context:

A number of studies criticise **VaR-based capital rules as being procyclical** in nature.

This may induce cyclical lending behavior by banks and exacerbate the business cycle.

Another criticism of VaR-based capital rules is that banks may fail to consider system-wide endogeneity in their internal decisions.

If all banks do this, they may act uniformly in booms and busts leading to instabilities in asset markets.

Unfortunately, the literature does not offer convincing alternatives.

2. Key findings from a survey of industry practices

The Trading Book Group conducted a survey of industry practices in risk management, capital allocation and other measures for the trading book that could be used to inform the development of regulatory capital standards.

The key findings are as follows.

Length of holding period for risk assessment:

For day-to-day risk management the use of one-day VaR is universal among banks surveyed.

However, for internal capital adequacy and strategic risk management, banks are generally moving beyond short-horizon models (eg one-day and 10-day VaR).

It is now acknowledged that, to determine the level of capital necessary to remain in business after sustaining a large loss, risk must be assessed over a longer holding period.

Shorter horizons do not address the liquidity risk for all exposures and do not capture tail events that are important for capital adequacy.

Some banks are developing risk models with varying holding periods for risk assessment across products and conditional on the market liquidity of the exposure, though validation will be difficult.

Alternatives to traditional VaR models:

Many banks see the need for a measure of risk for exposures that are hard to capture in traditional VaR models.

Stress tests are utilised but most view that risk needs to be assessed over a range of possible scenarios because the nature of the next crisis cannot be predicted.

Consequently, more ambitious comprehensive statistical models of stress scenarios are used.

Such models allow systematic assessment of risk across multiple stress scenarios beyond those present in historical data sets.

These approaches are **similar to reverse stress tests in that they are sensitive to the scenario to which the bank is most exposed.**

Alternatively, some banks recommend the use of risk sensitive add-ons to risk model outputs for exposures whose risks cannot be reliably measured with VaR.

These banks believe that use of add-ons where complexity and model uncertainty exist would be preferable to blunt risk-insensitive standardised measures.

The same complexity and measurement issues that are challenges for VaR models are likely to affect the robustness of standardised risk weights.

Model validation:

The emerging modelling approaches for assessment of exposure to stress events will **present a challenge for model validation** because of the paucity of relevant historical data.

In addition, models that assess risk over long holding periods such as in the IRC model present a validation challenge because some products have less than 10 years of historical data.

In cases where historical data are **not sufficient** for traditional backtesting, several banks suggested using benchmark portfolios to discover which models were outliers in underestimating of risk.

Scaling of VaR and nonlinearities:

Nonlinearities in exposures are captured in most banks' models to some degree albeit imperfectly.

Almost all banks' VaR models capture nonlinearities at a local level (small price changes) for much of their market risk exposure, but many banks' VaR models fail to capture non-linearity at a global level (large price changes).

A common weakness in the capture of non-linearity is the use of scaling of oneday VaR to estimate exposures at longer holding periods.

Such scaling only captures local non-linearity in the range of one-day price changes and can underestimate non-linear exposure over longer horizons, even when full revaluation is used.

To learn more:

www.bis.org/publ/bcbs219.htm

Table 6
Accounting classification versus regulatory classification of losses from investment banking activities (at time of loss in billions USD)

Accounting classification		Regulatory classification	
Fair value	349	Trading book	265
Amortised cost	15	Banking book	100
Total	365	Total	365

Figure 2
Losses by business line

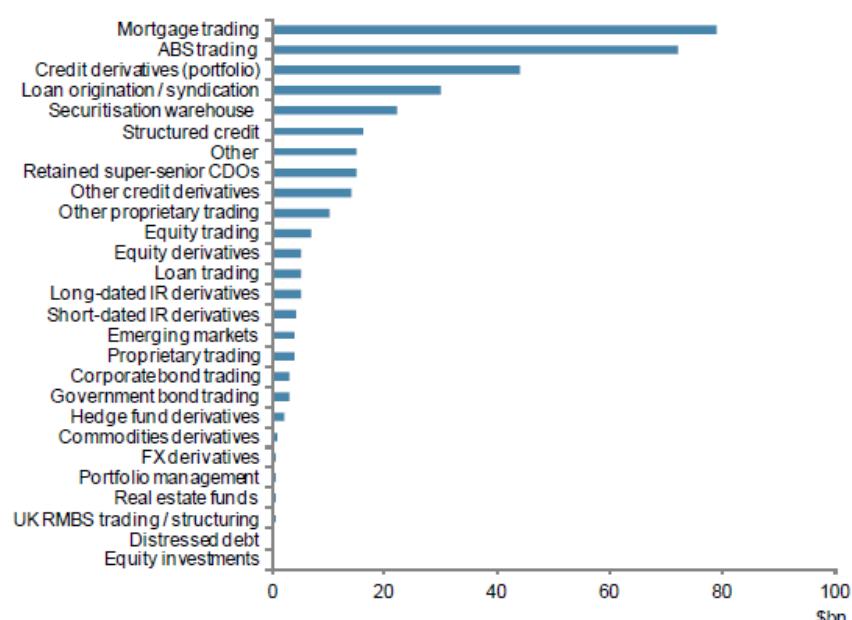
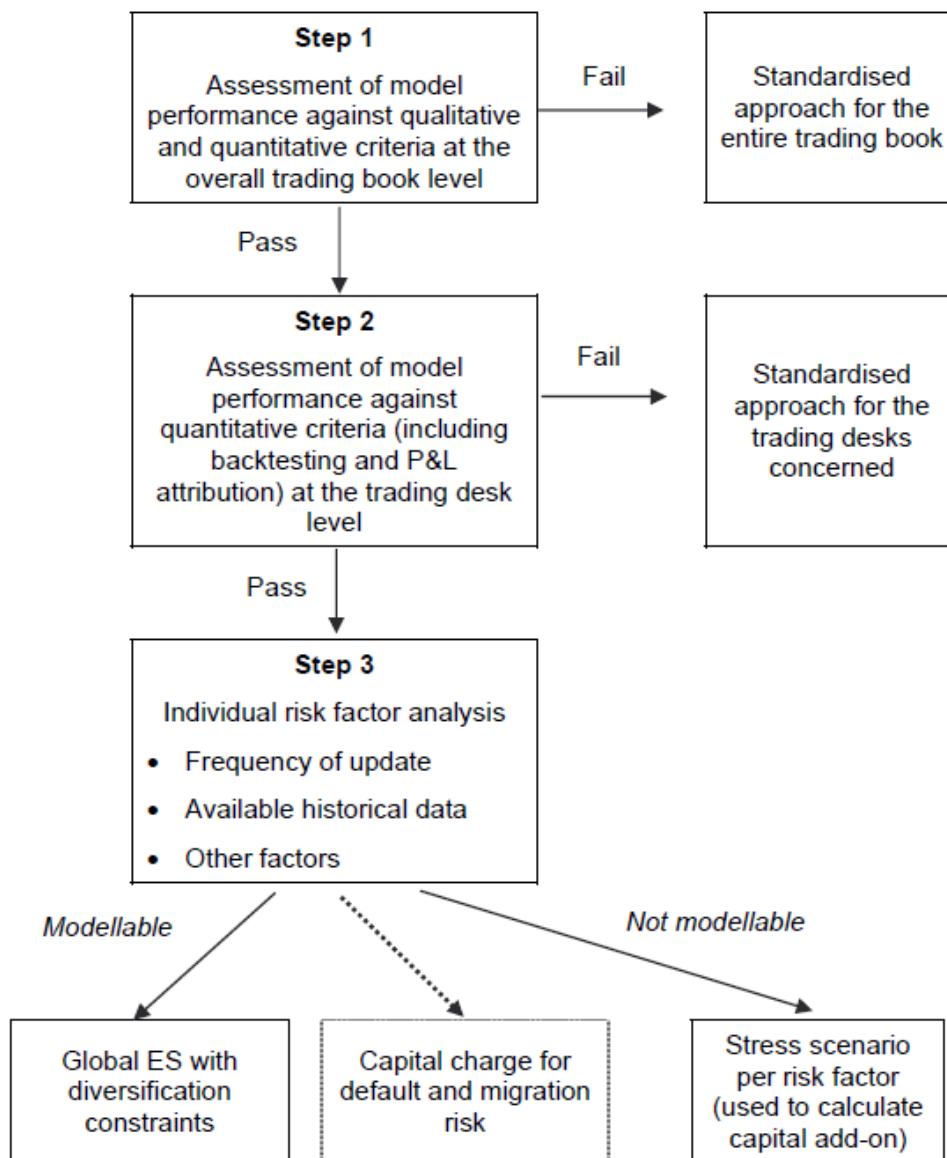


Figure 1
Process for determining eligibility of trading activities for the internal models-based approach





Basel III – the big issues

Speech by Andrew Bailey, Director of UK Banks & Building Societies at the Seventh City of London Swiss Financial Roundtable

Thank you for inviting me to speak this morning.

Firstly I do want to take this opportunity to mark the stalwart service that Angela has given to the British Bankers' Association (BBA) over the last five years.

None of your predecessors can have faced such a difficult task, which you have carried out with great fortitude.



I want to spend my time this morning on the **big issues that lie behind the subject of Basel III and national finishes.**

Why are we undertaking such wide-ranging reforms?

The simple answer, because we have had a major crisis, is not good enough as an explanation – it explains the timing of the reforms, but the substance of them requires more explanation.

Let me put forward a number of principles on which I want to focus this morning.

First, achieving a stable financial system will in turn enable the development of a strong, competitive system, and likewise will foster the strength of financial centres.

Financial stability and competitiveness are not fundamentally in conflict; rather, the former is a necessary but not sufficient condition of the latter, much as stable low inflation is a condition of sustainable economic growth.

The key point here is that our respective objectives of stability and competitiveness are fundamentally not at odds.

Second, the other key objective of the reforms is to achieve the stability of the financial system without recourse to public money as the buttress – both implicit dependence and in bad states of the world explicit dependence.

This objective has a number of profound consequences, including **placing the resolution of banks and its planning at the heart of bank supervision**.

Again, I think this objective of resolvability is fundamentally consistent with the objective of having a competitive financial system.

The reason I believe this strongly is that with well-established resolution tools and plans, the incentives for governments to want to intervene in the operations of banks will be reduced.

Likewise, **as supervisors we should be less interventionist for a bank that can be resolved**.

Of course, resolution is never costless, and this should guide our interventions, but other things equal we will be less intrusive where we are more assured of resolvability.

As an example of that approach, I think that with a robust resolution plan in place – which can be quite simple for small banks – we should be more open to allowing new entrants to start-up, and then sink or swim.

This is important because we will only foster more competition if we enable banks to leave the scene if their business model does not work.

So, again, an objective of resolvability for banks does support the objective of competitiveness.

The third principle on which I want to focus concerns clarity in the objectives of supervision.

Put simply, **it does not support an effective regime to create unnecessary uncertainty on the ultimate objectives of prudential supervision** – ie how large should the capital and funding buffers held by banks eventually be.

Lack of clarity in this respect is not in my view conducive to a well-functioning market economy.

There are at least **two complications** here.

