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EVOLUTION OF FINANCIAL REGULATION AT BCBS AND FSB SINCE 2008

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THE FINANCIAL STABILITY BOARD AND THE BASEL COMMITTEE ON BANKING SUPERVISION

International financial regulation has been strengthened and become more coordinated since 2008. The Financial Stability Forum (FSF), founded by G7 finance ministers and central bank governors in 1999, was enlarged by the G-20 in 2009. And, through the transformation into the Financial Stability Board (FSB), was put on a stronger institutional basis. The FSB has now been mandated, among other things, to promote coordination among authorities concerned with financial stability and to review the international standard-setting bodies work to ensure that it is timely and focused.[1]

The FSB works as an independent organisation under the umbrella of the Bank for International Settlement (BIS). The BIS also hosts the Basel Committee on Banking Supervision (BCBS) which continues to serve as the main platform for discussion and

[1] See www.financialstabilityboard.org/about/mandate.htm (18.07.12).

coordination among experts from both central banks and supervisors with regard to standard-setting for banking regulation.

CONSENSUS BUILDING

Both the FSB and the BCBS claim to work on the basis of consensus decision-making.[2] The starting point for a high-level consensus are the individual working groups that comprise a selected number of central bank and supervisor representatives (in the case of the FSB, representatives from the ministry of finance may participate as well). As regards BCBS, the Policy Development Group oversees and coordinates the work of all working groups, amounting to currently seven.[3] The Policy Development Group is directly subordinated to the BCBS. Under this two-layer guidance, the working groups meet regularly to coordinate the work undertaken by individual representatives. There is a difference in the number of representatives per member country with developed countries often being better represented than developing countries. For example, in the Trading Book Group, a working group that currently performs a fundamental review of the trading book standards, the USA has four representatives, France, United Kingdom, Japan, Germany and Switzerland have two and Mexico, Brazil, Russia, South Africa, China and Singapore have one.[4] In the case of the USA, the large number of representatives is due to the fact that four institutions share responsibility for domestic regulation and supervision, namely the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. Given that the domestic responsibilities of these institutions differ it is not clear that they will always agree.

Chairs and co-chairs of working groups coordinate discussions within the working groups and are therefore influential. From the seven working groups currently active under the Policy

[2] See 'Charter of The Financial Stability Board', 2012, art. 9 and for instance www.bis.org/press/p040511.htm (04.12. 12).
[3] See www.bis.org (06.09.12).
[4] See www.bis.org (06.09.12).

Development Group, four chairs/co-chairs come from the USA, two each from the United Kingdom and Switzerland, and one each from Japan and Germany.[5] Currently, therefore, the chairs and co-chairs come exclusively from countries with large banking sectors and developing countries are not represented in this respect.

The usual process of standard-setting begins with the publication of a consultative paper, followed by an analysis of the feedback received by individual banks or industry associations, such as the Institute of International Finance that includes most of the world's largest financial institutions. Because the effects of new standards are difficult to estimate in advance, the BCBS regularly undertakes quantitative impact studies among a large set of global banks. The results of such impact studies enable the working groups to calibrate new standards to the desired outcomes. In cases where the BCBS publishes consolidated results of such impact studies, they can serve as benchmarks enabling individual banks to determine their position among their peers. Furthermore, interest groups can use the results to argue for changes in standards before they become effective.

While the BCBS comprises only central banks and supervisors, the FSB's membership is wider as it includes ministries of finance and international organisations, such as the International Monetary Fund, the World Bank, the OECD, or the European Central Bank, as well as a number of international standard-setting bodies, such as the BCBS, the International Association of Insurance Supervisors, the International Accounting Standards Board, and the International Organization of Securities Commissions. As it directly reports to G-20 governments, establishing the FSB provided the G-20 governments the enhanced control over international regulation that is necessary to be able to confront the global financial crisis in a timely, coordinated and adequate manner. It also gave the G-20 governments more control over national implementation of agreed standards, as the FSB

[5] See www.bis.org (06.09.12).

regularly produces progress reports for the G-20 on the national implementation and performs country peer reviews.[6]

The plenary is the FSB's governing body, but the Steering Committee, with a more limited membership, directly oversees the FSB's numerous standing committees and working groups that rely, as do BCBS working groups, on the work and participation of member institutions.

NEW REGULATION AS A RESPONSE TO THE GLOBAL FINANCIAL CRISIS

Following the near collapse of the financial system in 2008, international financial regulation has tried to minimize systemic risks by decreasing the probability of default by large financial institutions and enabling an orderly resolution in case of default.

