



# Regulatory capital reform

The global banking crisis has led regulators to propose fundamental changes to the quantity and quality of bank capital. We review the main proposals in this briefing.

The regulatory response to the global banking crisis is currently under discussion at the highest levels. Most notably this has just been considered in some detail at the meeting of the G20 in London on 2 April 2009. Reforms to regulatory capital requirements for banks and other financial institutions lie at the heart of these discussions, as emphasised by the G20 leaders agreeing to take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system. In this briefing we identify the main areas that are likely to form the substance of the proposed reforms.

## Counter-cyclical

The regulatory framework under Basel II, which is more risk-sensitive than its predecessor, Basel I, has been criticised for creating pro-cyclical effects by matching capital requirements to risk, resulting in regulatory capital levels fluctuating according to the broader economic cycle. With the creditworthiness of borrowers declining during a downturn, the result of Basel II's risk approach is broadly to require banks to hold more capital during bad times.

A consensus is emerging that the current Basel II framework should be amended to reduce these pro-cyclical effects. Although this would be likely to constrain the growth of bank lending during good times, it should reduce the need for banks to cut back on lending during a downturn to maintain capital ratios.

It may be possible to take steps within the existing system to mitigate Basel II's pro-cyclical effects. The Turner Review, published on 18 March 2009, notes that the level of pro-cyclical effects under Basel II depends, to some extent, on the risk models used by banks and whether these are based on so-called 'through-the-cycle' or 'point in time' estimates of losses that are likely to arise (with the 'through-the-cycle' approach being less pro-cyclical). However, any risk-based measure of capital required is inherently pro-cyclical and so there may be a need for expressly counter-cyclical measures.

At a global level, the Basel Committee on Banking Supervision (the Basel Committee) has accepted the need for such measures. Following its 10-11 March 2009 meeting, the Basel Committee announced that the level of capital in the banking system needs to be strengthened to raise its resilience to future episodes of economic and financial stress. This was envisaged to be achieved by a number of measures, including capital buffers that could be drawn down during periods of stress and also by introducing a non-risk based supplementary measure. The Financial Stability Forum (FSF) published more detailed proposals in its report dated 2 April 2009 in the areas of capital, provisioning and valuation and leverage. The FSF's recommendations on bank capital included the following:

- the Basel Committee should strengthen the regulatory capital framework so that the quality and level of capital increase during strong economic conditions and can be drawn down during periods of economic and financial stress;

- the Basel Committee should revise the market risk framework of Basel II to reduce the reliance on cyclical VaR-based capital estimates (see further below);
- the Basel Committee should supplement the risk-based capital requirement with a simple, non-risk based measure to help contain the build-up of leverage in the banking system and put a floor under the Basel II framework;
- supervisors should use the Basel Committee's enhanced stress testing practices as a critical part of the Pillar 2 supervisory review process to validate the adequacy of banks' capital buffers above the minimum regulatory capital requirement; and
- the Basel Committee should continue to monitor the impact of the Basel II framework and make appropriate adjustments to dampen excessive cyclicality of the minimum capital requirements.

The G20 leaders also emphasised in the communiqué of 2 April 2009 that strengthened regulation and supervision must 'dampen rather than amplify the financial and economic cycle' and that regulation should in future require buffers of resources to be built up in good times. In particular, the new Financial Stability Board (FSB) (essentially an expanded, strengthened and re-established FSF), the Basel Committee and the Committee on the Global Financial System were mandated to take forward, implementation of the recommendations to mitigate pro-cyclicality with a deadline of end 2009, including the requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate.

In Europe, the *de Larosière* report, published on 25 February 2009, recognised that instead of having a dampening effect, the current regime has amplified market trends. The report suggested that regulation should introduce specific counter-cyclical measures and in this regard noted that the 'dynamic provisioning' introduced by the Bank of Spain appeared as a practical way of dealing with the issue, ie building up counter-cyclical buffers and allowing these under certain circumstances to be drawn down in recessions. Another method would be to move capital requirements in a similar anti-cyclical way.

On a UK level, the Turner Review agrees that there are 'strong arguments for taking action to avoid unnecessary

pro-cyclicality but also for introducing overt counter-cyclicality into the capital regime'. In considering the introduction of counter-cyclical measures, the Turner Review notes that the level of any capital buffer could be defined in one of the following ways:

- *Discretionary system*: the regulator would judge the appropriate level of required capital ratios in the light of analysis of the macroeconomic cycle and of macro-prudential concerns; or
- *Formula-driven system*: the required level of capital would vary according to a pre-determined metric, such as the growth of the balance sheet or estimates of average 'through-the-cycle' loans.

