

## ABSTRACT

The main argument of this paper is, namely, the need for greater emphasis on disclosure requirements and measures – particularly within the securities markets. This argument is justified on the basis of lessons which have been drawn from the recent Financial Crises, one of which is the inability of bank capital requirements on their own to address funding and liquidity problems. The engagement of market participants in the corporate reporting process, a process which would consequently enhance market discipline, constitutes a fundamental means whereby greater measures aimed at facilitating prudential supervision could be extended to the securities markets. Auditors, in playing a vital role in financial reporting, as tools of corporate governance, contribute to the disclosure process and towards engaging market participants in the process. This paper will however consider other means whereby transparency and disclosure of financial information within the securities markets could be enhanced, and also the need to accord greater priority to prudential supervision within the securities markets.

Furthermore, the paper draws attention to the need to focus on Pillar 3 of Basel II, namely, market discipline. It illustrates how through Pillar 3, market participants like credit agencies can determine the levels of capital retained by banks – hence their potential to rectify or exacerbate pro cyclical effects resulting from Pillars 1 and 2. The challenges encountered by Pillars 1 and 2 in addressing credit risk is reflected by problems identified with pro cyclical, which are attributed to banks' extremely sensitive internal credit risk models, and the level of capital buffers which should be retained under Pillar Two. Such issues justify the need to give greater prominence to Pillar 3.

As a result of the influence and potential of market participants in determining capital levels, such market participants are able to assist regulators in managing more effectively, the impact of systemic risks which occur when lending criteria is tightened owing to Basel II's procyclical effects. Regulators are able to respond and to manage with greater efficiency, systemic risks to the financial system during periods when firms which are highly leveraged become reluctant to lend. This being particularly the case when such firms decide to cut back on lending activities, and the decisions of such firms cannot be justified in situations where such firms' credit risk models are extremely sensitive – hence the level of capital being retained is actually much higher than minimum regulatory Basel capital requirements.

In elaborating on Basel II's pro cyclical effects, the gaps which exist with internal credit risk model measurements will be considered. Gaps which exist with Basel II's risk measurements, along with the increased prominence and importance of liquidity risks - as revealed by the recent financial crisis, and proposals which have been put forward to mitigate Basel II's procyclical effects will also be addressed.

**Key Words:** Capital Requirements Directive (CRD); Post BCCI Directive; prudential supervision; liquidity; capital; maturity mismatches; regulation

# **Extending the Scope of Prudential Supervision: Regulatory Developments during and beyond the “Effective” Periods of the Post BCCI and the Capital Requirements Directives.**

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## **Introduction**

Each pillar within Basel II was intended to serve as a complement to the other and consequently, Pillar 3 disclosure requirements on their own, would not be sufficient to address issues relating to prudential supervision. However, even though Pillar Three is intended to serve as a complement to other pillars, the inability of bank capital on its own to address funding and liquidity problems constitutes a focal theme throughout this paper. The ECB highlights the fact that even though “added disclosures for large counter parties and those that exceed certain thresholds would be useful in order to enable market participants to better assess their counter party risk and the potential for systemic spill over effects, that no disclosure requirements currently exist within the IASB accounting standards with respect to the main counterparts for derivative transactions.”<sup>2</sup>

The rectification of such a gap, namely the introduction of disclosure requirements with respect to the main counterparts of derivative transactions, would facilitate greater engagement of market participants in the standard setting process – hence promoting better corporate governance. Furthermore, such an engagement is crucial to the success of market based regulation – however, state intervention still finds a role in regulation. Within the context of the importance of state intervention in acting promptly to prevent the failure of “too interconnected” or “too big too fail” institutions, the impact of systemic risk will be illustrated later on in this paper.

The regulatory developments which took place or have taken place before, during and after the introduction of directives such as the Post BCCI Directive, Consolidated Banking Directive and the Capital Requirements Directive, not only highlight a focus on capital adequacy requirements as a foundation of prudential supervision, but also indicate a shift from the focus on banking to principally include investment activities. However, the recent crisis has highlighted the contribution of liquidity risks in fuelling the problems which arose from the crisis – and the inability of capital adequacy requirements on their own to address such problems.