First, quite sensibly we want supervision to be **judgemental**, in other words to **embody sensible flexibility**.

Likewise, we think that **exercising judgement is in large part about applying the Basel III framework** on a forward-looking basis in order to assess the vulnerability of institutions to big risks.

Indeed, the big switch here was arguably from the Basel I to Basel II frameworks, which introduced judgement into the capital adequacy framework by allowing firms to use approved models to measure risk.

These models are by their nature inherently judgemental tools for both firms and supervisors – the question is not whether the model is right in an absolute sense (it won't be) but whether it helps to form an acceptable view of prudent capital requirements.

But, the use of judgement in this way inevitably creates uncertainty on how it will be applied in the future.

The second complication in terms of clarity around the objectives of supervision is that **we are applying the Basel III changes as a transition over a number of years**.

This is wise in terms of the consequences of the change and their impact on the real economy, but it prompts uncertainty over how Augustinian authorities may be in their approach to transition.

Clearly, I think it is fair enough to say that **the UK and Switzerland do not look to be particularly Augustinian in their approaches**.

I think the key point here for me is to minimise uncertainty and thus to support a functioning market economy.

I am not a supporter of a system which leaves people guessing what we will eventually want from banks.

Looking at the UK arrangements, it is in my view helpful that a consensus is building around the Independent Commission on Banking's recommendations of **17% primary**

loss-absorbing capacity measured on a risk-weighted assets basis, with a core tier one capital or common equity component within that of 10%.

All of this should be measured on a Basel III basis, and supported by a leverage ratio, as the ICB recommended.

And, there should be clear liquidity standards.

Switching to the Basel III capital standard will require a transition where banks do restructure their balance sheets and retain more earnings while they transition.

Providing the objectives are well understood, I believe the banks can make this transition.

But I do accept the challenge that the process needs to be well understood – markets are more likely to give banks credit for their prudential buffers of capital and liquid assets if they understand the end-points and the ways in which we as supervisors will exercise our judgement.

An important example of this use of judgement is that when we ask banks to hold prudential buffers we treat them just like that – ie as protection which can be used, and where the response of the supervisor to a firm going into a buffer is to require a sensible plan to correct the use of a buffer over a reasonable period of time.

To conclude, supervision needs to support banks operating in a market economy.

This means earning a sensible rate of return calculated on a basis that appropriately factors in the amount of risk taken.

I do believe that Basel III is correct to raise prudential requirements; that is the crucial lesson of the crisis.

We are also right in my view to end the dependence on public money through effective resolution techniques.

Here, by the way, we should thank a Swiss bank, Credit Suisse, for providing much of the early thinking to support the notion of bail-in as the way to end the dependence on public money.

But, as policymakers, we need to enable our judgements and standards to be understood and appropriately predicted so that we support the operation of banks in a market economy.

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EBA BS 2012 048 final

30 April 2012 Report on the fulfilment of the EBA Recommendation following the 2011 EU-wide stress test

Executive summary

Following the publication of the **2011 EU-wide stress test results** in July 2011, the EBA issued a Recommendation to national supervisory authorities (NSAs) to ensure that appropriate mitigating actions were put in place with respect to

- (i) Banks with a Core Tier 1 capital (CT1) ratio below 5% in the adverse scenario and
- (ii) To banks with a CT1 ratio close to 5% in the adverse scenario and with sizeable exposures to sovereigns under stress.

Forward looking mitigating measures were identified in the publication templates for relevant banks to address weaknesses.

The EBA, as a part of its ongoing monitoring activities, has continued to assess the implementation of these mitigating measures against the requirements of the EBA Recommendation.

NSAs responsible for the supervision of the banks falling under the scope of the EBA Recommendation have provided the details of the mitigating measures taken for the respective banks and of their close monitoring of banks as a part of ongoing supervisory activities.

In total, **eight banks of the 90 participating in the EBA 2011 stress test exercise had a CT1 ratio under the adverse scenario below the set 5% benchmark.**

According to the information provided to the EBA, mitigating measures have been put in place for all banks with a post stress capital ratio below 5%, and were deemed sufficient by the EBA to comply with its Recommendation.

Following a deterioration of the external environment, in many cases, additional measures have been put in place by NSAs which the EBA notes and supports.

In some cases, these actions are ongoing and NSAs have confirmed to the EBA that the mitigating actions are being closely followed under national initiatives and will be finalised within reasonable timelines agreed between banks and their respective NSAs.

Most of the banks with a CT1 ratio above 5% and with sizeable exposures to sovereigns under stress will be addressed under the monitoring of the December 2011 Recommendation following the results of the 2011 EU Capital exercise, where they have been included in the sample of 71 banks.

The EBA is, in general, satisfied with progress in the fulfilment of the July 2011 Recommendation noting the actions that have been taken that include capital strengthening and adequate recognition of losses.

In addition, those banks identified as having weaknesses have subsequently undergone restructuring processes and will no longer exist in the same form as at the moment of the stress test.

Some of the banks falling under the scope of the July 2011 Recommendation and the December 2011 Recommendation are subject to the implementation of more stringent measures under the pre-agreed EU/IMF assistance programmes and to a separate monitoring by the so called “Troika” authorities (EU Commission, ECB, IMF).

Background and introduction

The results of the second EU-wide stress tests conducted by the European Banking Authority (EBA) in cooperation with the EU Commission, European Systemic Risk Board (ESRB), European Central Bank (ECB) and national supervisory authorities (NSAs) were published in July 2011.

The aim of the stress test was to assess the resilience of 91 participating banks from 21 EEA countries against an adverse but plausible scenario.

The aggregate Core Tier 1 (CT1) ratio of the 90 banks that published information in the 2011 EBA stress test decreased from 8.9% to 7.7% after two years of stress.

The largest driver of the decrease is impairment charges which led to CT1 decrease of 3.6 percentage points.

As a result of the application of the adverse macro-economic scenario and common constraining assumptions applied in the exercise, the post stress capital ratios of eight banks fell below the capital threshold set at the level of 5% CT1 with the overall **capital shortfall of EUR 2.5 bn based on the EBA definition of CT1**.

In addition, 16 banks displayed post stress CT1 ratios between 5 and 6% after the application of the adverse scenario over the two-year time horizon.

On the basis of the results of the stress test, the EBA issued its first formal Recommendation addressed to NSAs and requiring remedial actions.

In particular, pursuant to Article 21.2(b) of the EBA Regulation, the Recommendation published as a part of the EBA Aggregate report, states the following:

a. NSAs to request banks whose CT1 ratio falls below the 5% threshold under the adverse scenario defined in the stress test exercise to promptly remedy this capital shortfall.

In particular, national supervisors should ensure that these banks are requested to present within three months (i.e. by 15 October 2011) to their competent authorities **a plan to restore the capital position to a level at least equal to the 5% CT1 benchmark based on this analysis**.

The remedial measures agreed with the competent authority had to be fully implemented by end of 2011, with flexibility allowed only if justified by market conditions or required procedures.

b. NSAs to request all banks whose CT1 ratio under the adverse scenario is above but close to 5% and which have sizeable exposures to sovereigns under stress to take specific steps to strengthen their capital position, including where necessary restrictions on dividends, deleveraging, issuance of fresh capital or conversion of lower quality instruments into Core Tier 1 capital.

These banks were expected to plan remedial action within three months. The plans had to be **fully implemented within nine months from the publication of the stress test results**.

With the publication of these Recommendations, the EBA committed to reviewing their fulfilment and to publishing the outcomes of such review.

This report directly addresses the fulfilment of the first part of the July 2011 Recommendation (banks failing to meet the 5% CT1 threshold), whereas the second part will be followed-up under the December 2011 EU Capital exercise Recommendation.

Link to the 2011 Capital exercise

Following the further escalation of the sovereign debt crisis, and the announcement of the European coordinated policy package on 26 October 2011, the EBA has conducted a Capital exercise **amongst 71 banks** aimed at assessing banks recapitalisation needs after the prudential revaluation of the sovereign exposures and at applying higher capital threshold set at 9% CT1.

It should be noted that the EBA Capital exercise was not a stress test.

Against the ongoing developments in the markets and the deterioration of the sovereign debt crisis in Europe, the EBA reviewed banks' actual capital positions and sovereign exposures as of September 2011 and requested them to set aside additional capital buffers.

The capital buffer is designed to provide reassurance to markets about the ability to withstand a range of shocks and still maintain adequate capital.

Following the outcomes of the Capital exercise, the EBA has issued its second Recommendation requiring banks failing to meet the capital threshold to ensure that appropriate mitigating measures are put in place and that by 30 June 2012, all 71 banks attain and maintain until such time as this Recommendation has been amended, repealed or cancelled, the temporary capital buffer **at a level of 9% CT1 (December 2011 Recommendation).**

To this end, the NSAs have been recommended to ensure that all banks build a temporary capital buffer to reach a **9% CT1 ratio** by 30 June 2012, after the removal of the prudential filters on the sovereign assets in the available-for-sale portfolio and the conservative valuation of sovereign debt exposures in the held-to-maturity and loans and receivables portfolios, reflecting market prices as of 30 September 2011.

Pursuant to this Recommendation, the EBA has set up a series of follow-up steps requiring banks with a capital shortfall to present the recapitalisation plans outlining the measures they plan to take in order **to meet the 9% CT1 capital threshold by 30 June 2012.**

Such recapitalisation plans have been scrutinised by the respective consolidating NSAs in close cooperation with the Colleges of Supervisors and the EBA.

The December 2011 Recommendation effectively augments the outcomes of the 2011 stress tests.

Therefore, the mitigating efforts for banks falling under the second part of the July 2011 Recommendation (banks close to the threshold but with sizable exposures to sovereigns under stress), will be monitored under the December 2011 Recommendation and are not discussed in this report.

Methodology for assessing the fulfilment of the Recommendation

The assessment of the fulfilment of the July 2011 Recommendation is **based on the information on mitigating measures provided to the EBA by the consolidating NSAs of the banks failing to meet the capital threshold.**

The assessment is based on recalculating the CT1 ratio under the adverse scenario for 2012 adjusting risk weighted assets (RWA) and CT1 capital according to the mitigating actions reported by NSAs (either in a separate communication or in the stress test disclosure templates).

This assessment is based on the information collected during the stress tests as well as on additional information on the mitigating measures provided by the NSAs without recalculating possible impacts of the stress or taking into account actual financial or portfolio information.

Some of the banks subject to the July 2011 Recommendation are undergoing deep restructuring as part of the pre-agreed measures under EU/IMF programmes.

This **directly affects the Greek banks**, where quantitative capital targets stemming from the pre-agreed EU/IMF programmes exceed the results of the EBA EU-wide stress tests and the EU Capital exercise.

