
THE BANKING REGULATION REVIEW

SEVENTH EDITION

EDITOR
JAN PUTNIS

LAW BUSINESS RESEARCH

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THE BANKING REGULATION REVIEW

Seventh Edition

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EDITOR'S PREFACE

Nearly eight years after the collapse of Lehman Brothers it might have been expected that fundamental questions about the business models, governance and territorial scope of large banks would have been answered clearly, but that is not yet truly the case. Debates rage on in many countries about 'too big to fail', management accountability in banks, resolution planning and conduct issues in the banking sector. What is the 'safest' form of international banking and what might shareholders in banks reasonably expect as a long-term rate of return on their investment? When is all this uncertainty going to end? Perhaps it never will for so long as large banks remain as important to the global economy as they are and the political classes throughout the world remain divided on whether this is a good thing. It is also worth remembering that the reform agenda that was born in the financial crisis of 2007–2009 established a very long implementation period – to 2019 and beyond – for many of the regulatory changes agreed upon by the G20 and the Basel Committee. So we are still in the midst of what will no doubt be seen in decades to come as the 'post-crisis' period in banking regulation.

Looking forward then, what can we see beyond the implementation of the post-crisis reforms? That depends, of course, in part on whether there is another cross-border banking crisis. It is worth noting in this context that localised banking failures remain commonplace, and with more countries around the world introducing specialised bank resolution regimes there will be further opportunities to test the uses and pitfalls of bail-in and other resolution powers.

The continuing debate about the impact of technology on banks has increased significantly in volume in much of the world in the past year. Forecasts of the eventual eclipse of banks by technology firms seem wide of the mark in the short to medium term, although there is clearly an 'adapt or die' threat to many banks in the longer term. One adaptation of sorts that we may well see more of in the next few years is banks acquiring technology firms (or otherwise entering into strategic partnerships with them).

The most obvious benefits of new technology in the banking sector concern the customer interface and market infrastructure. However, some important but less immediately obvious ways in which technology will continue to revolutionise banking arise in the context of the safety and soundness of banks. For example, some banks are looking at how innovative

uses of technology can improve their risk management, and ultimately the credibility of their recovery and resolution plans through, for example, more precise classification and management of derivative positions and counterparty relationships.

Many of the largest cross-border regulatory investigations into past conduct in the banking sector have drawn to a close over the past year. While for some that signalled the close of a painful and costly chapter in the post-crisis development of the banking sector, it remains difficult to conclude that the threat of further such investigations has gone away.

As an English lawyer it would be odd if I did not mention the June 2016 referendum in the UK on membership of the European Union, parochial though that may seem to some readers outside Europe. The legal and regulatory regime that will apply to business that banks undertake in and from London is, however, of global interest, and the result of the referendum, and its aftermath, will therefore be of very considerable importance to all large banks and many smaller ones.

This seventh edition of *The Banking Regulation Review* contains chapters provided by authors in 39 countries and territories in March and April 2016, as well as chapters on International Initiatives and the European Union. My sincere thanks, as in previous years, go to the authors who have made time to contribute their chapters despite their heavy workload.

The team at Law Business Research have, once again, tolerated the hectic schedules and frequent absences on business of many of the authors, and I would like to thank them for doing so with such good humour and understanding. Thank you also to the partners and staff of Slaughter and May in London and Hong Kong for continuing to encourage projects such as this book, and in particular to Ben Kingsley, Peter Lake, Nick Bonsall, Edward Burrows, Tim Fosh, Kristina Locmele and Helen McGrath.

Jan Putnis

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Chapter 1

INTERNATIONAL INITIATIVES

Jan Putnis and Kristina Locmele¹

I INTRODUCTION

Banking regulation has never had a higher profile – and has arguably never been so important – as today. The subject has risen up the agenda as politicians have realised the damage that the failure of banks can do to national and regional economies.

If anyone assumed that an internationally agreed set of common principles as to how banks should be regulated would emerge quickly from the financial crisis of 2007–2009, they have been disappointed. However, much of the new regulatory framework is now in place, and new standards have been or are in the course of being adopted on most of the important issues. In particular, the Basel Committee on Banking Supervision (Basel Committee) has published and further developed the Basel III Capital Accord in response to the financial crisis and is carrying out work on updating other aspects of its prudential framework, including a fundamental review of the trading book and the treatment of securitisations.

Since the global crisis first manifested itself in 2007, it has at times been difficult to keep track of the numerous international initiatives that have been launched. These initiatives may broadly be classified as those developed to try to understand what went wrong before and during the crisis, and those developed to propose and monitor the implementation of reforms to prevent the recurrence of problems that have been identified. The proliferation of international initiatives has reflected the number of stakeholders involved, and the potentially conflicting approaches to identifying and addressing the causes of the crisis as well as differing political agendas, with the crisis being seen by some as an opportunity for advancing proposals that previously had attracted limited support. It has also reflected a period of intense reflection among financial regulators and governments on the causes and consequences of the financial crisis. Cynics may, however, argue that the world could have done with fewer ‘initiatives’ and greater clarity about the direction of reform in the past few years.

¹ Jan Putnis is a partner and Kristina Locmele is a senior associate at Slaughter and May.

As far as banking regulation is concerned, we focus in this chapter on the two main bodies that have emerged from the crisis to lead the debate: the Basel Committee, and the Financial Stability Board (FSB), which emerged in 2009 as a new global leader in the debate on measures to improve international financial stability.

II BASEL COMMITTEE

i Introduction

The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for international cooperation on banking supervisory matters. It is principally concerned with the prudential regulation of banks rather than the regulation of their business activities as such. It must, however, be recognised that there are many overlaps between these two areas of regulation, with capital requirements creating incentives for banks to engage in certain activities but not in others.

The Basel Committee comprises senior officials with bank regulatory and financial supervisory responsibilities from central banks and banking regulators in 28 jurisdictions.² The Committee now also reports to an oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), which comprises central bank governors and (non-central bank) heads of supervision from member countries. The current chair is Stefan Ingves, who is also chair of Sveriges Riksbank (the Swedish central bank).

The stated mandate of the Basel Committee is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.³ Its main focus has traditionally been on internationally active banks, although the Committee's standards have been applied more widely, particularly in the European Union.

The Basel Committee formulates standards and guidelines and recommends statements of best practice. The rules and guidance adopted by the Basel Committee have no legal force,⁴ and their authority derives from the commitment of banking supervisors in member countries (and, increasingly, non-member countries) to implement the requirements agreed by the Committee. The Basel Committee has adopted standards on a wide range of issues relevant to banking supervision, including banks' foreign branches, core principles

2 Argentina, Australia, Belgium, Brazil, Canada, China, France, the European Union, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. (In addition to member organisations, a number of institutions currently hold the observer status. These include the following: (1) country observers: the Central Bank of Chile / Banking and Financial Institutions Supervisory Agency, the Central Bank of Malaysia and the Central Bank of the United Arab Emirates; and (2) the following supervisory groups and international agencies or bodies: Bank of International Settlements, Basel Consultative Group, European Banking Authority, European Commission and International Monetary Fund.)

3 Basel Committee on Banking Supervision Charter, paragraph 1.

4 Ibid, paragraph 3.

for banking supervision (revised in September 2012), core principles for effective deposit insurance, internal controls, supervision of cross-border electronic banking and risk management guidelines for derivatives.

However, in recent years, the Basel Committee has devoted most of its attention to regulatory capital, principles for effective banking supervision and cross-border banking supervision. It has also been active in the important areas of liquidity risk and developing frameworks for the recovery or orderly wind-down of internationally active banks that get into financial difficulties.

The Basel Committee's work is largely organised around groups, working groups and task forces. Groups report directly to the Committee and form part of the Committee's permanent internal structure. Working groups consist of experts that support the technical work of Committee groups. Task forces comprise technical experts from Committee members and are created to undertake specific tasks for a limited time; high-level task forces serve a similar purpose.

