EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

Letter to the G20

Statement No. 30

Warsaw, September 21, 2009

In this statement the European Shadow Financial Regulatory Committee (ESFRC) comments, ahead of the G-20 Government Leaders Meeting in Pittsburgh on September 24-25, on proposals by the Group of Central Bank Governors and Heads of Supervision to strengthen the regulation, supervision and risk management of the banking sector. Although the proposals made by the Group are an important step into the right direction, they are not likely to substantially reduce the likelihood of future crises. The ESFRC would like to suggest that the G-20 Government Leaders consider the following reforms:

1. *Raise the average bank capital requirement substantially enabling bank capital to serve as a buffer against losses of individual banks as well as against system-wide losses.*

2. *Make capital requirements for each financial institution depend on its contribution to systemic risk to reduce perverse incentives created by Too Big to Fail financial institutions.*

3. *Implement binding rules for structured early intervention and resolution (SEIR) for banks and other systemically important financial institutions.*

4. *Make banks' remuneration arrangements, including potentially unhealthy incentive structures, part of the overall supervisory assessment and require mandated intervention in periods of insufficient capital as defined by a SEIR regime.*

The Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, met on September 6 to review measures to reform regulation and supervision of financial institutions to reduce the likelihood of future crises. The measures include microprudential regulation to enhance the Basel II framework as well as macroprudential regulation to create countercyclical buffers above the minimum capital requirements. Furthermore, the Group endorsed the supervision of compensation in the industry to ensure alignment with prudent risk-taking and long-term sustainable performance.

In this statement the ESFRC discusses and elaborates on the issues raised by the Group of Central Bank Governors and Heads of Supervision. In addition, the ESFRC takes this opportunity to propose that the G20 Government Leaders also address the important issue of crisis management in order to make it possible for financial institutions to be restructured or closed without causing serious systemic harm.

Capital requirements

Although the ESFRC supports the introduction of a non risk–weighted leverage ratio, as we have advocated in previous statements, to complement the risk-weighted ratio within Pillar 1 of Basel II, we would like to go further in important respects. The fact that many banks' capital buffers were so rapidly depleted in the current crisis indicates that the required levels before the crisis were inadequate. The ESFRC recommends that a required capital/asset ratio of 15 percent on a non risk-weighted basis should be introduced when the world economy has fully recovered from the current crisis. Assets must include off-balance sheet items expressed as the asset equivalents of contingent liabilities, as presently calculated for the Basel capital requirement. The non risk-weighted ratio should be specified along with the risk-weighted ratio calculated under the Basel II rules. Both of these two ratios should be binding.

In order to reduce the burden for banks to substantially increase their capital base, we support existing proposals to make it possible for banks to increase their regulatory capital to the new higher level without having to resort fully to equity markets. One proposal is to include some kinds of long-term debt in regulatory capital.[1] Another proposal is to enforce mandatory convertibility of specific bank debt to equity when the capital ratio reaches a pre-determined low level. [2]

Increasing capital requirements to 15 percent could strengthen their pro-cyclical impact. The aim of the Group of Governors and Heads of Supervision "to promote the build-up of capital buffers that can be drawn down in periods of stress" is, therefore, laudable. Spain has been operating a system aimed at reducing pro-cyclicality and proposals exist to include macro-prudential criteria such as credit growth and asset price inflation in capital requirements. There are doubts, however, about the possibility of designing a scheme that can properly separate periods of inappropriate build up of credit risk from periods of shifts in profit opportunities. Bubbles are easily identifiable ex post but rarely recognized beforehand when it would be desirable to build up the capital base.

In spite of the difficulties of ensuring that macro-prudential criteria for build-up of capital correctly identify periods of increasing and decreasing credit risk, we consider it important to enhance the buffer role of the capital base of financial institutions. Rigid adherence to a minimum capital ratio is likely to contribute to pro-cyclicality. The ESFRC has in several statements recommended a system of Structured Early Intervention and Resolution (SEIR) that allows capital to fall in periods of stress without increasing the perverse incentives of banks to increase risk-taking when the level of capital falls. This objective is accomplished by the specification of trigger points for capital at which gradually more restrictive conditions on banks' risk-taking behavior are imposed. In order to achieve the objective of reducing pro-cyclicality of SEIR it is important that macroeconomic conditions are taken into account when implementing the risk reducing measures at each trigger ratio. If applied, macro

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[1] This "debt capital" must be explicitly and credibly uninsured and it may not be redeemed except from funds that were obtained from new issues replacing the debt capital. See H.A. Benink and G.J. Benston (2005), "The Future of Banking Regulation in Developed Countries: Lessons from and for Europe", *Financial Markets, Institutions & Instruments*.