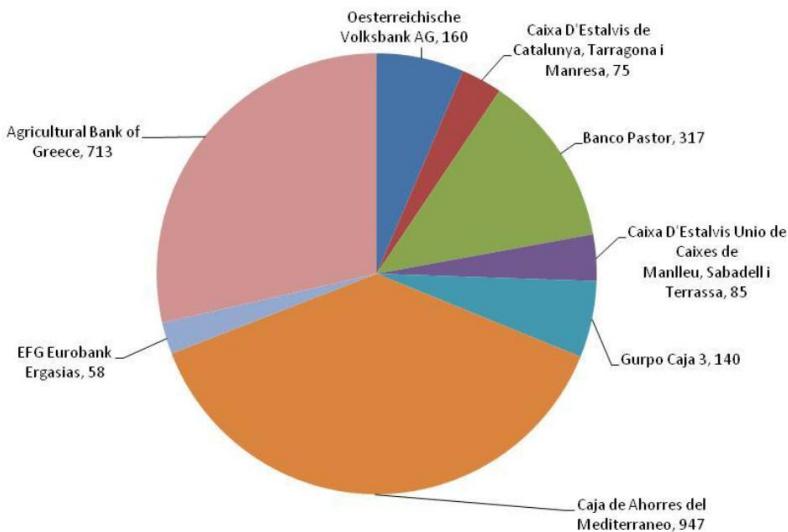
The implementation of EU/IMF measures and fulfilment of capital targets is being closely followed by the respective national authorities together with the EU Commission, ECB and IMF.

Fulfilment of the Recommendation by banks below 5% CT1 threshold

In total, eight out of the 90 banks that published the results of the 2011 EU-wide stress test have a CT1 ratio under the adverse scenario that falls below the threshold of 5%.

The aggregate CT1 capital shortfall for these banks amounted to EUR 2.5 bn (see Chart 1).

Chart 1: Breakdown of total shortfall (in mln)



When analysing the impact of the mitigating measures put in place after the stress test, it should be noted that most of the banks with a shortfall have gone or currently are undergoing restructuring processes and will no longer exist in the same form as at the moment of the stress test.

Austria

The Oesterreichische Volksbanken AG (OeVAG) submitted a [detailed restructuring plan to the Austrian NSAs](#) to promptly remedy its capital shortfall and has already

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completed a major step: the closed sale of its international operations (Volksbank International AG) to the Russian Sberbank.

Furthermore, OeVAG currently pursues the implementation of additional restructuring measures - based on a term-sheet agreed on by its shareholders and the Republic of Austria - combining OeVAG and more than 60 local Volksbanks into a single affiliated group according to Article 3 Directive 2006/48/EC by mid of 2012.

On 26 April 2012, OeVAG's general meeting of shareholders decided on a number of milestones in this regard, resulting in a new ownership - structure retroactive as of 31 December 2011, where the local Volksbanks hold the majority of OeVAG and the Republic of Austria is the second largest shareholder.

After completion of these fundamental restructuring steps, OeVAG nevertheless will continue to streamline and restructure the group with the final target of becoming a lean central institution serving the local Volksbanks with a clear focus on the Austrian market.

Spain

In total, **five Spanish institutions** have gone or are undergoing significant integration processes which will result in their merger with other banks or their integration within other groups of credit institutions.

Each of these processes is at a different stage and is being closely monitored by the Spanish authorities.

The timeline for their completion depends on different resolutions and authorisations, and in some cases, it may fall outside the timeframe set by the EBA Recommendation:

- Caixa D'Estalvis de Catalunya, Tarragona i Manresa: In this case, Catalunya Bank, in which the FROB has a stake of 90%, has started the necessary steps for an integration process with another credit institution through a competitive procedure in accordance with Article 9.8 of Royal Decree-Law 9/2009, on bank restructuring and credit institutions equity reinforcement.
- Caixa D'Estalvis Unio de Caixes de Manlleu, Sabadell I Terrassa (Unnim): In the case of Unnim Banc, S.A. on 7 March 2012 the Government Committee of the FROB, which was its sole owner, drew up the restructuring plan for this bank, envisaging its integration within the Spanish bank BBVA.

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- Grupo Caja 3: This bank announced on 29 February 2012 its merger with Ibercaja Banco.
- Caja de Ahorros del Mediterraneo (CAM): On 7 December 2011, the Government Committee of the FROB drew up restructuring plan for Banco CAM, which envisages that it will be integrated within Banco Sabadell.
- Banco Popular is finalising its takeover of Banco Pastor.

Greece

Two Greek banks, EFG Eurobank Ergasias and Agricultural Bank of Greece, have shown a capital shortfall in the stress test.

These banks are undergoing deep restructuring as part of the pre-agreed measures under the EU/IMF programme.

Quantitative capital targets stemming from the latter exceed the results of the EBA EU-wide stress tests and EU Capital exercise.

The implementation of EU/IMF measures and the fulfilment of capital targets are being closely followed by the respective national authorities together with the EU Commission, ECB and IMF.

Germany

In addition to the **eight banks** with identified capital shortfall, the EBA has followed up on **one bank**, which did not publish the EBA 2011 stress test results, namely Landesbank Hessen-Thuringen (Helaba) to understand the actions it has taken since the stress test.

Helaba has “hardened” its participation capital in order to comply with the CT1 definition of the EBA.

This conversion has led to an increase of CT1 capital by EUR 1.92bn.

Conclusions and further monitoring

The EBA is, in general, satisfied with the progress made in the fulfilment of the July 2011 Recommendation noting that the actions taken include capital strengthening and adequate recognition of losses.

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In addition, the EBA supports the measures undertaken to significantly restructure those banks in difficulty and sees this as an appropriate response to the Recommendation.

Generally, the EBA July 2011 Recommendation has been strengthened by the EBA December 2011 Recommendation.

The 71 banks participating in the 2011 Capital exercise are being monitored by the EBA in order to check whether they adhere to the CT1 ratio of 9% by the end of June 2012.

Some Spanish banks subject to the July 2011 Recommendation are not represented in the sample for the December 2011 Capital exercise and therefore do not fall under the scope of the December 2011 Recommendation.

Those banks remain under close scrutiny by their respective national supervisory authorities, and are also subject to the wide-ranging restructuring programmes undertaken under the aegis of the national measures put forward by the Spanish Government.

The EBA will continue to monitor and assess risks and vulnerabilities from a micro-prudential perspective in the EU banking sector employing a wide range of tools, including analyses of key risk indicators, bottom-up risk questionnaires to the supervisors of the largest cross-border banking groups, and joint risk assessments done by the colleges of supervisors.

The EBA is currently developing its approach to the next EU-wide stress test exercise, which will take place in 2013.



Chairman Ben S. Bernanke

**At the 48th Annual Conference on Bank Structure and Competition, Chicago, Illinois
(via satellite) - May 10, 2012**

Banks and Bank Lending: The State of Play

I am pleased to speak this morning at what has become, over nearly 50 years, perhaps the most prestigious conference for bankers, academics, and bank supervisors in the United States.

The first part of my remarks will highlight the significant progress that has been made over the past several years toward restoring the banking system to good health.

I will also talk about some of the challenges banks face as they adapt to the post-crisis economic and regulatory environment.

I will then review recent trends in credit conditions, noting that bank lending has generally been improving but remains restrained in some areas.

The State of the Banking System

Since the financial crisis, **banks have made considerable progress in repairing their balance sheets and building capital.**

Risk-based capital and leverage ratios for banks of all sizes have improved materially and are significantly above their previous highs.

Importantly, the **19 largest banking institutions** that participated in the 2009 stress tests, as well as the two subsequent Comprehensive Capital Analysis and Review (CCAR) processes, have considerably more and better-quality capital than a few years ago.

Indeed, those firms have **increased their Tier 1 common equity, the best buffer against future losses, by more than \$300 billion since 2009, to nearly \$760 billion.**

The Tier 1 common ratio for these firms, which compares this high-quality capital to risk-weighted assets, stood at 10-1/2 percent at the end of last year.

The latest CCAR, conducted earlier this year, demonstrated that most of the 19 firms would likely have sufficient capital to withstand a period of intense economic and financial stress and still be able to lend to households and businesses.

The **hypothetical supervisory stress scenario** used in the CCAR was quite severe; it included a peak unemployment rate of 13 percent, a 50 percent drop in equity prices, and a 21 percent further decline in housing prices, as well as steep falls in prices of financial assets most exposed to conditions in Europe.

Under this highly adverse scenario, **the 19 bank holding companies were projected to incur aggregate losses of more than \$500 billion through the fourth quarter of 2013.**

Nevertheless, their aggregate Tier 1 common ratio was projected to be **6.3 percent** at the end of the scenario period, **and 15 of the 19 bank holding companies** were projected to maintain capital ratios above all four of the regulatory minimum levels--even after taking into account their proposals for capital actions such as dividends, share buybacks, and share issuance in the baseline scenario.

The banking sector overall also has substantially improved its liquidity position over the past few years.

Indeed, **large banks in the aggregate have more than doubled their holdings of cash and securities since 2009.**

Large banks have reduced their collective dependence on short-term wholesale funding, and many are flush with retail deposits, which tend to be a more stable funding source.

Challenges on the liquidity front remain, however: Some large firms still rely heavily on wholesale short-term funding; and the liquidity needs of the banking system as a whole may become somewhat higher for a while as some of the securities issued under the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program come due, and as the unlimited insurance on noninterest-bearing transaction accounts expires at the end of the year.

Nevertheless, over time, greater liquid asset positions and reduced dependence on wholesale short-term funding, together with more and better capital, will make the banking sector less susceptible to unexpected disruptions in short-term funding markets.

The credit quality of large banks' assets is looking better as well, although the improvements have been uneven across types of loans.

In the aggregate, delinquency rates on loan portfolios at large banks have declined substantially from their peaks.

However, while delinquencies on commercial and industrial (C&I) loans and consumer loans have fallen to the lower end of their historical ranges, delinquencies on loans backed by commercial or residential real estate have declined only moderately and remain elevated.

The profitability of large banks has been edging up as credit quality has firmed and banks have trimmed noninterest expenses.

Even so, large banks' profitability remains well below the levels that prevailed before the financial crisis began, and banks continue to struggle to expand their revenues.

Developments that can be traced back to the financial crisis--including a still-weak economy, changes in market conditions and practices, and tighter financial regulations--are clearly important reasons for these trends.

Community banks play important roles in local economies, and so it is notable that their condition has also improved.

Their regulatory capital ratios have increased significantly since 2009 and stand well above their recent norms.

As has been the case at large banks, delinquency and charge-off rates at community banks have declined across most major categories of loans, and fewer institutions failed in 2011 than in each of the previous two years. That said, clusters of small bank failures can affect credit availability in a community while bank-dependent borrowers work to establish new relationships with surviving institutions.

In addition, while standard measures of community banks' profitability, such as return on equity and assets, improved last year, as was also true at larger institutions, most of the gains were due to reductions in loan loss provisions rather than to more sustainable sources of profit such as expanded lending.

Financial-market indicators reflect the substantial improvements in banks' financial conditions since the crisis as well as the sizable challenges remaining.

Bank credit default swap (CDS) premiums are now well below their crisis peaks, and bank stock prices have retraced some of their earlier losses and have outperformed the broader market this year, boosted somewhat by the release of the CCAR results in March and first-quarter earnings that largely beat analysts' expectations.

However, CDS premiums remain elevated for some of the larger, more globally connected firms, and their stocks continue to trade at market-to-book ratios of less than 1.

A number of key systemic risk measures that evaluate the potential performance of firms during times of financial market stress have improved in recent months.