The Financial Services Authority (FSA) appears to favour the latter option combined with some degree of regulatory discretion to add further requirements where appropriate.

The Turner Review questions whether the additional buffer should form part of the regulatory capital requirement, with the capital ratio varying through the cycle, or whether it should be a separate reserve excluded from capital calculations.

The Turner Review also advocates the introduction of a gross leverage backstop. The FSA states that it believes the case for a maximum gross leverage ratio (the ratio of total assets to capital) is compelling and that it will be putting this case forward at the international level.

## Trading book capital

Increasing leverage in banks has been identified by regulators as one of the causes of the banking crisis. The Turner Review notes that on-balance sheet leverage increases were driven in some cases by dramatic increases in gross assets (and derivative positions). But these asset growths were concentrated in the trading book that has light capital requirements compared with the banking book. The report illustrates this with examples including a case where 57 per cent of a bank's assets were held in trading book but where trading book capital was only four per cent of the total capital requirement.

The regulatory response at an international and European level and by the FSA is to call for significant increases in trading book capital. At the international

level, the Basel Committee has consulted on measures for implementation by 2010 requiring (i) stressed value-at-risk (VaR) calculations, (ii) an incremental capital charge, and (iii) increased charges for securitisations. On 25 March 2009, the European Commission (the Commission) issued a working document dealing with possible changes to the Capital Requirements Directive (CRD) covering each of the measures proposed by the Basel Committee. The FSA endorses these measures but the Turner Review also calls for a more radical review of trading book risk measurement.

### **Value-at-risk**

The Turner Review identifies several deficiencies with the internal VaR model approach to the measurement of market risk (ie the risk of a price change in an investment owing to a change in the level of interest rates or broad market movements). In summary, the perceived problems with the VaR approach, which essentially uses historical patterns of price movement as a predictor of future market risk, are that it can create pro-cyclical behaviour: it can lead a bank to think that it is facing a low risk when at systemic level the risk is extreme because it fails to capture low probability high impact events.

The Basel Committee and the Commission therefore propose strengthening the existing standards for firms using VaR models. The capital charge will include an additional VaR measure based on a period of significant financial stress. There is also some further prescription as to the factors to be included in internal models. For example, banks will be expected to justify not including in models any factors that are included in the pricing of products. It is also proposed to extend the prudent valuation guidance (under which adjustments to current value are required where there is uncertainty around the current realisable value of a position due to illiquidity) to all positions subject to fair-value accounting. This may require adjustments in addition to any changes required for financial-reporting purposes.

### **Incremental risk capital charge (IRC)**

The Basel Committee and the Commission also propose introducing an incremental risk capital charge (IRC) that represents an estimate of the default and migration risks of unsecuritised positions. The IRC will apply to

firms that have approval to model specific risk – the risk of a price change in an investment due to factors related to its issuer. This is an expansion of a previous requirement imposed in July 2005 designed to capture the increased exposure in banks' trading books to credit risks, which was not captured in VaR models. As noted, the IRC is intended also to cover credit migration risk – ie not only the risk of actual default but also the risk of the change in credit ratings combined with the widening of credit spreads and the loss of liquidity. No specific approach is prescribed for calculating this risk although there are guidelines in the Basel document and in the proposed CRD amendments to specify the positions and risk to be covered by the IRC. These indicate that a bank's IRC model must measure losses due to default and migration at a 99.9 per cent confidence level over a one-year horizon.

### **Alternative approach – adopting banking book treatment**

The Basel Committee is concerned about incentives to arbitrage between the traditionally more favourable treatment of credit risk in the trading book and the banking book. It therefore suggests copying the charges that are applied to securitisation positions in the banking book into the trading book approach. The Committee also raises the possibility of adopting this approach for all trading book positions that are subject to specific risk capital requirements.

### **Effect of changes**

The proposed changes to trading book capital will reduce or remove entirely the regulatory capital advantage of holding credit exposures in the trading book rather than the banking book. This is likely to make proprietary trading an unattractive business proposition for banks, although there are suggestions in the Turner Review of a more favourable treatment for positions held to facilitate transactions for clients (eg market making and underwriting).

### **Securitisation**

Before the banking crisis, securitisation had been widely recognised as an important funding and risk diversification tool for the market. However, as the Turner Review makes clear, diversification of risk had not actually been achieved; the vast majority of the losses

that arose were not on the books of end investors whose intention it was to hold the assets to maturity, but on the books of banks and bank-like institutions that had retained positions or had provided liquidity facilities to special purpose vehicles (SPVs), which held the assets.

Regulatory and supervisory institutions have made a range of proposals designed to restore discipline and confidence to the securitisation market. We highlight here three areas of focus:

- requiring originators to retain on their books a meaningful amount of the underlying risk;
- risk management and due diligence; and
- the treatment of ‘resecuritisations’.