The Basel Committee's work is organised under five main groups:

- a* the Supervision and Implementation Group, which concentrates on the implementation of the Committee's guidance and standards and the advancement of improvements in banking supervision;
- b* the Policy Development Group, which is charged with identifying issues of importance to banking supervision as they emerge, and with developing policies for the Basel Committee that promote a sound banking system and high supervisory standards;
- c* the Macroprudential Supervision Group, which monitors and reports to the Committee on systemic risk and global developments that relate to macroprudential and systemically important banks' supervision policy;
- d* the Accounting Experts Group, which is concerned with international accounting and auditing standards and, in particular, with ensuring that those standards promote sound risk management at financial institutions, support market discipline through transparency and reinforce the safety and soundness of the banking system; and
- e* the Basel Consultative Group, which provides an interface between the Basel Committee and non-member banking regulators.

ii The Basel framework

Prior to the financial crisis, Basel II was the prudential regulatory framework promulgated by the Basel Committee.

The Basel Committee on Banking Supervision has its origins in the financial market turmoil that followed the breakdown of the Bretton Woods system of managed exchange rates in 1973, which led to a number of banks across the globe incurring large foreign currency losses, some forced to close their doors as a result. In response to these and other disruptions in the international financial markets, the central bank governors of the G10 countries established a Committee on Banking Regulations and Supervisory Practices, later renamed the Basel Committee. At the outset, one important aim of the Committee's work was to close gaps in international supervisory coverage so that (1) no foreign banking establishment would escape supervision; and (2) supervision would be adequate and consistent across member jurisdictions. A number of principles and standards on sharing supervisory responsibility and exchanging information between the regulatory authorities followed, laying down the foundation for supervision of internationally active banks.

Once this initial framework was in place, capital adequacy became the main focus of the Committee's activities. In 1988, a capital measurement system commonly referred to as the 'Basel Capital Accord' (Basel I) was approved by the G10 Governors and released to banks. Basel I comprised a set of international banking regulations setting out the minimum capital requirements aimed at minimising credit risk and creating a bank asset classification system. Over the next few years the framework had evolved with several amendments and additions introduced to it, including the Market Risk Amendment which took effect at the end of 1997. One important aspect of the Market Risk Amendment was that banks were, for the first time, allowed to use internal models (value-at-risk models) as a basis for measuring their market risk capital requirements, subject to strict quantitative and qualitative standards.

In June 1999, the Basel Committee issued a proposal for a new capital adequacy framework to replace Basel I. This led to the release of the Revised Capital Framework in June 2004 (generally known as Basel II), which remained the prudential regulatory framework promulgated by the Basel Committee up until the financial crisis of 2007–2009.

Basel II was based on three pillars that were intended to be interdependent and mutually reinforcing:

- a* Pillar I (minimum capital standards) set out the minimum capital requirements for banks;
- b* Pillar II (the supervisory review process) set out standards for banking supervisors in applying Basel II. In particular, it required that supervisors should have the power to compel banks to hold capital in excess of the 8 per cent minimum ratio under Basel II where this was justified. Standards were also established for the control of interest rate risk in a bank's loan portfolio, and to capture other risks not specifically covered under Pillar I (e.g., certain risks arising out of securitisations); and
- c* Pillar III (market discipline) provided for extensive disclosure of information to the market. The intention was that pressure from a bank's counterparties, analysts and rating agencies would serve to reinforce the minimum capital standards and ensure that banks carried on their business prudently. As was seen in the financial crisis, it is highly debatable whether this aim was achieved.

iii The structure of Basel II

Basel II provided a choice of approaches for determining capital requirements. For example, it set out three different ways of calculating credit risk and up to four ways of determining the capital charge for operational risk. Generally, banks were free to choose between more complex methodologies with the potential for capital savings, and simpler approaches that generally led to a higher capital charge, but with lower operational and systems costs.

The focus of Basel II was on internationally active banks. However, the Basel Committee considered that the principles developed in Basel II were, when taken together with the reforms described later in this chapter, suitable as an international benchmark.

Overall, Basel II was considerably more risk-sensitive than its predecessor, Basel I. It also marked a shift away from the approach in Basel I of allocating specific capital charges for particular exposures in favour of greater reliance on banks' internal models and methodologies and external credit ratings. It was the intention of the Basel Committee that most sophisticated banks would adopt internal models to determine their capital requirements once they had the operational capacity to do so. Given the perceived failures by credit rating agencies in the run-up to the financial crisis, more recently the focus on external ratings under the standardised approach has been challenged.

Basel II underwent a number of developments prior to the financial crisis. In July 2005, the Basel Committee published a document addressing the treatment of banks' trading books under Basel II, which it had prepared in conjunction with the International Organization of Securities Commissions (IOSCO). The Basel Committee integrated this document into Basel II, and published a revised consolidated text of Basel II in June 2006.

III FROM BASEL II TO BASEL III

i The limitations of Basel II

It is fair to say that critics of Basel II who blamed aspects of the financial crisis on features of that regime have not properly taken into account the fact that when the crisis arose, Basel II had not been implemented at all in a number of key jurisdictions, and had not long been implemented in others. The main requirements of Basel II came into force on 1 January 2007, with the most advanced methodologies only being implemented in January 2008. However, it is reasonable to conclude that, had Basel II been implemented in more countries for a longer period of time before the financial crisis, it is unlikely that the regime would have prevented many aspects of the crisis as they emerged. Hindsight is easy to employ, however, and there are many who argue that the crisis might not have been so severe had Basel II been implemented earlier.

In response to the crisis, the Basel Committee has chosen to build on Basel II rather than fundamentally change it. A consensus has emerged that there were a number of deficiencies in the Basel II framework that needed to be addressed, including:

- a* insufficient capital in the banking system, often of inadequate quality;
- b* an excessive focus on capital at the expense of liquidity and leverage;
- c* a failure by firms and supervisors to see the overall picture;
- d* inadequate capital requirements in respect of banks' trading books; and
- e* deficiencies in respect of the treatment of securitisations.

ii The Basel Committee's July 2009 reform package

The first package of changes to Basel II following the financial crisis was adopted by the Basel Committee in July 2009, and included the following:

- a* increasing the capital charges for securitisation exposures, including introducing a new higher capital charge for resecuritisations (e.g., collateralised debt obligations (CDOs) and certain conduits) as well as increasing the capital charge for certain liquidity facilities. Banks that invest in securitisations are required to carry out due diligence on the underlying asset pool, and if they fail, or are unable to do so, they are required to deduct such positions from their capital;
- b* eliminating the regulatory arbitrage under which banks that choose to hold securitisation exposures in their trading book could avoid higher capital charges – instead, capital requirements for such exposures have been broadly aligned across the banking and trading books, based on the former's requirements;
- c* improvements to banks' models used to calculate capital charges for non-securitisation positions held in the trading book through a 'stressed' value at risk calculation, which takes into account a defined observation period relating to significant losses. The intention is to capture the risks of low-frequency, high-impact 'tail' events, as well as significant market movements over a sustained period; and

d the introduction of an incremental risk capital charge to address the effect of credit risk migration (i.e., ratings downgrades) on a bank's holdings of debt instruments in the trading book. This reflects the fact that trading book losses in the financial crisis did not principally result from defaults but from credit migrations combined with the widening of credit spreads as a result of the loss of liquidity.