These indicators of systemic risk are now well below their levels in the crisis, and, overall, they present a picture of a banking system that has become healthier and more resilient.

Regulatory and Financial Challenges

Banks face a **number of significant challenges** as they adapt to the post-crisis economic environment and to new domestic and international regulatory requirements.

The most systemically important financial firms will face meaningfully higher capital and liquidity requirements and continue to undergo regular supervisory stress tests.

They will also be required to submit so-called living wills to facilitate their orderly resolution if necessary.

Additionally, **banks must enhance their reporting systems and improve disclosure.**

These new requirements are critical to safeguard the stability of the financial system and to help prevent another costly crisis.

At the same time, **regulators appreciate that the new rules impose significant burdens on banks.**

For that reason, and to minimize adverse effects on the supply of credit, many of the most significant rules are being phased in gradually and only after extended processes of consultation with industry and other stakeholders.

It is worth reiterating that most of these enhanced regulatory and supervisory measures focus on the largest, most interconnected financial institutions, and we are working to ensure that community banks are not subjected to rules designed primarily to constrain risks at larger institutions.

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We have an ongoing dialogue with community banks through many channels, including, for example, our Community Depository Institutions Advisory Council.

The council, whose membership is drawn from smaller banks, credit unions, and savings associations in each of the 12 Federal Reserve Districts, meets with the Board in Washington twice a year to discuss supervisory and regulatory issues that affect their institutions.

We have also established a special supervisory subcommittee of the Board which focuses on community banking issues.

In addition to strengthened regulatory and supervisory requirements, banks face market demands that they operate with more resilient business models.

In many contexts, counterparties are demanding greater security in the form of more and better-quality collateral or higher margins.

In addition, lenders to banks may be requiring greater compensation for risk, thereby raising banks' funding costs.

Banks have also been navigating an economic recovery that has been halting at times.

Consequently, although the condition of the banking system is improving, demand for credit generally has remained sluggish, and the creditworthiness of some borrowers that would normally turn to banks for loans remains impaired.

These factors, together with tighter credit policies imposed by many lenders, have restrained somewhat the expansion of bank credit.

Credit Conditions and Bank Lending

Notwithstanding the various headwinds, credit conditions in the United States have improved significantly in a number of areas.

Many--though certainly not all--businesses and households are finding it easier to borrow than they did a few years ago, in part because of better conditions in financial markets more broadly.

Large businesses with access to capital markets have generally been able to raise funds at attractive terms, with both investment- and speculative-grade firms taking advantage of historically low interest rates to issue bonds at a robust rate.

Moreover, consumers with strong credit histories have ready access to credit cards and auto loans, supported by solid issuance of consumer-related asset-backed securities.

Banks also supply credit by purchasing securities, and their purchases have grown rapidly in recent months--in particular, those of agency-guaranteed mortgage-backed securities (MBS).

In this challenging time for housing markets, banks are attracted by the securities' government guarantee.

Additionally, some larger banks may be accumulating these securities in preparation for more-stringent liquidity regulations.

Signs of improvement notwithstanding, credit conditions in some sectors and for some types of borrowers remain tight.

Mortgage lending is an important example.

Since its peak, U.S. home mortgage credit outstanding has contracted about 13 percent in real terms.

Many factors suggest that this situation will be difficult to turn around quickly, including the slow recovery of the economy and housing market, continued uncertainty surrounding the future of the government - **sponsored enterprises (GSEs)**, the lack of a healthy private-label securitization market, and cautious attitudes by lenders.

Financing conditions in the commercial real estate sector also remain strained as fundamentals, including high vacancy rates, depressed property prices, and the poor quality of existing loans, continue to be weak.

Moreover, the market for commercial MBS--a source of liquidity for some lenders in this sector--is still struggling to regain its footing.

The Federal Reserve's quarterly **Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS)** offers a more-nuanced view of how lending terms are changing.

The SLOOS indicates that standards and terms in many loan categories have eased somewhat further in recent quarters from the very tight conditions that prevailed earlier in the recovery.

For example, the April SLOOS pointed to the first material net easing in lending standards for commercial real estate loans since 2005 and to a further easing of standards for most types of consumer loans.

In addition, SLOOS respondents suggested that stepped-up competition has induced a large number of domestic banks to reduce fees and spreads on C&I loans to firms of all sizes.

The SLOOS also indicates that demand for many types of loans has continued to increase, with demand for C&I loans having risen to relatively high levels.

Consistent with the results of the SLOOS, C&I lending has indeed been rising sharply lately.

Banks have focused on C&I lending because business borrowers' creditworthiness is improving and because the majority of C&I loans carry floating interest rates that reduce interest rate risk.

In addition, domestic banks reportedly are picking up customers as a result of a pullback by some European institutions.

Auto lending also has reportedly been solid, reflecting strong fundamentals in auto markets--such as robust demand for used cars and relatively low delinquency rates on existing auto loans.

The strong fundamentals for auto loans in turn also appear to have contributed to an easing of lending standards and terms.

But, as I mentioned earlier, residential mortgage lending has been particularly sluggish.

Tight lending standards and terms remain especially evident.

To be sure, a return to pre-crisis lending standards for residential mortgages wouldn't be appropriate; however, current standards may be limiting or preventing lending to many creditworthy borrowers.

For instance, in the April SLOOS, we asked banks a hypothetical question about their willingness to originate GSE-eligible mortgages relative to 2006 for borrowers with a range of credit scores and available down payments.

The SLOOS found that even when the loans were accompanied by a 20 percent down payment, many banks were less likely to originate loans to borrowers with given GSE-eligible credit scores, despite the originating bank's ability to sell the mortgage to the GSEs.

Most banks indicated that their reluctance to accept mortgage applications from borrowers with less-than-perfect records is related to "putback risk"--the risk that a

bank might be forced to buy back a defaulted loan if the underwriting or documentation was judged deficient in some way.

Small businesses owners, who in the past might have tapped into the equity in their homes or used their homes as collateral for small business loans, also have found conditions challenging in recent years.

The stock of small loans to businesses on bank balance sheets at the end of last year was more than 15 percent below its peak in 2008.

These loans looked to have ticked up in the fourth quarter of 2011, consistent with the reported increase in demand for loans by small firms in the SLOOS.

Responses to the monthly National Federation of Independent Business survey also suggest some modest improvement in the small business sector: The share of respondents reporting a need for credit has moved up from lows of recent years, and the net share of respondents who say that credit is more difficult to obtain than it was three months ago is notably below its peak in 2009.

The Federal Reserve is keenly interested in understanding how shifts in loan supply, loan demand, and borrower quality may be affecting lending and, by extension, the broader economy.

Of course, sorting out the relative effect of changes in loan demand from the effect of changes in loan supply can be quite difficult because they can be influenced by the same factors.

For example, a shift in the economic outlook can affect both the willingness of banks to lend and the desire and ability of firms and households to borrow.

Recent research at the Federal Reserve examines cyclical changes in banks' lending standards as reported in the SLOOS--a commonly used indicator of loan supply.

It attempts to assess how much of those changes were a "typical" response to macroeconomic and bank-specific factors, and how much was "atypical" or unexplained.

This analysis suggests that the tightening of lending standards that occurred between 2007 and 2009 was much greater than a model based on historical experience would predict, contributing to the subdued pace of lending.

These results are consistent with other evidence that the crisis induced exceptionally high levels of risk aversion and uncertainty on the part of both lenders and borrowers, constraining the flow of credit.

As these factors have receded and the economy has improved, lending standards have become less stringent.

Some bankers and borrowers believe that enhanced supervision and regulation has made it more difficult for banks to expand their lending.

The Federal Reserve takes seriously its responsibility to ensure that supervisory actions to protect banks' safety and soundness do not unintentionally constrain lending to creditworthy borrowers, and we have taken a variety of steps to address these concerns.

For example, we have issued guidance to supervisors stressing the importance of taking a balanced approach to supervision and of promptly upgrading a bank's supervisory rating when warranted by a sustainable improvement in its condition and risk management.

Some analysis has indicated that, all else being equal, banks with lower supervisory ratings tend to lend less; prompt upgrades by supervisors when such upgrades are appropriate may thus ease an unnecessary constraint on lending.

Indeed, **in the fourth quarter of 2011 and the first quarter of this year, the number of ratings upgrades for banks and bank holding companies supervised by the Federal Reserve exceeded the number of downgrades. The last time that upgrades exceeded downgrades was in 2005.**

In addition, we have stepped up examiner training on relevant lending issues, and we have emphasized to examiners that an open dialogue with bank management is essential.

We have also looked into specific concerns raised about the examination process and its effect on banks' willingness to lend.

For example, during 2011, we reviewed commercial real estate loan classification practices to assess whether examiners were properly implementing the interagency policy statement on workouts of commercial real estate loans.

We analyzed documentation **for more than 300 loans with identified weaknesses in six Federal Reserve Districts.**

We found that Federal Reserve examiners were appropriately implementing the guidance and were consistently taking a balanced approach in determining loan classifications.

Moreover, the documentation we reviewed indicated that examiners were carefully considering the full range of information provided by bankers, including relevant mitigating factors, in determining the regulatory treatment for the loans.

Conclusion

To sum up, conditions in the banking system--and the financial sector more broadly--have improved significantly in the past few years.

Banks have strengthened their capital and liquidity positions.

The economic recovery has facilitated the rebuilding of capital and helped improve the quality of the loans and other assets on banks' balance sheets.

Nonetheless, banks still have more to do to restore their health and adapt to the post-crisis regulatory and economic environment. As the recovery gains greater traction, increasing both the demand for credit and the creditworthiness of potential borrowers, a financially stronger banking system will be well positioned to expand its lending.

Improving credit conditions will in turn help create a more robust economy.

**Statistical release: OTC derivatives
statistics at end-December 2011**
Monetary and Economic Department
May 2012

Bank for International Settlements

A summary of the latest statistics on over-the-counter (OTC) derivatives markets.

Data at end-December 2011 are **not fully comparable** with previous periods because of an increase in the reporting population.

Australia and Spain reported for the first time, expanding the reporting population to dealers headquartered in 13 countries.

(The other reporting countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.)

Total notional amounts outstanding of OTC derivatives amounted to **\$648 trillion at end-2011 (Graph 1, left-hand panel, and Table 1).**

Notwithstanding the increase in the reporting population, total notional amounts declined between end-June and end-December 2011.

At the same time, gross market values, which measure the cost of replacing existing contracts, **increased to \$27.3 trillion, driven mainly by an increase in the market value of interest rate contracts.**

Consequently, gross market values rose from 2.8% of notional amounts at end-June 2011 to 4.2% at end-December 2011.