The distressed market conditions in 2008 heightened awareness of systemic risks. The near defaults of Bear Stearns, Merrill Lynch and AIG, and the disorderly default of Lehman Brothers in 2008 lead to a general environment of distrust between financial institutions and consequently a break-down of interbank lending. The fact that many banks across the world experienced substantial problems at the same time and that a deterioration of one bank's situation often led to a deterioration of another bank's situation highlighted the interconnectedness of financial markets and the risks a disorderly default of systemically-important financial institutions pose.

International financial regulation sought to decrease the probability of large financial institutions' default in various ways.

- First, BCBS updated the market risk framework of Basel II in light of the recent experience showing a weak relationship between the loss absorbing capital banks are required to have in place for trading book assets and their riskiness in a crisis. The new

[6] See http://www.financialstabilityboard.org (06.09.12).

regulations require banks to improve their methodology for assessing the risk of default of the credit positions they hold in the trading book. Banks are now also required to calculate the capital requirement based on how their assets would react in a stressed environment.[7]

- Second, the BCBS embarked on a holistic effort to update the Basel II framework, known as Basel III. The new regulations require that banks hold better quality and larger amounts of capital in order that they be more resilient in case of a fast deterioration of their assets. Furthermore, in light of the mutual distrust among financial institutions that led to severe funding shortfalls, the new regulations demand that banks have sufficient liquidity to survive 30 days of severe stress. To further ensure that banks are not overly reliant on short-term funding, banks must have long-term assets funded by long-term, stable funding.[8]

- Third, the FSB, together with the BCBS, developed and agreed on a methodology to identify systemically-important global banks (G-SIBs), based on an indicator approach that takes into account a bank's size, interconnectedness, the lack of available substitutes, the size of its cross-jurisdictional activity, and the complexity of its business activities (the larger the complexity, the more difficult it is to resolve a failing bank). Such global banks, initially 29 in number, are then assigned to a bucket, depending on their global systemic relevance which determines how much additional loss absorbing capital is required.[9]

- Forth, the FSB recently embarked on an attempt to extend this G-SIB framework to systemically important domestic banks (D-SIBs). While the domestic framework will include the indicators developed in the global framework, domestic regulators will retain

[7] See BCBS, 'Revisions to the Basel II market risk framework', 2009.

[8] See BCBS, 'Basel III: International framework for liquidity risk measurement, standards and monitoring', 2010, and BCBS, 'Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011', 2011.

[9] See BCBS, 'Global systemically important banks: Assessment methodology and the additional loss absorbency requirement – final document', 2011.

appropriate discretion to account for country-specific financial market characteristics.[10] In the end, both the G-SIB and the D-SIB framework need to be compatible, especially if a G-SIB is also classified as a D-SIB in one or more jurisdictions.

International financial regulation aims to enable an orderly resolution of large financial institutions in case of default through establishing institutional preparedness. The FSB issued principles of effective resolution regimes as guidelines with regard to cross-border cooperation and information sharing between home and host regulators, the legal instruments needed for effective resolution, funding of institutions in resolution, and last but not least, concrete resolution plans per G-SIB. Such resolution plans are produced in detail jointly by banks and regulators so that in case of resolution, there is a clear strategy as to how each part of the bank can be resolved without causing major distress in the market.[11]

STILL A LONG WAY TO GO, BUT IS THERE A CONSENSUS ON THE DIRECTION?

It is not the purpose of regulation to reach a point where it prevents financial institutions from defaulting. At best it can minimize the risk of such a default and ensure that there is a clear process in place in case of a default. Both aspects of regulation contain unresolved issues:

- First, how can an orderly resolution of a large institution be orchestrated? The experience of Lehman Brothers shows the difficulties of resolving a highly complex institution. Open questions remain especially with regard to the interaction of home and host regulators: is there a clear lead or will each regulator specifically protect the interests of the national jurisdiction?
- Second, financial institutions tend to become more complex over time. Regulation can response to that by aiming for more complex rules, or they can opt for simplicity,

[10] See FSB, 'Extending the G-SIFI Framework to domestic systemically important banks', 2012.
[11] See FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', 2011.

knowing that they will never be able to adequately address the ever-changing risks undertaken by financial institutions. International regulation has generally taken the first route and became more complex over time. For example, the Basel Accord (Basel I) from 1988 comprises of 30 pages, the revised accord (Basel II) from 2004 347 pages, and finally the current accord (Basel III) from 2010 616 pages. [12] However, a number of central banks seem to have shifted their preference towards simplicity.

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[12] See Haldane, G. and Madouros, V. (2012) *The dog and the frisbee*, Bank of England speech given at the Federal Reserve Bank of Kansas City's 36th economic policy symposium.