The Basel Committee's July 2009 reform package initially addressed the treatment of securitisation and trading book exposures. However, the Committee recognised the need for a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector. The result was a consultation paper entitled 'Strengthening the Resilience of the Banking Sector', published on 17 December 2009. This led to the adoption of a new, comprehensive reform package on design of the capital and liquidity requirements (Basel III) in 2010 (see below).

iii Other work

The Basel Committee is also currently engaged in work in the following areas:

Systemically important financial institutions (SIFIs)

The Basel Committee is continuing to work with the FSB to implement an integrated approach to systemically important banks. On 28 September 2011, the Basel Committee finalised details of the additional capital buffer that will apply to global systemically important banks (G-SIBs). G-SIBs will be required to hold an additional buffer (above the Basel III requirements) of between 1 and 2.5 per cent of common equity, depending on the bank's systemic importance (the percentages being of risk-weighted assets). An initially empty 3.5 per cent bucket will be imposed on G-SIBs that become even more systemically important as a disincentive to such behaviour. Final rules for G-SIBs were published on 2 November 2011. In October 2012, the Basel Committee adopted a framework for domestic systemically important banks (D-SIBs), which builds on the rules adopted for G-SIBs. The framework is composed of 12 principles and gives states considerable national discretion to reflect the characteristics of their domestic financial system. D-SIBs will be required to meet higher capital requirements to reflect their degree of systemic importance. An updated assessment methodology for G-SIBs was published by the Basel Committee in July 2013. The latest FSB list of banks identified as G-SIBs using the Basel Committee's methodology was issued in November 2015. The list will be next updated in November 2016.

Bail-in

Work continues internationally on the feasibility of developing debt write-down and conversion of debt to equity to enable a failing bank to continue (whether temporarily or permanently) as a going concern. The Basel Committee published its requirements for enhanced loss absorbency for additional Tier 1 and Tier 2 capital instruments on 13 January 2011. These requirements are summarised in Section IV, *infra*.

IV BASEL III: CAPITAL REQUIREMENTS

On 12 September 2010, the Basel Committee announced agreement on the new Basel III minimum capital requirements for banks, which significantly increased the amount of common equity that banks must hold. The detailed requirements were published on

16 December 2010 and revised on 1 June 2011. Further guidance on the new capital definitions and the requirements for counterparty credit risk was published in the form of 'frequently asked questions' in 2011.

Basel III reforms aim to strengthen the regulation, supervision and risk management of the banking sector and are designed to target both microprudential regulation and macroprudential risks.

More specifically, Basel III extends the framework in a number of ways, including introducing the following additional measures:

- a* a capital conservation buffer, an additional layer of common equity that, when breached, restricts distribution of capital to help protect the minimum common equity requirement (see sub-section iv, *infra*, for further details);
- b* a countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts (see sub-section v, *infra*, for further details);
- c* a leverage ratio (a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting) (see subsection vi, *infra*, for further details);
- d* two liquidity requirements: (1) a liquidity coverage ratio (LCR), a minimum liquidity ratio intended to provide enough cash to cover funding needs over a 30-day period of stress; and (2) a net stable funding ratio (NSFR), a longer-term ratio intended to address maturity mismatches over the entire balance sheet (see Section V, *infra* for further details); and
- e* additional proposals for systemically important banks, including requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

i New definitions of capital

Much more equity

Under Basel II, banks were required to hold common equity equal to 2 per cent of risk-weighted assets (although, in practice, most banks held more). Regulatory deductions were applied to total Tier 1, or total capital, so certain hybrid instruments and preference shares, as well as some subordinated debt, could be used to cover such deductions.

Under Basel III, the common equity component of capital (including reserves) will increase to 4.5 per cent and the total Tier 1 ratio to 6 per cent. This increase will be phased in as explained below. For banks structured as joint-stock companies, the equity requirement must be met solely with common shares.

Non-core Tier 1 capital

Detailed requirements have been adopted in respect of additional (i.e., non-core) Tier 1 capital, which will be limited to 1.5 per cent of risk-weighted assets. Such instruments must be perpetual, and may only be called after five years and with prior supervisory consent. Interest payments must be made out of distributable profits and, if the instrument is classified as a liability for accounting purposes, it must have principal loss absorption through either conversion to common equity or write-down of principal. The trigger level for write-down or conversion must be at least 5.125 per cent, although banks can choose to apply a higher trigger. The EU also applies this requirement to equity-accounted instruments (e.g., most preference shares).

Other tiers of capital

Basel III abolished innovative Tier 1 and Tier 3 capital, and harmonised Tier 2 capital based on lower Tier 2 capital under Basel II. Recognition of Tier 2 capital is effectively limited to 2 per cent of risk-weighted assets. Under Basel II, the limit was 4 per cent.

Under Basel III, all Tier 1 and Tier 2 capital instruments (other than common equity) are required to include a clause in their terms and conditions requiring the instrument to be written off on the occurrence of a trigger event (i.e., the bank ceases to be a going concern or receives an injection of public sector capital) if there is no statutory scheme under which such instruments can be required to absorb losses. The only compensation for such write-off that may be provided to investors is the issue of new ordinary shares (or the equivalent for mutuals).

The new requirements for common equity, as well as the other minimum ratios, are being phased in as follows:

	<i>Common equity</i>	<i>Total Tier 1</i>	<i>Total Tier 1 and Tier 2</i>	<i>Total capital including the capital conservation buffer*</i>
Basel II requirement	2%	4%	8%	8%
From 1 January 2015	4.5%	6%	8%	8%
From 1 January 2016	4.5%	6%	8%	8.625%
From 1 January 2017	4.5%	6%	8%	9.25%
From 1 January 2018	4.5%	6%	8%	9.875%
From 1 January 2019	4.5%	6%	8%	10.5%
* Explained below				

Minority interests

Detailed rules set out the contribution that third-party minority interests in group companies can make towards consolidated capital. This treatment is being phased in from 1 January 2014. No recognition will be given from 1 January 2018 for minority interests that do not satisfy the new requirements.

ii Grandfathering of existing capital instruments

The Basel III agreement includes a detailed approach to the grandfathering of existing instruments. It should be noted that the approach to grandfathering in the EU under the Capital Requirements Regulation is different. Under Basel III:

- a* non-compliant capital instruments issued on or after 12 September 2010 are not grandfathered. It follows that any such instruments needed to satisfy the Basel III requirements for Tier 1 and Tier 2 capital if they were to be eligible from 1 January 2013. An exception to this rule is available for non-core Tier 1 and Tier 2 capital instruments that did not meet the requirement for write-down or conversion to common equity at the point of non-viability if issued before 1 January 2013. Such instruments are eligible for grandfathering;
- b* capital instruments that do not meet the criteria for inclusion in common equity Tier 1 ceased to be recognised from 1 January 2013. Public sector capital injections will be grandfathered until 1 January 2018;
- c* capital instruments that no longer qualify as non-common equity Tier 1 or Tier 2 capital under Basel III are being phased out over a 10-year period that started

on 1 January 2013. The base is fixed at the nominal amount outstanding on 1 January 2013. The level of recognition was capped at 90 per cent on 1 January 2013, and is being reduced by 10 percentage points in each subsequent year. Recognition of such instruments will be fully phased out by 1 January 2022;

- d* recognition of instruments with an incentive to redeem (e.g., a step-up in their coupon if redemption does not take place on a certain date) will be phased out at their effective maturity date. This will catch most existing innovative Tier 1 issues as well as Tier 2 issues with a step-up; and
- e* there are no transitional provisions for Tier 3 capital. However, as such subordinated debt had a maturity of only two years, banks were able to replace existing Tier 3 capital prior to the implementation of Basel III without the need for transitional arrangements.

iii Deductions from capital

Basel III provides for a harmonised set of deductions from capital, with most such deductions being made from common equity. The list of deductions includes:

- a* goodwill and other intangibles;
- b* deferred tax assets that rely on future profitability to be realised;
- c* cash-flow hedge reserve relating to hedging of items not fair valued on the balance sheet;
- d* shortfall of provisions to expected losses;
- e* cumulative gains and losses owing to changes in a bank's own credit risk on fair-valued liabilities (including derivatives);
- f* defined benefit pension fund assets and liabilities;
- g* investments in own shares;
- h* reciprocal cross-holdings; and
- i* significant investments in the capital of banking, financial and insurance entities outside of the consolidated group.