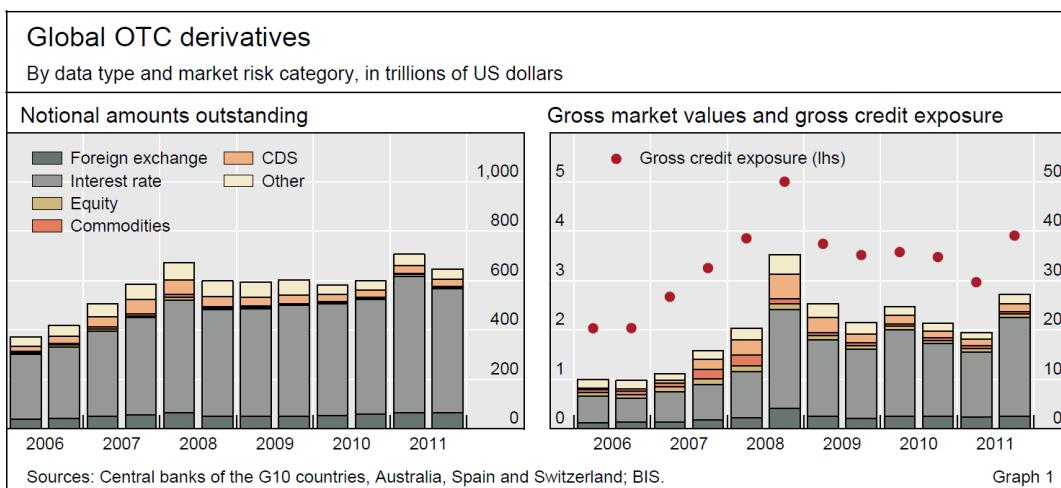


The rise in gross market values was the largest since the second half of 2008.

Gross credit exposures, which take account of legally enforceable bilateral netting agreements, also increased, but not by as much as market values.

Gross credit exposures rose to \$3.9 trillion, their highest level since end-2008 (Graph 1, right-hand panel).

At the same time, they declined from 15.2% of gross market values at end-June 2011 to 14.3% at end-2011 as dealers made greater use of netting to reduce their credit and settlement risk.



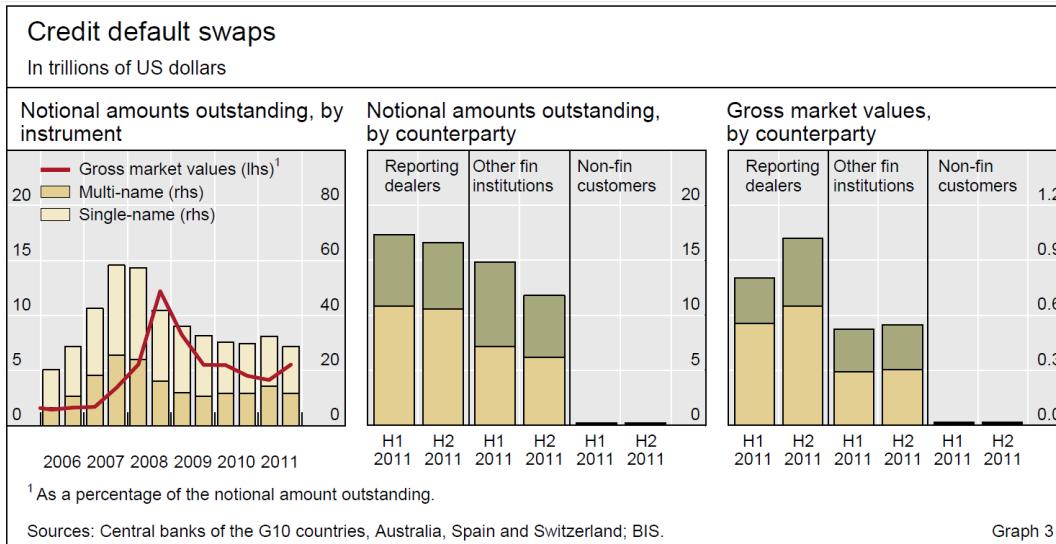


Table 1
Global OTC derivatives market¹
Amounts outstanding, in billions of US dollars

	Notional amounts outstanding				Gross market value			
	H1 2010	H2 2010	H1 2011	H2 2011	H1 2010	H2 2010	H1 2011	H2 2011
GRAND TOTAL	582,685	601,046	706,884	647,762	24,697	21,296	19,518	27,285
A. Foreign exchange contracts	53,153	57,796	64,698	63,349	2,544	2,482	2,336	2,555
Outright forwards and forex swaps	25,624	28,433	31,113	30,526	930	886	777	919
Currency swaps	16,360	19,271	22,228	22,791	1,201	1,235	1,227	1,318
Options	11,170	10,092	11,358	10,032	413	362	332	318
<i>Memo: Exchange-traded contracts²</i>	347	314	389	309
B. Interest rate contracts³	451,831	465,260	553,240	504,098	17,533	14,746	13,244	20,001
FRAs	56,242	51,587	55,747	50,576	81	206	59	67
Swaps	347,508	364,377	441,201	402,611	15,951	13,139	11,861	18,046
Options	48,081	49,295	56,291	50,911	1,501	1,401	1,324	1,888
<i>Memo: Exchange-traded contracts²</i>	69,551	61,943	76,055	53,305

C. Equity-linked contracts	6,260	5,635	6,841	5,982	706	648	708	679
Forwards and swaps	1,754	1,828	2,029	1,738	189	167	176	156
Options	4,506	3,807	4,813	4,244	518	480	532	523
<i>Memo: Exchange-traded contracts²</i>	5,520	5,689	6,416	4,718
D. Commodity contracts⁴	2,852	2,922	3,197	3,091	458	526	471	487
Gold	417	397	468	521	45	47	50	82
Other	2,434	2,525	2,729	2,570	413	479	421	405
Forwards and swaps	1,551	1,781	1,846	1,745
Options	883	744	883	824
E. Credit default swaps⁵	30,261	29,898	32,409	28,633	1,666	1,351	1,345	1,586
Single-name instruments	18,494	18,145	18,105	16,881	993	884	854	962
Multi-name instruments	11,767	11,753	14,305	11,752	673	466	490	624
Index products	...	7,476	12,473	10,466
F. Unallocated⁶	38,329	39,536	46,498	42,609	1,789	1,543	1,414	1,977
GROSS CREDIT EXPOSURE⁷	3,581	3,480	2,971	3,912
<i>Memo: Exchange-traded contracts^{2,8}</i>	75,418	67,947	82,860	58,332

¹ Based on the data reported by 11 countries up to H1 2011. Includes data reported by Australia and Spain from H2 2011 onwards. Data on total notional amounts outstanding, gross market value and gross credit exposure are shown on a net basis, ie transactions between reporting dealers are counted only once. The definitions of notional amounts outstanding, gross market value and gross credit exposure are available under Section 2 of the statistical notes.

² Sources: FOW TRADEdata; Futures Industry Association; various futures and options exchanges. ³ Single currency contracts only.

⁴ Adjustments for double-counting partly estimated. ⁵ See Tables 4 to 8. ⁶ Includes foreign exchange, interest rate, equity, commodity and credit derivatives of non-reporting institutions, based on the latest Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, in 2010.

⁷ Before 2011, excludes CDS contracts for all countries except the United States. ⁸ Excludes commodity contracts.



**Testimony Before the US Senate Committee on Banking,
Housing and Urban Affairs, Washington, DC
CFTC Chairman Gary Gensler**

May 22, 2012



Good morning Chairman Johnson, Ranking Member Shelby and members of the Committee.

I thank you for inviting me to today's hearing on implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), international harmonization of swaps market reforms, and the Commodity Futures Trading Commission's (CFTC) role in overseeing markets for credit derivative products, such as those traded by JPMorgan Chase's Chief Investment Office.

I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

I'm pleased to testify along with Securities and Exchange Commission (SEC) Chairman Schapiro.

Swaps, now comprising a \$700 trillion notional global market, were developed to help manage and lower risk for commercial companies.

But they also concentrated and heightened risk in international financial institutions.

And when financial entities fail, as they have and surely will again, swaps can contribute to quickly spreading risk across borders.

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As the financial system failed in 2008, most of us learned that the insurance giant AIG had a subsidiary, AIG Financial Products, originally organized in the United States, but run out of London.

The fast collapse of AIG, a mainstay of Wall Street, was again sobering evidence of the markets' international interconnectedness.

Sobering evidence, as well, of how transactions booked in London or anywhere around the globe can wreak havoc on the American public.

Recently, we've had another stark reminder of how trades overseas can quickly reverberate with losses coming back into the United States.

According to press reports, the largest U.S. bank, JPMorgan Chase, just suffered a multi-billion dollar trading loss from transactions in London.

The press also is reporting that this trading involved credit default swaps and indices on credit default swaps.

It appears that the bank here in the United States is absorbing these losses.

And as a U.S. bank, it is an entity with direct access to the Federal Reserve's discount window and federal deposit insurance.

I am authorized by the Commission to confirm that the CFTC's Division of Enforcement has opened an investigation related to credit derivative products traded by JPMorgan Chase's Chief Investment Office.

Although I am unable to provide any specific information about a pending investigation, I will describe generally the Commission's oversight of the swaps markets, the entities and products in our jurisdiction, and the Dodd-Frank reforms relevant to credit default swaps, and in particular index credit default swaps.

The role the unregulated swaps market played in the 2008 crisis led to a new international consensus that the time had come for comprehensive regulation.

Swaps, which were basically not regulated in Asia, Europe and the United States, should now be brought into the light of regulation.

When President Obama gathered together the G-20 leaders in Pittsburgh in 2009, they agreed that the swaps market needed to be reformed and that such reform should be completed by December 2012.

In 2010, Congress and the President came together and passed the historic Dodd-Frank Act.

The goal of the law is to:

- Bring public market transparency and the benefits of competition to the swaps marketplace;
- Protect against Wall Street's risks by bringing standardized swaps into centralized clearing; and
- Ensure that swap dealers and major swap participants are specifically regulated for their swap activity.

Despite different cultures, political systems and financial systems, we've made significant progress on a coordinated and harmonized international approach to reform.

Japan passed reform legislation in 2010, and has made real progress on their clearing mandate.

Further, they have a proposal before their Diet on the use of trading platforms, as well as post-trade transparency.

The European parliament last month adopted the **European Market Infrastructure Regulation (EMIR)** that includes mandatory clearing, reporting and risk mitigation for derivatives.

And the European Commission has published proposals providing for both pre-trade and post-trade transparency.

Other major jurisdictions, including the largest provinces in Canada, have the legislative authority and have made progress on swaps reform.

Implementation of Dodd-Frank Swaps Market Reforms

The CFTC has made significant progress in completing the reforms that will bring transparency to the swaps market and lower its risk to the rest of the economy.

During the rule-writing process, we have benefitted from significant public input.

CFTC Commissioners and staff have met over 1,600 times with the public and we have held 16 public roundtables on important issues related to Dodd-Frank reform.

We are consulting closely with other regulators on Dodd-Frank implementation, including the SEC, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and other prudential regulators.

This coordination includes sharing many of our memos, term sheets and draft work product.

In addition, we are actively consulting with international regulators to harmonize our approach to swaps oversight, and share memos, term sheets and draft work product with our international counterparts as well.

We substantially finished our proposal phase last spring, and then largely reopened the mosaic of rules for additional public comments.

We have accepted further public comment after the formal comment periods closed.

The agency received 3,000 comment letters before we proposed rules and more than 28,000 comment letters in response to proposals.

Last summer, we turned the corner and started finalizing rules. To date, we've completed 33 rules with less than 20 more to go.