### **Skin in the game**

In its October 2008 proposals to amend the CRD, the Commission suggested that investors should be required to ensure that originators and sponsors retain a ‘material share of the risks and in any event not less than 5 per cent of the total securitised participations’. In terms of quantum, the 5 per cent retention requirement is a significant reduction from both the 15 per cent minimum capital charge proposed in April 2008 and the 10 per cent minimum capital charge proposed in June 2008.

It is proposed that the retention requirement will apply to exposures incurred by credit institutions after 1 January 2011. It would apply to two categories of entities. Firstly, to ‘the persons or entities that directly negotiated, structured and documented the original agreement with the obligor or potential obligor’ and, secondly, to ‘the persons or entities that manage and purchase such obligations or potential obligations directly or indirectly on behalf of the credit institution’. In both cases, the entities in question ‘must have issued an *explicit commitment* to the credit institution to maintain, on an ongoing basis, a material net economic interest and, in any event, not less than 5 per cent in positions having the same risk profile as the one that the credit institution is exposed to’.

It is commonly stated that the retention requirement will mean that, in practice, the originator and/or the sponsor would be required to commit to retaining at least 5 per cent of the credit risk of each tranche (a ‘vertical strip’) in a securitisation sold to investors that include a credit institution. What is less clear, however, is:

- whether the retention requirement may prevent UK investors from investing in products originating from outside the EU;
- whether it is practicable or feasible for investors to monitor and enforce compliance of originators and/or sponsors with the retention requirement;
- whether those retained positions are permitted to be hedged;
- how such an ‘explicit commitment’ would be practically implemented; and
- what effect the retention requirement would have on the liquidity of the notes issued (assuming that such an ‘explicit commitment’ would need to be transferred or entered into afresh with a secondary investor).

In the context of these questions, it is relevant to note that the HM Treasury report entitled *Mortgage finance: final report and recommendations* published in November 2008 commented that ‘it is important that any specific proposal on retention is based on firm evidence that they will bring benefits to these markets, while avoiding unintended consequences’. It remains to be seen if any ‘unintended consequences’ will follow the introduction of an amended CRD, eg arising from the fact that the retention requirement does not apply to investors other than credit institutions.

### **Risk management and due diligence**

The G20 leaders at the Washington summit on 20 November 2008 identified the importance of risk management as one of their common principles and, in particular, that reforms should be aimed at ensuring that banks exercise effective risk management and due diligence over structured products and securitisation. In furtherance of this objective, the Commission proposed in its amendments to the CRD that credit institutions should be required to demonstrate to their competent authority (in respect of each securitisation position they hold) that they have a thorough understanding of and have implemented formal policies and procedures for analysing and recording the risk characteristics of the position and the exposures underlying the position. This will include analysing:

- the prior loss experience of the originator;
- the due diligence carried out by the originators and/or sponsors on the obligors;

- the collateral quality of the exposures underlying the securitisation position; and
- the valuation methodologies and concepts in respect of the collateral supporting those exposures.

Additionally, credit institutions will be required to establish formal procedures to monitor performance of the exposures underlying their securitisation positions, including: information on the percentage of loans more than 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; collateral type and occupancy; frequency distribution of credit scores or other measures of credit worthiness across underlying exposures; industry and geographical diversification; and frequency distribution of loan-to-value ratios. If these requirements have not been satisfied, credit institutions will be required to apply a risk weight of 1,250 per cent to the relevant securitisation positions.

The G20 in London on 2 April 2009 agreed that the Basel Committee and national authorities should take forward the work on improving incentives for risk management of securitisation, including considering due diligence and quantitative retention requirements, by 2010.

Taken together, these requirements will require a significant increase in due diligence by the holders of securitisation positions and more transparency in the information that is provided to them. This may lead, for example, to the introduction of virtual data rooms on a transaction by transaction basis.

### Resecuritisations

On 16 January 2009 the Basel Committee published *Proposed Enhancements to the Basel II Framework* for consultation and comment by 17 April 2009, and for implementation in December 2009. It commented that the banking crisis has clearly shown that collateralised debt obligations comprised of asset-backed securities (ie collateralised debt obligations (CDOs) of asset-backed securities (ABS) – so-called ‘resecuritisations’) are more highly correlated with systematic risk than are traditional securitisations and, for this reason, the Basel Committee has proposed that resecuritisations warrant a higher capital charge.