These deductions will be made on a 'corresponding deduction' approach, so the deduction will be from the element of capital that it would have constituted had it been issued by the bank.

The new approach to deductions started on 1 January 2014 (i.e., one year after the implementation of the new requirements for common equity) and is being phased in progressively, coming fully into effect on 1 January 2018. Inevitably, this parallel running of the existing and new regimes during the transition period has practical implications for banks, as they need to calculate deductions under both Basel II and the new rules.

iv Capital conservation buffer

A key element of Basel III is the requirement that banks hold a capital buffer on top of the minimum capital requirements. This buffer is not intended to form part of the minimum capital requirement. It follows that a bank that fails to hold sufficient common equity to satisfy the buffer (but meets the other minimum capital requirements) will not be subject to restrictions on its operations, and will not be at risk of resolution or the withdrawal of its banking licence. However, banks that operate within the buffer will be subject to restrictions

on the distribution of capital, including the payment of dividends and staff bonus payments, with the result that the buffer is likely to be treated by banks as an effective floor. According to the Basel Committee:

- a* the purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distribution; and
- b* banks will, of course, be able to rebuild capital buffers through raising new capital. However, in the Committee's view, it is not acceptable for banks that have depleted their capital buffers to use future predictions of recovery as justification for maintaining generous distributions to shareholders, other capital providers and employees.

The restrictions on distributions, share buy-backs and staff bonus payments are as follows:

<i>Common equity Tier 1</i>	<i>Minimum capital conservation ratio (expressed as a percentage of earnings)</i>
4.5% to 5.125%	100%
>5.125% to 5.75%	80%
>5.75% to 6.375%	60%
>6.375% to 7%	40%
>7%	0%

The requirements apply on a consolidated basis, although supervisors will be able to apply the regime at a solo level to conserve capital in specific parts of the group. The new capital buffer requirements have been introduced from 1 January 2016 (i.e., after the new common equity and Tier 1 capital requirements were required to have been fully implemented), but once again a transitional period will apply:

<i>Date</i>	<i>Amount of buffer</i>
From 1 January 2016	0.625%
From 1 January 2017	1.25%
From 1 January 2018	1.875%
From 1 January 2019	2.5%

The Basel Committee has stated that national authorities should have the discretion to impose a shorter transition period and 'should do so where appropriate'. Banks that meet the minimum capital ratio during the transition period but whose common equity is less than 7 per cent 'should maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible'.

v Countercyclical capital buffer

The countercyclical capital buffer is intended to ensure that capital requirements take account of the macro-prudential environment in which banks operate. It will be applied when excess credit growth is associated with a build up of system-wide risk. It is based on the following elements:

- a* each regulator will decide, based on credit conditions in its country, when to activate the buffer. Once activated, the buffer will take the form of an add-on to minimum capital requirements. At all other times the buffer will be zero;
- b* a decision to impose a buffer will be announced up to 12 months before it takes effect to give banks time to adjust (if necessary, by increasing capital or reducing lending). Reductions to the buffer will take effect immediately when announced;
- c* banks with purely domestic exposure will be subject to the full amount of the buffer; and
- d* banks that are internationally active will apply an add-on depending on the geographical location of their credit exposures.

The Basel Committee has stated that setting this buffer is likely to be appropriate where the ratio of credit to GDP exceeds its long-term trend. However, as this measure is not always a clear indicator of excessive credit growth, judgement will need to be applied.

The range of the buffer will generally be between zero and 2.5 per cent, and will be added to the capital conservation buffer. Unlike the capital conservation buffer, this additional buffer may be satisfied by ‘common equity or other fully loss-absorbing capital’, although until the Basel Committee has issued further guidance on the requirements for such loss-absorbing capital, the buffer will need to be met with common equity. According to the Committee, countries that experience excessive credit growth should consider accelerating the build up of the capital conservation buffer and the countercyclical capital buffer.

In December 2010, the Basel Committee published guidance for national authorities operating the countercyclical capital buffer. In October 2015, the Basel Committee published further guidance on countercyclical capital buffer in the form of ‘frequently asked questions’.

vi Leverage ratio

The years leading up to the financial crisis were characterised by a significant increase in the leverage of financial institutions, enhancing the (apparent) profitability of the financial sector, but also resulting in a greater probability of individual firms failing as well as increased systemic risk generally. Basel III’s leverage ratio is defined as the ‘capital measure’ (the numerator) divided by the ‘exposure measure’ (the denominator), and is expressed as a percentage. The capital measure is currently defined as Tier 1 capital, and the minimum leverage ratio is 3 per cent. Accounting values will generally be applied. More detailed requirements for the leverage ratio, including its disclosure from 1 January 2015, were published by the Committee in January 2014. In July 2015, the Committee published guidance on the leverage ratio in the form of ‘frequently asked questions’. In a press release published on 11 January 2016 the Committee stated that it would finalise the calibration of the leverage ratio in 2016 to allow for its implementation as a Pillar 1 measure on 1 January 2018.

From 1 January 2013 to 1 January 2017, supervisors will measure the leverage ratio. Banks are required to disclose their leverage ratio from 1 January 2015. Based on this four-year parallel run, any final adjustments will be made in the first half of 2017, with the leverage ratio coming into effect as a Pillar I capital requirement on 1 January 2018 ‘based on appropriate review and calibration’.

vii Counterparty credit risk

Basel III made a number of improvements to the treatment of counterparty credit risk with effect from 1 January 2013. The changes included the following:

- a* banks that use an internal model to calculate their counterparty credit risk on OTC derivatives, repurchase agreements and securities financing transactions are required to use stressed inputs to address the risk of the model underestimating low-frequency, high-impact events;
- b* a new capital charge was introduced to cover mark-to-market losses associated with a deterioration in the creditworthiness of counterparties;
- c* requirements have been imposed to address ‘wrong-way’ risk (i.e., where an exposure to a counterparty is adversely correlated to the credit quality of that counterparty);
- d* risk weights on exposures to large financial institutions are subject to a multiplier to reflect the fact that during the financial crisis, financial institutions’ credit quality deteriorated in a more highly correlated manner than that of non-financial counterparties;
- e* standards for collateral management and margining are strengthened. Banks with large and illiquid derivatives exposures have to apply a longer margining period when determining their capital requirements;
- f* greater haircuts apply to securitisation collateral, with a prohibition on recognition of resecuritisation exposures as collateral to reduce counterparty exposures; and
- g* harmonised capital charges for exposures to central counterparties have been introduced.

viii Revised standardised approach

In December 2014, the Basel Committee published a consultation document on revisions to the standardised approach to credit risk. In December 2015, the Committee published a second consultation document, which aims to address the issues raised by respondents with respect to the initial proposal. The new proposal differs in several ways from the initial proposal (the key differences are noted below).

The key aspects of the proposals are:

- a* under the original proposals, exposures to banks would no longer be risk-weighted by reference to the relevant bank’s external credit rating or the sovereign credit rating of the state of its incorporation, but would instead be based on two risk drivers: the bank’s capital adequacy and its asset quality. However, according to the revised proposals, the Committee has decided to reintroduce the use of ratings, in a non-mechanistic manner, for exposures to banks and corporates. In the second consultation paper the Committee has also proposed to include alternative approaches for jurisdictions that do not allow the use of external ratings for regulatory purposes;
- b* exposures to corporates would no longer be risk-weighted by reference to the borrowing firm’s external credit rating, but would instead be based on the firm’s revenue and leverage. Further, risk sensitivity and comparability with the internal ratings-based approach would be increased by introducing a specific treatment for specialised lending;
- c* the retail category would be enhanced by tightening the criteria to qualify for a preferential risk weight, and by introducing an alternative treatment for exposures that do not meet those criteria;

- d* the original proposals were that residential real estate would no longer be subject to a 35 per cent risk weight. Instead, risk weights would be based on two commonly used loan underwriting ratios: the amount of the loan relative to the value of the real estate securing the loan (i.e., the loan-to-value ratio (LTV ratio)) and the borrower's indebtedness (i.e., a debt-service coverage ratio). In the second consultation paper the Committee proposes to modify the risk weighting and suggests the use of the LTV ratio as the main risk driver. The Committee rejected the debt-service coverage ratio as a risk driver because of the challenges of defining and calibrating a global measure capable of being consistently applied across jurisdictions;
- e* in relation to commercial real estate, two options are currently under consideration: treating the exposures as unsecured with national discretion for a preferential risk weight under certain conditions, or determining the risk weight based on the LTV ratio; and
- f* in relation to credit risk mitigation, the proposals are that the framework would be amended by reducing the number of approaches, recalibrating supervisory haircuts and updating the eligibility criteria for corporate guarantors.