The Commission is turning shortly to the rule to further define the terms "swap" and "security-based swap," the second of the two key joint further definition rules with the SEC.

The staff recently has put forth to the Commission a final rule for our consideration.

It is essential that the two Commissions move forward on the further product definition rulemaking expeditiously.

Consistent with the provisions of the Dodd-Frank Act, the proposal states the CFTC regulates credit default swaps on broad-based security indices, while the SEC regulates them on narrow-based security indices (as well as credit default swaps on single name securities or loans).

Under the proposal, most of the credit default swap indices compiled by the leading index provider, Markit, generally would be broad-based indices.

These indices would generally include, but not be limited to, Markit's CDX North American Investment Grade, as well as its CDX North American High Yield.

While the credit default swaps based on these indices would be swaps under CFTC jurisdiction, the SEC would retain certain anti-fraud and anti-manipulation enforcement authorities over them as well, as it had prior to Dodd-Frank.

Transparency

The Dodd-Frank financial reform shines bright lights of transparency – to the public and to regulators – on the swaps market for the benefit of investors, consumers, retirees and businesses in America.

Transparency is critical to both lowering the risk of the financial system, as well as reducing costs to end-users.

The more transparent a marketplace is to the public, the more efficient it is, the more liquid it is, and the more competitive it is.

The CFTC has completed key rules on transparency that, for the first time, provide a detailed and up-to-date view of the physical commodity swaps markets so regulators can police for fraud, manipulation and other abuses.

We have begun to receive position information for large traders in the swaps markets for agricultural, energy and metal products.

We also finished a rule establishing registration and regulatory requirements for swap data repositories, which will gather data on all swaps transactions.

Starting this summer, real-time reporting to the public and to regulators will begin for interest rate and credit default swaps with similar reporting on other swaps later this year.

Also later this year, market participants will benefit from the transparency of daily valuations over the life of their swaps.

By contrast, in the fall of 2008, there was no required reporting about swaps trading.

This month, we completed rules, guidance and acceptable practices for designated contract markets (DCMs).

DCMs will be able to list and trade swaps, helping to bring the benefit of pre-trade transparency to the swaps marketplace.

Looking forward, we have two important remaining transparency rules to complete related to block sizes and swap execution facilities (SEFs).

The trading of credit default swap indices will benefit from the transparency provided on SEFs.

The Japanese and European transparency proposals, as well as initiatives well underway in other jurisdictions, will further align international reform efforts and benefit the public.

Central Clearing

For over a century, through good times and bad, central clearing in the futures market has lowered risk to the broader public.

Dodd-Frank financial reform brings this effective model to the swaps market.

Standard swaps between financial firms will move into central clearing, which will significantly lower the risks of the highly interconnected financial system.

The CFTC has made significant progress on central clearing for the swaps market.

We have completed rules establishing new derivatives clearing organization risk management requirements.

To further facilitate broad market access, we completed rules on client clearing documentation, risk management, and so-called “straight-through processing,” or sending transactions immediately to the clearinghouse upon execution.

In addition, the Commission has adopted important customer protection enhancements.

The completed amendments to rule 1.25 regarding the investment of funds bring customers back to protections they had prior to exemptions the Commission granted between 2000 and 2005.

Importantly, **this prevents use of customer funds for in-house lending through repurchase agreements.**

Clearinghouses also will have to collect margin on a gross basis and futures commission merchants will no longer be able to offset one customer’s collateral against another and then send only the net to the clearinghouse.

And the so-called “LSOC rule” (legal segregation with operational comingling) for swaps ensures customer money is protected individually all the way to the clearinghouse.

Furthermore, Commissioners and staff have gotten a lot of feedback from market participants on additional customer protection enhancements, including through a public roundtable.

Staff is actively seeking further public input through our website and further meetings. Staff will use this outreach and review to put forward recommendations to the Commission for consideration.

In addition, the National Futures Association and the CME Group have proposals for greater controls for segregation of customer funds.

CFTC staff is working with these self-regulatory organizations on their proposals.

CFTC staff now is preparing recommendations for the Commission and for public comment on clearing requirement determinations.

The Commission's first determinations will be put out for public comment this summer and hopefully completed this fall.

They will begin with key interest rate products, as well as a number of CDX and iTraxx credit default swap indices.

There is a great deal of consistency among the major jurisdictions on the clearing requirement, and the CFTC's timeframe broadly aligns with both Japan and Europe.

Currently, clearing exists for much of the standardized interest rate swaps, as well as for credit default swap indices, done between dealers.

The major clearinghouses providing swaps clearing are registered with the CFTC.

Moving forward, the Commission will consider a final rule on the implementation phasing of the clearing requirement and the end-user exception related to non-financial companies.

Swap Dealers

Regulating banks and other firms that deal in derivatives is central to financial reform.

Prior to 2008, it was claimed that swap dealers did not need to be specifically regulated for their swaps activity, as they or their affiliates already were generally regulated as banks, investment banks, or insurance companies.

The crisis revealed the inadequacy of relying on this claim.

While banks were regulated for safety and soundness, including their lending activities, there was no comprehensive regulation of their swap dealing activity.

Similarly, bank affiliates dealing in swaps, and subsidiaries of insurance and investment bank holding companies dealing in swaps, were not subject to specific regulation of their swap dealing activities.

AIG, Lehman Brothers and other failures of 2008 demonstrate what happens with such limited oversight.

The CFTC is well on the way to implementing reforms Congress mandated in Dodd-Frank to regulate dealers and help prevent another AIG.

The Commission has finished sales practice rules requiring swap dealers to interact fairly with customers, provide balanced communications and disclose conflicts of interest before entering into a swap.

In addition, this agency has finalized internal business conduct rules to require swap dealers to establish policies to manage risk, as well as put in place firewalls between a dealer's trading, and clearing and research operations.

We completed in April a joint rule with the SEC further defining the terms "swap dealer" and "securities-based swap dealer," which is pivotal to lowering the risk they may pose to the rest of the economy.

Based on completed registration rules, dealers will register after we finalize the second major definition rule with the SEC: the further definition of the terms “swap” and “securities-based swap.”

Swap dealers who make markets in credit default swap indices would be amongst those dealers who may have to register with the CFTC.

Following Congress’ mandate, the CFTC also is working with our fellow financial regulators to complete the Volcker rule, which prohibits certain banking entities from engaging in proprietary trading.

In adopting the Volcker rule, Congress prohibited banking entities from proprietary trading, an activity that may put taxpayers at risk.

At the same time, Congress permitted banking entities to engage in certain activities, such as market making and risk mitigating hedging.

One of the challenges in finalizing a rule is achieving these multiple objectives.

The international community is closely coordinating on margin requirements for uncleared swaps, and is on track to seek public comment in June on a consistent approach.

This is critical to reducing the opportunity for regulatory arbitrage.

The CFTC’s proposed margin rule excludes non-financial end-users from margin requirements for uncleared swaps.

I’ve been advocating with global regulators that we all adopt a consistent approach.

The Commission is working with fellow regulators here and abroad on an appropriate and balanced approach to the cross-border application of Dodd-Frank swaps market reforms.

The CFTC will soon seek public comment on guidance regarding the cross-border application of Title VII rules.

Market Integrity/Position Limits

Financial reform also means investors, consumers, retirees and businesses in America will benefit from enhanced market integrity.

Congress provided the Commission with new tools in Dodd-Frank to ensure the public has confidence in U.S. swaps markets.

Rules the CFTC completed last summer close a significant gap in the agency's enforcement authorities.

The rules implement important Dodd-Frank provisions extending our enforcement authority to swaps and prohibited the reckless use of manipulative or deceptive schemes.

Thus, for example, the CFTC has clear anti-fraud and anti-manipulation authority regarding the trading of credit default swaps indices.

Also, the CFTC now can reward whistleblowers for their help in catching market misconduct.

Congress also directed the CFTC to establish aggregate position limits for both futures and swaps in energy and other physical commodities.

In October 2011, the Commission completed final rules to ensure no single speculator is able to obtain an overly concentrated aggregate position in the futures and swaps markets.

The Commission's final rules require compliance for all spot-month limits 60 days after the CFTC and SEC jointly adopt the rule to further define the term "swap" and "securities-based swap" and for certain other limits, following a collection of a year's worth of large trader swap data.

Two associations representing the financial industry, however, are challenging the agency's final rule establishing those limits in court.

The Commission is vigorously defending the Congressional mandate to implement position limits in court.

Last week, the Commission approved a proposed rule that would modify the CFTC's aggregation provisions for limits on speculative positions.

The proposal would permit any person with a **10 to 50 percent ownership or equity interest** in an entity to disaggregate the owned entity's positions, provided there are protections and firewalls in place to ensure trading decisions are made independently of one another.

The proposal was a response to a Working Group of Commercial Energy Firms (WGCEF) petition seeking relief from the aggregation provisions of the position limits rule.

Position limits is another area where there has been close international coordination.

The G-20 leaders endorsed an International Organization of Securities Commissions (IOSCO) report last November noting that market regulators should use position management regimes, including position limits, to prevent market abuses.

The European Commission has proposed such a position management regime to the European Parliament.

Cross-border Application of Dodd-Frank's Swaps Reforms

The Dodd-Frank Act states in Section 722(d) that swaps reforms shall apply to activities outside the United States if those activities have “a direct and significant connection with activities in, or effect on, commerce” of the United States.

CFTC staff will soon be recommending to the Commission to publish for public comment a release on the cross-border application of swaps market reforms.

It will consist of interpretive guidance on how these reforms apply to cross-border swap activities.

It also will include an overview as to when overseas swaps market participants, including swap dealers, can comply with Dodd-Frank reforms through reliance on comparable and comprehensive foreign regulatory regimes, or what we call “substituted compliance.”

There is further work to be done on the CFTC cross-border release, but the key elements of the staff recommendations are likely to include:

- **First**, when a foreign entity transacts in more than a de minimis level of U.S. facing swap dealing activity, the entity would register under the CFTC's recently completed swap dealer registration rules.
- **Second**, the release will address what it means to be a U.S. facing transaction.

I believe this must include transactions not only with persons or entities operating in the United States, but also with their overseas branches.

In the midst of a default or a crisis, there is no satisfactory way to really separate the risk of a bank and its branches.

Likewise, I believe this must include transactions with overseas affiliates that are guaranteed by a U.S. entity, as well as the overseas affiliates operating as conduits for a U.S. entity's swap activity.

- **Third**, based on input the Commission has received from market participants, the staff recommendations will include a tiered approach for requirements for overseas swap dealers.

Some requirements would be considered entity-level, such as for capital, risk management and recordkeeping.

Some requirements would be considered transaction-level, such as clearing, margin, real-time public reporting, trade execution and sales practices.

- **Fourth**, such entity-level requirements would apply to all registered swap dealers, but in certain circumstances, overseas swap dealers could comply with these requirements through substituted compliance.
- **Fifth**, such transaction-level requirements would apply to all U.S. facing transactions, but for certain transactions between an overseas swap dealer (including a foreign swap dealer that is an affiliate of a U.S. person) and counterparties not guaranteed by or operating as conduits for U.S. entities, Dodd-Frank may not apply.