The Basel Committee defines a resecurisation exposure as a securitisation exposure where one or more of the underlying exposures meet the Basel II framework’s

definition of a securitisation exposure. The definition of resecuritisations would capture:

- CDOs of ABSs including, for example, CDOs backed by residential mortgage-backed securities (RMBS);
- a liquidity facility to an asset-backed commercial paper (ABCP) programme;
- a transaction within an ABCP programme that holds asset-backed securities; and
- a securitisation exposure where the underlying exposures consists of hundreds of mortgage loans and a single ABS.

Any multi-tiered or multiple SPV structure or any structure that is designed to ‘repackage’ assets will need to be considered very carefully to ensure that it will not constitute a resecuritisations for the purposes of the CRD.

The Basel Committee has proposed that exposures to resecuritisations will require, in some cases, up to 3.5 times more capital than securitisation exposures. Previously, there was no distinction between the two exposures. Furthermore, to maintain consistency between the ratings-based approach and the supervisory formula approach, the FSA floor-risk weight would be set at 20 per cent for resecuritisations exposures and would remain at seven per cent for other securitisation exposures. Also, the minimum capital required for resecuritisations exposures held in the trading book must be no less than the amount required under banking book treatment.

### Liquidity

Liquidity risks have been a central feature of the banking crisis and this has prompted the Basel Committee to revise its principles for the management and supervision of liquidity risk. The G20 in London on 2 April 2009 agreed that the Basel Committee and national authorities should develop and agree by 2010 a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions. At a UK level, the FSA has been consulting on substantial new rules to come into force in October 2009 covering qualitative and quantitative liquidity requirements. If you would like to know more about this please see our separate briefing note on the FSA’s proposals at [www.freshfields.com/publications/pdfs/2009/jan09/24841.pdf](http://www.freshfields.com/publications/pdfs/2009/jan09/24841.pdf).

## Quality of capital

Strengthening the quality of bank capital was one of the initiatives announced by the Basel Committee following its 10-11 March 2009 meeting and was also emphasised by the G20 in London on 2 April 2009. The Turner Review notes that capital of a lower quality than Core Tier 1 (share capital and reserves) has proved ineffective in absorbing losses on a 'going concern' basis during the banking crisis. Accordingly, it proposes that required capital ratios for systemically important banks should be expressed entirely in terms of Tier 1 capital and should not include term subordinated debt.

Detailed proposals in relation to quality of capital (other than proposals to amend the CRD to harmonise the requirements for and permitted amount of 'hybrid' Tier 1 capital) have not yet been put forward at an international level but it seems that fundamental changes to strengthen the quality of capital, along the lines suggested in the Turner Review, may well be proposed.

## Regulatory architecture

Plans for a new regulatory architecture for prudential supervision remain very much under discussion. However, although there are calls for rule making to be further centralised at a global or regional level, day to day supervision of banks and other financial institutions seems likely to remain the responsibility of national supervisors. A consensus is emerging on the need for greater co-operation between those supervisors: the enhancement of co-ordination and co-operation between regulators, particularly in relation to crisis prevention, management and resolution, was one of the key commitments made by G20 members in their declaration of 15 November 2008. The main means proposed to achieve this is the strengthening of the current system of colleges of supervisors.

The FSF originally recommended in its May 2008 report that supervisory colleges of the most relevant supervisors for each of the largest global financial institutions should be established by the end of 2008. The G20 leaders agreed at the London Summit on 2 April 2009 that the new FSB will be tasked with setting guidelines for and supporting the establishment and functioning of and participation in supervisory colleges, including through ongoing identification of the most systematically important cross-

border firms. Relatively informal colleges of supervisors at a global level are already in place for most of the largest banking and financial groups. The G20 have agreed to establish the remaining supervisory colleges for significant cross-border firms by June 2009.

In Europe, the Commission has proposed amending the CRD to require the establishment of colleges of supervisors for groups that are subject to consolidated supervision. The purpose of colleges would be to provide a forum for the consolidating supervisor and other supervising authorities to:

- exchange information;
- agree on the allocation and delegation of responsibilities;
- determine a programme of supervision for the institution in question;
- remove duplication of supervisory requirements (in particular, on requests for information);
- apply prudential requirements consistently across the group;
- work together in considering applications for the internal ratings-based (IRB) approaches; and
- co-ordinate action in an emergency situation.

The consolidating supervisor would be responsible for establishing and operating the college and would chair its proceedings and keep its members informed. The college would comprise the competent authorities responsible for the supervision of European Economic Area (EEA) subsidiaries and also the competent authorities of host countries of 'systemically relevant' branches. The CRD revisions contain provisions to determine when a branch will be regarded as systemically relevant, with the ultimate decision in the case of disagreement resting with the host country supervisor. The proposals also leave open the possibility of non-EEA supervisors participating in colleges.

It will be important to ensure that the global and EU proposals operate in a compatible way, with either a single global college or at least a European college working within a global system according to common rules.

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