Further, the December 2015 consultation paper includes proposals for exposures to multilateral development banks, retail and defaulted exposures and off-balance sheet items. The consultation period closed on 11 March 2016.

ix Revised Market Risk Framework

In 2009, the Basel Committee introduced amendments to the Basel II market risk framework to address the weaknesses in the capital framework for trading activities that became apparent during the crisis (which was updated in December 2010). In addition, the Committee initiated a review of the trading book with the aim of tackling a number of structural flaws in the market risk framework that were not addressed by the amendments introduced in 2009. This work has led to the revised market risk framework. Following a number of consultation papers and several quantitative studies, the Basel Committee has, on 14 January 2016, issued the final standards on minimum capital requirements for market risk. The new framework takes effect in 2019.

In summary, the revisions focus on three key areas:

- a* A revised boundary between the banking book and trading book to reduce incentives for a bank to arbitrage its regulatory capital requirements between the two regulatory books, while continuing to respect banks' risk management practices. In particular, stricter limits along with capital disincentives are applied to the transfer of instruments between the banking book and trading book.
- b* A revised internal models approach for market risk with more coherent and comprehensive risk capture. In addition, the new approach introduces a more rigorous model approval process.
- c* A revised standardised approach for market risk that facilitates more consistent and comparable reporting on market risks across banks and jurisdictions and which is suitable for banks with limited trading activity while also sufficiently risk sensitive to serve as a credible fall-back for, as well as a floor to, the internal models approach.

The Committee is expected to complete its work to address the problem of excessive variability in risk-weighted assets by the end of 2016.

V BASEL III: LIQUIDITY

The financial crisis demonstrated the critical importance of liquidity. Prior to the crisis, funding was easily available at relatively low cost. However, the rapid reversal of market sentiment demonstrated how quickly liquidity can evaporate, necessitating unprecedented central bank intervention to support the money markets and individual financial institutions. As a result, the Basel Committee has adopted two liquidity standards: the LCR and the NSFR. These liquidity requirements will be applied on a consolidated basis. Revisions to the LCR, incorporating amendments to the definition of high-quality liquid assets and net cash outflows, were adopted in January 2013. Details of the NSFR were published in 2014.

i LCR

The LCR is an essential component of the Basel III reforms. It seeks to ensure that banks have an adequate stock of unencumbered high-quality liquid assets that can be converted into cash to meet their liquidity needs over a 30-day period under a significant liquidity stress scenario. The 30-day period is based on the assumption that this will be sufficient for corrective action to be taken by the bank, or for the bank to be resolved in an orderly manner without exposing the taxpayer to losses.

Once fully implemented, the LCR standard will be as follows:

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over a 30-day period}} \geq 100 \text{ per cent}$$

The LCR is being introduced in stages from 1 January 2015 (see below).

The LCR is based on two elements: a definition of high-quality liquid assets and a metric for calculating net cash outflows in a liquidity stress scenario.

ii High-quality liquid assets

The Basel Committee has identified two types of eligible assets: Level 1 assets and Level 2 assets. Level 1 assets can be used to satisfy the LCR without limit, whereas Level 2 assets are capped at 40 per cent of the overall stock of assets held to satisfy the LCR. The calculation of the limit is adjusted to reflect the impact of secured funding transactions or collateral swaps.

Level 1 assets include cash, central bank reserves, claims on sovereigns and public sector entities assigned a zero per cent risk weight under the Basel II standardised approach, and claims on non-zero per cent risk-weighted sovereigns and public sector entities that are issued in the domestic currency of the relevant sovereign.

Following the January 2013 revision to the LCR, Level 2 assets are divided into Level 2A and Level 2B assets. Level 2A assets include claims on sovereigns and public sector entities risk-weighted 20 per cent under Basel II, together with corporate bonds and covered bonds that are rated AA- or better and have a proven record as a reliable source of liquidity during stressed market conditions. Level 2 assets are subject to a minimum 15 per cent haircut on their current market value. Level 2B assets comprise lower quality assets, and are capped at 15 per cent of overall liquid assets. This subclass includes corporate bonds rated A+ to BBB-, certain equities and residential mortgage-backed securities rated AA or higher. Haircuts of

15 or 50 per cent will apply to Level 2B assets. In addition, supervisors may choose to include within Level 2B assets the value of any committed liquidity facility provided by a central bank where this has not already been included in high quality liquid assets.

iii Net cash outflows and inflows

Basel III sets out a metric with assumed outflows and inflows depending on the type of deposit or transaction that was revised in January 2013. Some examples of outflows are set out in the following table:

<i>Transaction type</i>	<i>Assumed cash outflow</i>
Trade finance	0% to 5%
Fully insured retail deposits	3% or 5%
Less stable retail deposits	10%
Unsecured wholesale funding (small business)	5% or 10%
Unsecured wholesale funding within operational relationships	25%
Unsecured wholesale funding from non-financial corporates, sovereigns and public sector entities	20% or 40%
Unsecured wholesale funding from others	100%
Secured funding	0% to 100% depending on collateral
Derivatives	0% to 100% depending on collateral
Covered bonds and structured financing instruments	100%
Asset-backed commercial paper, conduits, structured investment vehicles (SIVs) and other financing facilities	100%
Committed credit and liquidity facilities	5% to 100% depending on borrower. The assumed outflow on committed liquidity facilities extended to corporates has been reduced from 100% to 30%

The Basel Committee has also specified parameters for expected cash inflows. Some examples are given in the table below:

<i>Transaction type</i>	<i>Assumed cash inflow</i>
Maturing reverse repos and similar transactions	0% to 100% depending on collateral
Lines of credit, liquidity facilities and similar arrangements	0%
Retail and small business receivables	50%
Receivables from non-financial wholesale counterparties	50%
Receivables from financial institutions	100%
Derivatives	100%

Of particular relevance to banks is the assumption that credit lines and other contingent funding arrangements provided by other financial institutions are assumed to be incapable of being drawn. The intention is to reduce the contagion risk of liquidity shortages at one bank causing shortages at other banks. Inflows are capped at 75 per cent, requiring banks to hold liquid assets of at least 25 per cent of outflows.

As the LCR is being introduced in stages from 1 January 2015, banks will need to hold liquid assets at least equal to 60 per cent of the LCR from this date. This figure will then rise by 10 percentage points per year, reaching 100 per cent in 2019.

In January 2014, the Basel Committee published the final version of the disclosure requirements for the LCR. The Committee expected national authorities to give effect to the liquidity disclosure requirements relating to the LCR by no later than 1 January 2015. The banks were expected to comply with these requirements from the date of the first reporting period after 1 January 2015.

iv NSFR

The Basel Committee was unable to finalise the detailed requirements for the NSFR in the text of Basel III. As a result, it will not be introduced as a minimum standard until 1 January 2018. The objective of the NSFR is to establish a minimum amount of stable funding based on the liquidity characteristics of a bank's assets and activities over a one-year horizon. The aim is to ensure that longer-term assets are funded with at least a minimum amount of stable liabilities.