For example, this would be the case for a transaction between a foreign swap dealer and a foreign insurance company not guaranteed by a U.S. person.

In putting together this release, we've already benefitted from significant input from market participants.

Throughout our nearly 60 rule proposals, we've consistently asked for input on the cross-border application of swaps reforms.

Commenters generally say **they support reform**.

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But in what some of them call a “clarification,” we find familiar narratives of the past as to why many swaps transactions or swap dealers should not be regulated.

Some commenters have expressed the view that if a transaction is done offshore, it should not come under Dodd-Frank.

Others contend that as long as an offshore dealer is regulated in some capacity elsewhere, many of the Dodd-Frank regulations applicable to swap dealers should not apply.

The law, the nature of modern finance, and the experiences leading up to the 2008 crisis, as well as the reminder of the last two weeks, strongly suggest this would be a retreat from much-needed reform.

When Congress and the Administration came together to draft the Dodd-Frank Act, they recognized the lessons of the past when they expressly set up a comprehensive regulatory approach specific to swap dealers.

They were well aware of the nature of modern finance: financial institutions commonly set up hundreds if not thousands of “legal entities” around the globe with a multitude of affiliate relationships.

When one affiliate of a large, international financial group has problems, it’s accepted in the markets that this will infect the rest of the group.

This happened with AIG, Lehman Brothers, Citigroup, Bear Stearns and Long-Term Capital Management.

Implementation Phasing

As we move on from the rule-writing process, a critical part of our agenda is working with market participants on phased implementation of these reforms.

We have reached out broadly on this topic to get public input.

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Last spring, we published a concepts document as a guide for commenters, held a two-day, public roundtable with the SEC, and received nearly 300 comments.

Last year, the Commission proposed two rules on implementation phasing relating to the swap clearing and trading mandates and the swap trading documentation and margin requirements for uncleared swaps.

We have received very constructive public feedback and hope to finalize the proposed compliance schedules in the next few months.

In addition to these proposals, the Commission has included phased compliance schedules in many of our rules.

For example, both the data and real-time reporting rules, which were finalized this past December, include phased compliance.

The first required reporting will be this summer for interest rate and currency swaps. Other commodities have until later this fall.

Additional time delays for reporting were permitted depending upon asset class, contract participant and in the early phases of implementation.

The CFTC will continue looking at appropriate timing for compliance, which balances the desire to protect the public while providing adequate time for industry to comply with reforms.

Resources

Confidence in the futures and swaps markets is dependent upon a well-funded regulator.

The CFTC is a good investment of taxpayer dollars.

This hardworking staff of 710 is just 10 percent more than what we had in the 1990s though the futures market has grown fivefold.

The CFTC also will soon be responsible for the swaps market – eight times bigger than the futures market.

Picture the NFL expanding eightfold to play more than 100 football games in a weekend, leaving just one referee per game, and, in some cases, no referee.

Imagine the mayhem on the field, the resulting injuries to players, and the loss of confidence fans would have in the integrity of the game.

Market participants depend on the credibility and transparency of well-regulated U.S. futures and swaps markets.

Without sufficient funding for the CFTC, the nation cannot be assured that the agency can adequately oversee these markets.

Conclusion

Nearly four years after the financial crisis and two years since the passage of Dodd-Frank, **it's critical that we fully implement the historic reforms of the law.**

It's critical that we do not retreat from reforms that will bring greater transparency and competition to the swaps market, lower costs for companies and their customers, and protect the public from the risks of these international markets.

In 2008, **the financial system and the financial regulatory system failed.**

The crisis plunged the United States into the worst recession since the Great Depression with eight million Americans losing their jobs, millions of families losing their homes and thousands of small businesses closing their doors.

The financial storms continue to reverberate with the debt crisis in Europe affecting the economic prospects of people around the globe.

The CFTC has made significant progress implementing reform having largely finished the rule proposals, and now having completed well over half of the final rules.

We are on schedule to complete the remaining reforms this year, but until we do, the public is not fully protected.

Last Updated: May 22, 2012

Note

Gary Gensler was sworn in as the Chairman of the Commodity Futures Trading Commission on May 26, 2009.

Chairman Gensler previously served at the U.S. Department of the Treasury as Under Secretary of Domestic Finance (1999-2001) and as Assistant Secretary of Financial Markets (1997-1999).

He subsequently served as a Senior Advisor to the Chairman of the U.S. Senate Banking Committee, Senator Paul Sarbanes, on the Sarbanes - Oxley Act, reforming corporate responsibility, accounting and securities laws.

As Under Secretary of the Treasury, Chairman Gensler was the principal advisor to Treasury Secretary Robert Rubin and later to Secretary Lawrence Summers on all aspects of domestic finance.

The office was responsible for formulating policy and legislation in the areas of U.S. financial markets, public debt management, the banking system, financial services, fiscal affairs, federal lending, Government Sponsored Enterprises, and community development.

In recognition of this service, he was awarded Treasury's highest honor, the Alexander Hamilton Award.

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Prior to joining Treasury, Chairman Gensler worked for 18 years at Goldman Sachs, where he was selected as a partner; in his last role he was Co-head of Finance.

Chairman Gensler is the co-author of a book, **The Great Mutual Fund Trap**, which presents common sense investment advice for middle income Americans.

He is a summa cum laude graduate from the University of Pennsylvania's Wharton School in 1978, with a Bachelor of Science in Economics and received a Master of Business Administration from the Wharton School's graduate division in 1979.

He lives with his three daughters outside of Baltimore, Maryland.



Thomas Jordan: Challenges facing the Swiss National Bank

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, to the General Meeting of Shareholders of the Swiss National Bank, 27 April 2012.

Mr President of the Bank Council

Dear Shareholders

Dear Guests

Also from a monetary policy perspective, the Swiss National Bank (SNB) has experienced another difficult year.

In 2011, the escalation of the European sovereign debt crisis triggered a very substantial appreciation of the Swiss franc.

In order to **avert major damage to the Swiss economy**, and work against the threat of a deflationary trend, the SNB had to react fast with exceptional measures.

I would like to begin by giving you a review of economic developments and monetary policy in 2011.

Then I will present our assessment of the international economic outlook and its impact on the Swiss economy.



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I will also outline the outlook for price stability. I will conclude by explaining the SNB's reflections on current monetary policy.

First, let me begin by reviewing the events of last year.

Review of 2011

In terms of the economic cycle, the year 2011 certainly began well.

Overall, economic activity was lively, and the situation on the labour market improved further.

Despite the appreciation of the Swiss franc in 2010, goods exports were robust during the first few months of the year.

However, in spring 2011, the international economic recovery stalled.

This was attributable to several different factors.

In major advanced economies, stimuli from fiscal policies diminished.

Moreover, in the second quarter in particular, international economic growth suffered from the effects of the Japanese earthquake and tsunami.

The destruction of production plants for important intermediate goods for the electronics industry led to substantial supply problems worldwide, which resulted in production losses.

Finally, **the concerns about fiscal problems in many advanced economies increased.**

In particular, the risk that the European sovereign debt crisis might escalate hung like a sword of Damocles over the outlook for the entire international economy.

The debt crisis did indeed escalate in the second half of the year.

While, initially, it was only the small peripheral states of the euro area that encountered problems because of their high levels of debt, the loss of confidence increasingly affected the larger economies of Europe as well.

At the same time, **there was growing concern about the stability of European banks.**

Given these developments, uncertainty in financial markets increased sharply in the second half of the year.

At the same time, **the demand for safe-haven investments soared.**

As we all know, these investments include those in the Swiss franc. The Swiss currency had already gained in value in the second quarter.

However, between July and the beginning of August, it appreciated very substantially within a very short period.

In August 2011, **the Swiss franc reached an all-time high against both the euro and the US dollar, in both nominal and real terms.**

Ladies and Gentlemen, in August 2011, the Swiss franc was massively overvalued, according to any yardstick.

In addition, in practically the same period, the international economic environment had become noticeably gloomier.

This situation presented an acute risk to our economy, as well as carrying the threat of a deflationary trend.

Consequently, the SNB reacted fast and announced an unscheduled interest rate reduction on 3 August.

In addition, from this moment onwards, **it increased the supply of Swiss franc liquidity by a hitherto unprecedented amount, in several steps, with the aim of weakening the Swiss currency.**

Overall, the liquidity measures achieved the expected results. They brought about significantly lower interest rates in the Swiss franc money market – interest rates that were, at times, even negative.

This tended to weaken the attractiveness of Swiss franc investments.

Thus the upward trend of the Swiss franc against the euro was checked for the time being.

However, the exchange rate remained very volatile, due to the persistence of negative reports from abroad, and at the end of August the Swiss franc appreciated again.

In this market environment, which was extremely uncertain and nervous because of the European debt crisis, the liquidity measures were ultimately insufficient to halt the appreciation of the Swiss franc.

In recognition of this fact, the SNB decided to introduce a measure which was exceptional in every respect.

On 6 September, the SNB set a minimum exchange rate of CHF 1.20 per euro.

It stated that it would enforce this minimum rate with the utmost determination and was prepared to buy foreign currency in unlimited quantities for this purpose.

This policy is still in force, without any restriction.

The impact on the Swiss economy of the deterioration in the international environment as well as the exchange rate movements in July and August had been steadily increasing.

Economic activity weakened significantly over the course of 2011 and the pressure on profit margins intensified further in many industries.

However, in the past few months there have been growing signs that the economic situation in Switzerland has stabilised as a result of the minimum exchange rate.

Thus the minimum exchange rate of CHF 1.20 per euro has, to date, proved to be effective.

It has reduced the very substantial overvaluation of the Swiss franc.

Moreover, the extreme exchange rate fluctuations which had been experienced previously have been lessened.

This has given business leaders a better basis for planning, thereby clearly limiting the damage inflicted by the appreciation of the Swiss franc on the real economy.

However, apart from the exchange rate, future economic growth in our country will once again depend on developments in the international economy.

That is why I will now present to you our assessment of the international economic outlook.

Economic outlook and outlook for price stability

The latest economic statistics suggest that the international economic recovery will continue, although growth rates are likely to be on the low side by comparison with typical recovery phases.

The debt reduction process which private households in the US are currently undergoing and the consolidation of government finances in several European countries, in particular, are dampening economic activity in the short term.

Nevertheless, the recovery should gradually gain some strength.

However, it is by no means certain that this moderately positive scenario for the international economy will become reality.

The international environment continues to be highly uncertain.

The European sovereign debt problem still presents the biggest risk. It is unclear whether the measures taken so far will really succeed in defusing the situation permanently.

Consequently, the sovereign debt crisis still has the potential to seriously affect the international financial system as well as international economic development.

What does this international environment mean for the Swiss economy?

The year 2012 is likely to be another difficult one.

At CHF 1.20 against the euro, the Swiss currency is still overvalued and presents major challenges to our economy.

Many companies have been forced to reduce their prices, which has lowered their turnover in nominal terms.

Companies exposed to international competition, with considerable depth of production in Switzerland, in particular, are facing pressure on their profit margins.

An additional factor is the muted outlook for the international economy.

Combined with the continued high level of uncertainty with respect to the European debt problem, this is likely to limit the willingness to invest in Switzerland.