[2] See Flannery (2005), "No pain, No Gain? Effective Market Discipline via Reverse Convertible Debentures", Chapter 5, in: H. Scott (ed.), *Capital Adequacy Beyond Basel; Banking, Securities and Insurance*.

prudential management of these ratios could be among the responsibilities of the System Risk Authorities that are in the process of being created both in the US and in the EU.

Mitigating the risk of systemic financial institutions

The Group of Governors and Heads of Supervision, as well as many other participants in the debate, have pointed out that the existence of large, systemically important financial institutions may result in unwanted consequences. The current crisis has demonstrated the unwillingness of governments to allow systemically important financial institutions to fail. Creditors of these institutions are de facto protected from losses creating expectations about similar protection in a future crisis. This implicit subsidization of the funding costs of large financial institutions leads to further concentration in the financial industry. Financial institutions wherein creditors are largely protected have incentives to take excessive risk since part of the downside risk is carried by tax payers and deposit insurance funds. Thus, current crisis management measures may have sawn the seeds of future crises.

A remedy for the Too Big to Fail problem is to require financial institutions which contribute more to systemic risk to hold more equity capital relative to assets than others. Thereby, their risk of default would decrease and their advantage in costs of funding would be counter-acted.

The complexity of finding an operational definition of contribution to systemic risk and the corresponding increase in required capital is substantial. It is necessary to consider systemic risk on the national level, the EU and, in some cases, the global level. The market share of a bank in sensitive product areas should enter the calculation of the required capital for the individual bank.

Crisis management procedures

The ongoing financial crisis provides evidence that crisis management procedures are inadequate. Irrespective of the current situation the creation of a *legal basis* for binding, enforceable rules for dealing with distressed financial institutions should be a priority in the light of the needs of the single market in financial services and capital.

The ESFRC emphasises again the need for a system of 'Structured Early Intervention and Resolution' (SEIR) for troubled institutions as proposed in the first ESFRC statement of June 1998, and further elaborated on in later statements.[3] As noted above SEIR consists of a sequence of steps that bank supervisors must take if the health of a bank deteriorates. Before insolvency occurs, pre-specified trigger levels for the ratio of capital to total assets should initiate a series of increasingly strict restrictions on a problem bank's activities with the objective of reducing the riskiness of the bank. As

[3] Statements No. 23, Frankfurt (November 2005) and No. 25, London (November 2006). All ESFRC statements are available at www.ceps.be.

we discuss below, the restrictions could include adjustment of compensation for top management in order to reduce its risk-taking incentives.

In case of insolvency the SEIR rules should allow the restructuring (or closing) of the bank without severe systemic consequences and without offering a bail-out of unsecured creditors and shareholders. An institution that reaches a 'critical level of under-capitalisation' defined as, for example, 2 per cent of capital to total assets (so-called leverage ratio, which is not risk-based) as in the US must be placed in receivership/conservatorship. The objective is to resolve problem banks in such a way as to minimize costs to the deposit insurance funds and, ultimately, taxpayers. This approach has the advantage of being predictable and of allowing the allocation of losses to shareholders and unsecured creditors, and thereby creating incentives on an ex ante basis for these parties to carefully monitor the financial soundness of banks and to increase the funding costs of relatively risky banks.

It is important to emphasize that SEIR would not only apply to small and medium-sized banks but also to large banks, which are at the centre of the current problems. Extensions of SEIR to non-bank financial institutions should also be considered.

Issues of compensation

Considering the unhealthy incentives caused by structures of compensation, not only of executives but also of traders and managers, we recommend that these remuneration arrangements will have to be disclosed to the supervisors of financial institutions and become part of the overall assessment of these institutions.

We also recommend that intervention in management compensation is mandated when the capital of a financial institution is impaired to the extent that a trigger capital ratio, as specified within an SEIR rule, has been reached. Specifically, we propose that any performance related remuneration contract for top management would be invalidated at this point including compensation that contractually would have been paid out under normal conditions. Since this change in contractual conditions would be known beforehand, top management would have strong incentives to reduce the probability that bank capital falls below the trigger ratio. It would also lie in the interest of shareholders to specify compensation contract with, for example, delayed bonus payments at risk for top management.