The requirement is as follows:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100 \text{ per cent}$$

Stable funding is defined as the portion of those types and amounts of eligible equity and liability financing expected to be reliable sources of funds over a one-year period in conditions of extended stress. The required amount of such funding depends on a bank's assets, off-balance sheet liabilities and activities. The detailed definitions of stable funding were published in October 2014.

The amount of available stable funding is summarised in the table below.

<i>Category of stable funding</i>	<i>Percentage recognised</i>
Regulatory capital before the application of deductions	100%
Any capital instrument that has an effective residual maturity of one year or more	100%
Secured and unsecured borrowings and liabilities with effective residual maturities of one year or more	100%
Stable deposits provided by retail and small business customers	95%
Less stable deposits provided by retail and small business customers	90%
Funding with a residual maturity of less than one year provided by non-financial corporate customers	50%
Operational deposits	50%
Funding with a maturity of less than one year from sovereigns, public sector entities and multi-lateral and national development banks	50%
Other funding (secured and unsecured) not included in the above with residual maturity of not less than six months and less than one year	50%
All other categories including liabilities without a stated maturity	0%

The amount of stable funding required depends on the broad characteristics of the risk profile of a bank's assets and off-balance sheet liabilities. Some examples are as follows:

<i>Asset</i>	<i>Required stable funding</i>
Coins and banknotes	0%
Central bank reserves	0%
Unencumbered Level 1 assets	5%
Unencumbered loans to financial Institutions with residual maturities of less than six months where the loan is secured against Level 1 assets	10%
Unencumbered Level 2A assets	15%
All other unencumbered loans to financial institutions with a maturity of less than six months	15%
Unencumbered Level 2B assets	50%
High-quality liquid assets encumbered for a period of between six months and one year	50%
Loans to financial institutions and central banks with a residual maturity of between six months and less than one year	50%
Other assets not included in the above with a residual maturity of less than one year including loans to non-financial corporate clients, loans to retail customers, loans to sovereigns, central banks and public sector entities	50%
Unencumbered residential mortgages with a residual maturity of one year or more attracting a risk weight of 35% or less under Basel II	65%
Other unencumbered loans – excluding loans to financial institutions – with a residual maturity of one year or more and a risk weight of 35% or less	65%
Unencumbered performing loans – excluding loans to financial institutions - with risk weights greater than 35% and a residual maturity of one year or more	85%
Unencumbered securities that are not in default and do not qualify as Level 1 or Level 2 assets and exchange-traded equities	85%
Physical commodities and gold	85%
All other assets including assets encumbered for one year or more, net derivatives assets, non-performing loans, loans to financial institutions with a residual maturity of over one year	100%

Off-balance sheet categories will be subject to the NSFR based broadly on whether the commitment is a credit or a liquidity facility, or some other contingent funding obligation, without assigning actual percentages other than for irrevocable and conditionally revocable credit and liquidity facilities. National supervisors will be able to specify the required stable funding based on national circumstances.

In June 2015, the Basel Committee published the final version of the disclosure requirements for the NSFR. The Committee expects national authorities to give effect to the liquidity disclosure requirements relating to the NSFR by no later than 1 January 2018. The banks will be required to comply with these requirements from the date of the first reporting period after 1 January 2018.

VI FINANCIAL STABILITY BOARD

i Introduction

The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system.

The FSB has its origins in the Financial Stability Forum (FSF), which was founded in 1999 by the Finance Ministers of the G7 countries.⁵ The foundation of the FSF arose from work carried out by the then Deutsche Bundesbank President, Hans Tietmeyer, on structures to enhance regulatory cooperation and cooperation between regulators and international financial institutions to promote international financial stability.

The FSF was re-established as the FSB at the G20 Summit held in London in April 2009 following calls in November 2008 by leaders of the G20 countries to enlarge the FSF's membership, and subsequent calls for the FSF to assume a more central role in developing structures and mechanisms to address international financial stability issues.⁶ The FSB emerged from the G20 Summit in London with a broader mandate to promote financial stability.

The Charter and organisation of the FSB

The Charter of the FSB came into effect on 25 September 2009, but is not intended to create legal rights and obligations. It does, however, set out the FSB's objective, which is:

[...] to coordinate at the international level the work of national financial authorities and international standard-setting bodies (SSBs) in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In collaboration with the international financial institutions, the FSB will address vulnerabilities affecting financial systems in the interest of global financial stability.⁷

The mandate and tasks of the FSB are stated in the Charter to be to:

- a* assess vulnerabilities affecting the global financial system, and identify and review on a timely and ongoing basis, within a macro-prudential perspective, the regulatory, supervisory and related actions needed to address them, and their outcomes;
- b* promote coordination and information exchange among authorities responsible for financial stability;
- c* monitor and advise on market developments and their implications for regulatory policy;

5 Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

6 The member jurisdictions of the FSB now comprise Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom, the United States and the European Union. Other members include international financial institutions (comprising the Bank for International Settlements, the International Monetary Fund, the Organisation for Economic Co-operation and Development (OECD) and the World Bank) and international standard-setting, regulatory, supervisory and central bank bodies (comprising the Basel Committee, the Committee on Payments and Market Infrastructures, the Committee on the Global Financial System, the International Accounting Standards Board, the International Association of Insurance Supervisors and the International Organization of Securities Commissions).

7 FSB Charter, Article 1. The Charter was amended and restated in June 2012.

- d* advise on and monitor best practice in meeting regulatory standards;
- e* undertake joint strategic reviews of, and coordinate the policy development work of, the standard-setting bodies (SSBs) to ensure their work is timely, coordinated, focused on priorities and addressing gaps;
- f* set guidelines for and support the establishment of supervisory colleges;
- g* support contingency planning for cross-border crisis management, particularly with respect to systemically important firms;
- h* collaborate with the International Monetary Fund to conduct ‘early warning exercises’;
- i* promote member jurisdictions’ implementation of agreed commitments, standards and policy recommendations through monitoring of implementation, peer review and disclosure; and
- j* undertake any other tasks agreed by its members in the course of its activities and within the framework of its Charter.⁸

The FSB has also taken on the task of coordinating the alignment of the activities of SSBs.⁹

The FSB comprises a Plenary Group, Steering Committee, standing committees, working groups, regional consultative groups, a chairperson and a Secretariat.¹⁰ The Plenary is the sole decision-making body of the FSB for all matters governed by its Charter, and comprises representatives of the members of the FSB,¹¹ chairs of the main SSBs and committees of central bank experts, and senior representatives of the IMF, the World Bank, the Bank for International Settlements and the OECD. Decisions are taken by consensus.¹² The Plenary may establish standing committees and working groups as necessary.¹³

The Steering Committee of the FSB is mandated with providing ‘operational guidance’ for the FSB between meetings of the Plenary. The duties of the Steering Committee include monitoring the progress of the FSB’s work, distributing information to members of the FSB and reviewing the policy development work of the SSBs for the Plenary to consider.¹⁴

The chair of the FSB is Mark Carney, currently Governor of the Bank of England.

G20 Pittsburgh Summit

The FSB submitted two reports to the G20 Pittsburgh Summit in September 2009:

- a* an interim report entitled ‘Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability’, which described the implementation of recommendations made by the FSB and the G20 at the April 2009 G20 Summit in London. Subsequent updates have been published by the FSB at regular intervals (most recently on 9 November 2015 for the Antalya G20 summit); and

8 FSB Charter, Article 2(1).

9 FSB Charter, Article 2(2).

10 FSB Charter, Article 7.

11 The representatives are to be at the level of central bank governor or immediate deputy, head or immediate deputy head of the main supervisory or regulatory agency and deputy finance minister: FSB Charter, Article 10(1).