However, there are reasons for a certain degree of confidence as far as our economy is concerned.

For instance, the low level of interest rates is still having a stimulating effect on the economy. Domestic demand continues to be supported by high immigration.

In addition, the repercussions of the high Swiss franc value are not only negative.

For example, imported preliminary products for companies and consumer goods for households have become cheaper.

Finally, Swiss firms and their employees have made huge efforts to deal with this difficult situation.

Overall, the SNB expects moderate economic growth of close to 1% for the year 2012.

This modest economic momentum is likely to be reflected in a moderate increase in unemployment over the course of the next few quarters.

The expected economic activity is lower than would be the case for normal capacity utilisation.

This means there will be no inflationary pressure from this source.

Our conditional inflation forecast of mid-March 2012 shows that there is no risk of inflation in Switzerland in the foreseeable future.

The forecast also makes it clear that the threat of a deflationary trend has been kept in check.

Inflation rates are only temporarily negative.

Nevertheless, the monetary policy challenges for the SNB remain very considerable.

I would now like to go into a little more detail on our reflections on monetary policy, particularly with respect to the minimum exchange rate.

Reflections on Swiss monetary policy

After being announced on 6 September 2011, the minimum exchange rate was rapidly attained.

When our press release was issued, at exactly 10 am, the euro was trading at a little over CHF 1.12.

Within minutes, the exchange rate exceeded the CHF 1.20 mark.

Seen from the outside, this may have created the impression that a minimum exchange rate can simply be generated by pressing a button and that such an exchange rate is a normal monetary policy measure which is straightforward to implement.

That is far from being the case.

A minimum exchange rate is an extreme measure, only to be introduced in a situation of massive overvaluation, with the aim of averting the worst developments.

It is neither a panacea capable of solving all the problems facing the Swiss economy, nor can it simply be implemented for any desired level, free of any risk.

On the contrary.

A minimum exchange rate can only be successfully implemented if there is a clear economic justification for its introduction, such as a massive overvaluation resulting from adverse developments on the foreign exchange market.

Within the framework of a system of flexible exchange rates, it is also important that it be internationally accepted, and that it is not seen as a competitive depreciation.

Finally, a vital element in the successful implementation of such an exchange rate is the central bank's credibility, in other words, the belief that the central bank will indeed defend the minimum exchange rate, if need be.

Financial markets are constantly changing their assessment of risks. A situation may also occur in which the market decides to test the defence of the minimum exchange rate.

Consequently, the SNB is present in the foreign exchange market at all times and is always prepared to purchase unlimited quantities of euros at CHF 1.20 per euro, in order to enforce the minimum exchange rate.

When trading took place at less than CHF 1.20 per euro, it was only for a few seconds and resulted from market idiosyncrasies.

Since 6 September, the best rate in the market for the sale of euros against Swiss francs has never fallen below CHF 1.20.

The SNB was thus able to successfully enforce the minimum exchange rate even under extremely difficult conditions.

These considerations clearly show that the introduction of a minimum exchange rate is associated with risks.

Under certain circumstances, implementing such a rate can lead to a very considerable expansion of foreign currency reserves.

The SNB is prepared to bear the risk.

Indeed, in summer 2011, the situation had become so acute that, by early September, the SNB felt that there was no longer any alternative to introducing a minimum exchange rate.

Doing nothing would have had an extremely negative impact on our economy.

Even at a rate of CHF 1.20 per euro, the Swiss franc remains overvalued.

We are acutely aware that considerable challenges still remain for the Swiss economy, despite the minimum exchange rate.

One particular reason for this is the fact that the international economy is recovering at only a moderate pace.

In addition, there is a very high level of uncertainty in the international environment.

An appreciation of the Swiss franc at the current time would again expose Switzerland to considerable risks and, once more, endanger both price stability and the stabilisation of the economy.

Given this situation, the SNB will enforce the minimum exchange rate with the utmost determination.

If developments in the international economy are worse than foreseen, or if the Swiss franc does not weaken further as expected, renewed downside risks for price stability could emerge.

Should the economic outlook and the threat of deflation require it, the SNB is prepared at any time to take further measures.

As you will probably have deduced from this account, seen from today's vantage point, interest rates in Switzerland are likely to remain low for a while yet.

This expansionary monetary policy is indispensable from the point of view of the economy as a whole.

In that it has significantly reduced the threat to the economy and the threat of a deflationary trend, the current monetary policy is also contributing to financial stability – in the short term.

Both a deep recession and a deflationary trend would pose a threat to the banking system.

In the longer term, a period of low interest rates carries the risk that imbalances will build up.

In Switzerland, the current low-interest-rate period has now lasted for over three years.

We are – in fact – currently observing increasing signs of adverse developments in the Swiss mortgage and real estate market for residential property.

The explanatory power of fundamental factors in explaining the developments in residential real estate prices is decreasing steadily, while the volume of mortgage loans in comparison to GDP has never been so high.

Should these imbalances increase further, considerable risks to financial stability could emerge.

Given this situation, the SNB has strongly advocated the introduction of a countercyclical capital buffer in Switzerland.

This buffer would not be a permanent increase in equity requirements for banks.

It is only to be activated temporarily in the event of excessive growth in domestic mortgage lending.

As soon as lending growth weakens again, the buffer can be deactivated.

An instrument of this kind was examined in detail last year by a working group headed by the Federal Department of Finance, to which both FINMA and the SNB also belonged.

The group proposed that the buffer be introduced rapidly so that a suitable instrument would be in place, in case the imbalances in the Swiss mortgage and real estate market increased further.

Concluding remarks

Ladies and Gentlemen, as you will have gathered from my remarks today, the challenges facing the SNB have not diminished.

Consequently, it is all the more important that we are able to devote our complete attention to our tasks, now and in the future.

The SNB's monetary policy decisions are directed purely and solely at fulfilling its statutory mandate.

It is our responsibility to ensure price stability.

In doing so, we take account of the development of the economy and make a contribution to the stability of the financial system.

The SNB pursues a monetary policy that serves the interests of the country as a whole, and we fulfil this mandate as an independent central bank.

To do this, we continue to rely on the total commitment of our staff, whom I would like to thank – also in the name of my colleague, Jean-Pierre Danthine – for their hard work and their solidarity with the SNB.

We thank our shareholders for their continuing support.

And we thank you all for taking such a great interest in the activities of the SNB.

Finally, we would also like to thank our former colleague and Chairman of the SNB Governing Board, Philipp Hildebrand, for the good collaboration we enjoyed over the years.

We very much regret his resignation and the circumstances leading up to it.

Thank you for your attention

Notes

Mandate

The Swiss National Bank conducts the country's monetary policy as an independent central bank.

It is obliged by Constitution and statute to act in accordance with the interests of the country as a whole.

Its primary goal is to ensure price stability, while taking due account of economic developments.

In so doing, it creates an appropriate environment for economic growth.

Price stability

Price stability is an important condition for growth and prosperity.

Inflation and deflation, by contrast, impair economic activity.

They complicate decision-making by consumers and producers, lead to misallocations of labour and capital, result in income and asset redistributions, and put the economically weak at a disadvantage.

The SNB equates price stability with a rise in the national consumer price index of less than 2% per annum.

Deflation – i. e. a protracted decline in price levels – is considered to be equally detrimental to price stability.

The SNB takes its monetary policy decisions on the basis of an inflation forecast.

Implementation of monetary policy

The SNB implements its monetary policy by steering liquidity on the money market and thereby influencing the interest rate level.

The three-month Swiss franc Libor serves as its reference interest rate.

In addition, since 6 September 2011, a minimum exchange rate for the euro against the Swiss franc has also applied.

Cash supply and distribution

The SNB is entrusted with the note-issuing privilege.

It supplies the economy with banknotes that meet high standards with respect to quality and security.

It is also charged by the Swiss Confederation with the task of coin distribution.

Cashless payment transactions

In the field of cashless payment transactions, the SNB provides services for payments between banks.

These are settled in the interbank payment system (SIC system) via sight deposit accounts held with the SNB.

Asset management

The SNB manages the currency reserves, the most important component of its assets.

Currency reserves engender confidence in the Swiss franc, help to prevent and overcome crises, and may be utilised for interventions in the foreign exchange market.

Financial system stability

The SNB contributes to the stability of the financial system.

Within the context of this task, it analyses sources of risk to the financial system, oversees systemically important payment and securities settlement systems and helps to promote an operational environment for the financial sector.

International monetary cooperation

Together with the federal authorities, the SNB participates in international monetary cooperation and provides technical assistance.

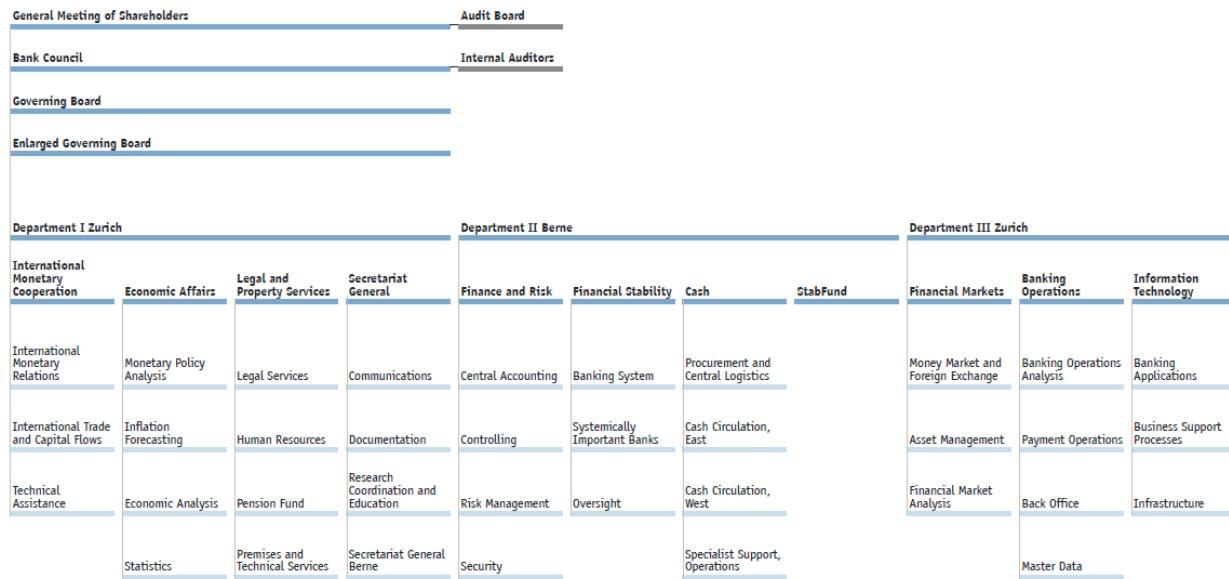
Banker to the Confederation

The SNB acts as banker to the Confederation. It processes payments on behalf of the Confederation, issues money market debt register claims and bonds, handles the safekeeping of securities and carries out money market and foreign exchange transactions.

Statistics

The SNB compiles statistical data on banks and financial markets, the balance of payments, direct investment, the international investment

position and the Swiss financial accounts.



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