12 FSB Charter, Article 9(2).

13 FSB Charter, Article 9(3)(g).

14 FSB Charter, Article 12(3).

- b* a report entitled ‘Improving Financial Regulation’, which set out a number of reforms aimed at creating a more robust and less pro-cyclical financial system, including:
- strengthening the global capital framework for banks;
 - introducing a new minimum global liquidity standard;
 - reducing the moral hazard represented by systemically important institutions;
 - strengthening accounting standards;
 - improving remuneration practices;
 - expanding oversight of the financial system to hedge funds and credit rating agencies;
 - strengthening the robustness of the OTC derivatives market;
 - relaunching securitisation on a sound basis; and
 - promoting adherence to international standards.

The FSB has focused on these areas in its subsequent work.

Peer reviews

Peer reviews take place under a new FSB Framework for Strengthening Adherence to International Standards. Under this Framework:

- a* member countries of the FSB will disclose their level of adherence to international financial standards;
- b* they will undergo periodic, thematic and single-country peer reviews to evaluate their adherence to these standards; and
- c* the FSB will identify non-cooperative jurisdictions (especially those of systemic importance with weak adherence) and then assist them with adherence.

OTC derivatives and rating agencies

In October 2010, the FSB published a report on implementing OTC derivatives market reforms. The report includes 21 recommendations addressing practical issues in implementing the G20 leaders’ commitments concerning standardisation, central counterparty (CCP) clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions. In particular:

- a* the report concluded that the proportion of the OTC derivatives market that is standardised should be substantially increased to promote central clearing and trading on organised platforms, to reduce systemic risk and improve market transparency;
- b* the report specifies factors that should be taken into account when determining whether a derivative product is standardised and suitable for central clearing;
- c* authorities may consider measures to limit or restrict trading in OTC derivatives that are suitable for clearing but not centrally cleared. Authorities should also ensure that access to CCPs is based on objective criteria, and that a safe and sound environment exists for indirect access. Supervisors should apply prudential requirements that appropriately reflect the risks of non-centrally cleared OTC derivatives;
- d* work should be undertaken to identify those actions needed to ensure that all standardised OTC derivative products are traded on exchanges or electronic trading platforms, where appropriate; and
- e* national authorities need to have a global view of the OTC derivatives markets through full and timely access to relevant data.

In Europe, these recommendations have been addressed through the new regulatory regime for OTC derivatives and CCPs contained in Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (see Section VIII of Chapter 14).

On 27 October 2010, the FSB published principles for reducing reliance on credit rating agency ratings. Excessive reliance on ratings as a substitute for independent credit analysis was a feature of the run-up to the financial crisis. The recommendations included the following:

- a* standard setters and authorities should assess references to credit rating agency ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness;
- b* banks, market participants and institutional investors should make their own credit assessments, and not rely solely or mechanistically on ratings;
- c* central banks should reach their own credit judgements on the financial instruments that they will accept in open market operations, both as collateral and as outright purchases; and
- d* banks must not rely mechanistically on ratings for assessing the creditworthiness of assets. Larger, more sophisticated banks should be expected to assess the credit risk of all assets that they hold (either outright or as collateral).

These principles are echoed in the Basel Committee's consultation papers on the revisions to the standardised approach (see above).

Dealing with SIFIs

On 2 November 2010, the FSB published a report containing recommendations for enhanced supervision of SIFIs. The FSB considered that the level of supervision applied by national authorities to SIFIs must be commensurate with the potential destabilisation risk that such firms pose to their domestic financial system, as well as the broader international financial system. The report made a series of recommendations covering the mandates of supervisors, independence, adequate resources, supervisory powers, techniques of supervision, group-wide and consolidated supervision, macro-prudential surveillance and the use of third parties.

On 12 November 2010, the FSB followed up with a report on reducing the moral hazard posed by SIFIs. Its recommendations included:

- a* all FSB member jurisdictions should put in place a policy framework to reduce the risks and externalities associated with domestic and global SIFIs (G-SIFIs) in their jurisdiction;
- b* G-SIFIs should have loss-absorption capacity beyond the Basel III standards. They should have a higher share of their balance sheets funded by capital or by other instruments that increase the resilience of the institution as a going concern. Depending on national circumstances, this could be drawn from a menu of alternatives, and achieved by a combination of a capital surcharge, a quantitative requirement for contingent capital instruments, and a share of debt instruments or other liabilities represented by 'bail-inable' claims. In some circumstances, further measures, including liquidity surcharges, tighter large exposure restrictions, levies and structural measures could reduce the risks that a G-SIFI presents. The Basel Committee's proposals for additional capital to be held by G-SIBs have already been

mentioned. In November 2011, the FSB published an initial list of G-SIFIs that are subject to requirements for additional loss absorbency. The list is reviewed and updated on an annual basis, with the latest update issued in November 2015;

- c* all jurisdictions should undertake legal reforms necessary to ensure that they have in place a resolution regime that makes feasible the resolution of any financial institution without taxpayer exposure to losses. National authorities should consider restructuring mechanisms to allow recapitalisation as a going concern by way of contractual or statutory debt-equity conversion and write-down tools; and
- d* recovery and resolution plans that assess G-SIFIs' resolvability should be mandatory. Authorities must have powers to require a financial institution to make changes to its legal and operational structure to facilitate resolution. If a SIFI has multiple significant legal entities, it should maintain information on a legal-entity basis; minimise any undue intra-group guarantees; ensure that service agreements are appropriately documented and cannot be abrogated in resolution; and ensure that significant global payment and settlement services are legally separable.

Resolution regimes

On 4 November 2011, the FSB published its 'Key Attributes of Effective Resolution Regimes for Financial Institutions', setting out the core elements necessary for an effective resolution regime. This followed an earlier consultation in July 2011. The key attributes include essential features that should be part of the resolution regimes of all jurisdictions, including scope, the resolution authority, set-off, segregation of client assets, safeguards, crisis management and institution-specific cross-border cooperation arrangements. The key attributes continue to provide the fundamental practical and intellectual basis for resolution regimes in all major banking jurisdictions. The FSB concluded that an effective resolution regime (interacting with applicable arrangements for the protection of depositors, insurance policyholders and retail investors) should:

- a* ensure continuity of systemically important financial services, and payment, clearing and settlement functions;
- b* protect, where applicable, depositors, insurance policyholders and investors that are covered by insurance arrangements, and ensure the rapid return of segregated client assets;
- c* allocate losses to firms' owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
- d* not rely on public support and not create an expectation that such support will be available;
- e* avoid unnecessary destruction of value, and therefore seek to minimise the overall costs of resolution and, where consistent with the other objectives, losses for creditors;
- f* provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;
- g* provide a legal mandate for cooperation, information exchange and coordination domestically and with foreign resolution authorities;
- h* ensure that non-viable firms can exit the market in an orderly manner; and
- i* be credible, and thereby enhance market discipline.

It was also determined that resolution powers should include stabilisation options (through the sale or transfer of shares to a purchaser or to a bridge bank, recapitalisation, or both) as well as liquidation options.

July 2013 saw the publication of three reports on aspects of recovery and resolution planning for SIFIs to assist authorities and firms in meeting the requirements of the FSB's Key Attributes of Effective Resolution Regimes.

The first FSB report set out guidance on developing effective resolution strategies. Resolution plans should help achieve an orderly resolution and facilitate the effective use of resolution powers. Common considerations include the sufficiency of loss-absorbing capital; the position of that capital in the creditor hierarchy and the operational structure, legal structure, enforceability and implementation of 'bail-in'; the treatment of financial contracts in resolution; funding arrangements; and cross-border cooperation and coordination in the proximity of failure. The report considered as alternatives a 'single point of entry' and 'multiple points of entry' in a banking group in a resolution scenario. In the former case, resolution powers would be applied at the top parent or holding company level, and would involve the write-down or mandatory conversion of unsecured debt into equity. Multiple point of entry resolution involves the application of resolution powers by two or more resolution authorities to different parts of the group, and is likely to result in the break-up of the group into two or more separate units. The choice of resolution strategy should take into account the structure and business model of the group concerned and the group's particular characteristics. According to the report, a single point of entry may represent the most effective option for a banking group that operates in a highly integrated manner, whereas a multiple point of entry strategy may well be suitable for a group with a decentralised structure, with subgroups of relatively independently capitalised and separately funded subsidiaries. Neither strategy is, in reality, without significant legal and practical challenges, and it may be that, over time, the 'norm' (if there could be such a thing) for global banking groups will be a resolution strategy that is a hybrid of the single point of entry and multiple point of entry strategies.

The second FSB report set out guidance on recovery triggers and stress scenarios. The report refers to both quantitative and qualitative triggers. Quantitative triggers include ratings downgrades, credit risk limits, withdrawal of deposits or other funding, and the three-month interbank rate. Qualitative triggers could include requests from counterparties for early redemption of liabilities, difficulties in issuing debt at current rates, an unexpected loss of senior management or adverse court rulings. The report noted that G-SIFIs typically use two to four stress scenarios for recovery planning purposes. These may include both systemic and idiosyncratic stress scenarios. Examples of stress scenarios include losses through a rogue trader, a euro or dollar crisis, decreasing GDP rates, loss of goodwill, a significant withdrawal of deposits, an exodus of talent, a collapse of global financial markets and fraud. The report notes that some G-SIFIs also perform reverse stress testing (which involves identifying scenarios in which the group would fail).

The third FSB report provided guidance on the identification of critical functions and critical shared services that resolution regimes and strategies should seek to preserve. A critical function is one provided by a G-SIFI to third parties where the sudden failure to provide the function would be likely to have a material impact on third parties due to the systemic relevance of the function or of the G-SIFI in providing the function.

Shadow banking

The FSB published a report entitled ‘Shadow Banking: Strengthening Oversight and Regulation’ on 27 October 2011, addressing the risks posed to financial stability in the pre-crisis period by non-banks that engaged in maturity transformation. The FSB defined shadow banking as credit intermediation involving entities and activities outside the regular banking system. National authorities should have appropriate system-wide oversight of the shadow banking system, backed up by adequate data-gathering powers and exchange of data within and between jurisdictions. The FSB proposed a three-step approach involving an assessment of the overall shadow banking system, the identification of systemic risk or cases of regulatory arbitrage followed by a detailed assessment of concerns identified. Particular attention should be paid to maturity transformation, liquidity transformation, credit risk transfer and leverage. The report also set out specific regulatory responses:

- a* consolidation rules should ensure that shadow banking entities that a bank sponsors are included within its regulatory balance sheet for the purposes of capital, liquidity and leverage;
- b* limits on the size and nature of a bank’s exposures to shadow banking entities should be enhanced;
- c* risk-based requirements for banks’ exposures to shadow banking entities should be reviewed to ensure all such risks are captured;
- d* banks’ ability to stand behind non-consolidated entities should be restricted through stricter regulation of ‘implicit support’;
- e* the regulation of money market funds needed to be enhanced;
- f* further regulation should be considered in respect of other shadow banking entities where they pose systemic risk or provide opportunities for regulatory arbitrage (e.g., conduits, SIVs), finance companies, mortgage insurance companies and credit hedge funds); and
- g* regulation of repurchase (repo) agreements and securities lending should be considered.

In August 2013, the FSB set out an Overview of policy recommendations for strengthening oversight and regulation of shadow banking. The FSB identified five areas where oversight and regulation needed to be strengthened:

- a* mitigating risks in banks’ interactions with shadow banking entities;
- b* reducing the susceptibility of money market funds to ‘runs’;
- c* improving transparency and aligning incentives in securitisation;
- d* dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending; and
- e* assessing and mitigating financial stability risks posed by other shadow banking entities and activities.

The Overview was accompanied by two reports. IOSCO had previously published policy recommendations for money market funds and global developments in securitisation markets. The first report provided a policy framework for addressing shadow banking risks in securities lending and borrowing. The report made a number of recommendations, including the following:

- a* authorities should collect more granular data on securities lending and repo exposures among large international financial institutions;
- b* trade data and regular snapshots of outstanding balances for repo markets should be collected;
- c* the total national and regional data for both repos and securities lending on a monthly basis should be aggregated;
- d* authorities should review reporting requirements for fund managers to end investors;
- e* authorities for non-bank entities that engage in securities lending should implement regulatory regimes meeting the minimum standards for cash collateral reinvestment in their jurisdiction;
- f* authorities should ensure that regulations governing re-hypothecation of assets meet minimum standards;
- g* authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants; and
- h* authorities should evaluate the costs and benefits of introducing CCPs in the inter-dealer repo market.

The report also set out a proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions. This regulatory framework was revised in November 2015.

The second report set out a policy framework for strengthening oversight and regulation of shadow banking entities. The report included a set of ‘toolkits’ available to address risks presented by specific shadow banking entities. These are based on four overarching principles:

- a* authorities should define and keep up to date the regulatory perimeter (i.e., the activities that are regulated);
- b* authorities should collect information needed to address the extent of risks caused by shadow banking;
- c* authorities should enhance disclosure by other shadow banking entities; and
- d* authorities should assess non-bank financial entities based on their economic functions.

ii Total Loss-Absorbing Capacity Principles for G-SIBs

In November 2014, the FSB published a consultation paper on the adequacy of loss-absorbing capacity of G-SIBs, expounding the concept of total loss-absorbency capacity (TLAC). The consultation paper consisted of two parts. The first proposed principles on loss absorption and recapitalisation capacity of G-SIBs in resolution. The second part of the consultation paper contained a proposal for a term sheet for instruments that contribute to TLAC, as an implementing measure of these principles in the form of an internationally agreed standard for G-SIBs.

On 9 November 2015, the FSB published the final TLAC principles and term sheet, which reflects changes made following the public consultation and the comprehensive impact assessment studies.

G-SIBs will be required to meet the TLAC requirement alongside the minimum regulatory requirements set out in the Basel III framework. Specifically, they will be required to meet a minimum TLAC requirement of at least 16 per cent of the resolution group’s risk-weighted assets (TLAC RWA Minimum) as from 1 January 2019 and at least 18 per

cent as from 1 January 2022. Minimum TLAC must also be at least 6 per cent of the Basel III leverage ratio denominator (TLAC Leverage Ratio Exposure (LRE) Minimum) as from 1 January 2019, and at least 6.75 per cent as from 1 January 2022.

G-SIBs headquartered in emerging market economies will be required to meet the 16 per cent RWA and 6 per cent LRE Minimum TLAC requirement no later than 1 January 2025, and the 18 per cent RWA and 6.75 per cent LRE Minimum TLAC requirement no later than 1 January 2028. This period will be accelerated if, within five years from 2015, corporate debt markets in these economies reach 55 per cent of the emerging market economy's GDP.

The FSB will monitor implementation of the TLAC standard and will undertake a review of the technical implementation by the end of 2019.

The Basel Committee was consulting separately on its proposal for the prudential treatment of banks' investments in TLAC. The consultation period closed on 12 February 2016, and at the time of writing no proposals have yet been submitted.

Appendix 1

ABOUT THE AUTHORS

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Jan Putnis has been a partner at Slaughter and May in London since 2003. His practice focuses on financial regulation, with particular emphasis on international corporate and commercial transactions. Mr Putnis acts for a broad range of financial institutions, including banks, insurance groups and asset managers, on strategic regulatory matters and investigations, cross-border and domestic mergers and acquisitions, and outsourcing. His work involves extensive advice on regulatory capital and on capital structures of new businesses, as well as capital structures to facilitate acquisitions and group reorganisations. Mr Putnis qualified as a solicitor in 1996. In a previous life, he graduated with a degree in physics from Oxford University in 1992.

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