In evaluating the progress and developments which have taken place since the Post BCCI Directive was introduced, to highlight the emphasis and focus which have been placed on capital adequacy requirements (through a consideration of these directives), and to explain why disclosure, transparency and prudential regulation within the securities markets have become so important, this paper will commence with a preliminary section which will consider directives which were introduced and have been introduced pre and post the Post BCCI Directive. In so doing it will highlight developments leading up to the introduction of the Post BCCI Directive, primary reasons for introducing the Post BCCI Directive, aims and objectives of the Post BCCI Directive and what

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<sup>2</sup> ‘Credit Defaults Swaps and Counter Party Risk’ ECB August 2009 at page 29

the Directive achieved. In considering directives introduced after the post BCCI directive - with particular reference to the Consolidated Banking Directive (Directive 2000/12/EC), and the Capital Requirements Directives (2006/48/EC and 2006/49/EC), their aims and achievements will be discussed. The 2006/48/EC will constitute the focal point for purposes of comparative analysis (with the Post BCCI Directive) under this preliminary section.

Section two will then proceed to consider the contribution of the insurance and investment sectors to financial stability and to systemic risks, as well as how such risks could be managed effectively. The recent Crisis has also highlighted the fact that regulators underestimated the role played by non bank institutions in contributing to systemic risks. The European Commission attributed a lack of transparency within the securities markets to the fact that many securities were traded “over the counter” (OTC).<sup>3</sup> Further it stated that derivative traders and other market participants as well as authorities and supervisors were not aware of the derivative trading activities which were taking place and how “a complex web of mutual dependence between market operators was being created, how to disentangle such interdependent market, and how to manage markets in cases which involved defaults and non payments by major derivative participants.”<sup>4</sup> The collapse of Bear Stearns and Lehman Brothers was attributed to factors such as defaults on sub prime mortgages and their exposure - this having been facilitated by collateralised debt obligations (CDOs).<sup>5</sup> It is also contended that this consequently resulted in “mistrust amongst market participants about their individual and reciprocal capacity to pay, lack of lending to those who participated in derivatives trading, and lack of money for the derivatives market.”<sup>6</sup> This section will therefore consider the importance and contribution on the insurance and investment sectors to systemic risks.

Section three will highlight developments which have taken place, and progress which has been achieved – particularly since the onset of the recent Financial Crisis. This amongst other achievements, include proposals for the establishment of an improved European Supervisory Framework, how Basel II has responded to criticisms relating to the pro cyclical effects generated by its overly sensitive internal credit risk models, and to the fact that capital requirements on their own, are not sufficient to counter problems arising from liquidity risks and maturity mismatches.

Section four will consider other recommendations and proposals which have been put forward as means of mitigating pro cyclical effects. The ensuing section (section five) will then elaborate on the role of market participants in assisting supervisory authorities in better management of systemic risk and other supervisory functions. This will then lead to section six which considers the link between prudential regulation and financial reporting, the importance of financial disclosure, reasons attributed to the need to extend the scope of present directives and a discussion on Credit Default Swaps (CDSs) and Counter Party Risk. A conclusion will then be drawn after having considered all these topics. Amongst other findings, this section will also highlight areas in which efforts and further research will still be required.

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<sup>3</sup> See “An Oversight of Selected Financial Reforms on the EU Agenda: Towards a Progressive European Response” September 2009 <http://www.ethicalmarkets.com/2009/09/11/an-oversight-of-selected-financial-reforms-on-the-eu-agenda/> at page 22 of 76.

<sup>4</sup> *ibid*

<sup>5</sup> *ibid*

<sup>6</sup> *ibid*

## **I. Developments leading up to and incorporating the introduction of the Capital Requirements Directive**

The **Consolidated Banking Directive** (Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000) relating to the taking up and pursuit of the business of credit institutions consists of seven banking directives (along with their amending directives) which were replaced by the Commission to derive a single directive (the Consolidated Banking Directive).<sup>7</sup> The seven directives are as follows:

- 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions
- First Banking Directive
- Banking Supervision Directive
- Second Banking Directive
- Own Funds Directive
- Solvency Ratio Directive
- Large Exposures Directive

The purpose of such a codification was aimed at enhancing clarity and transparency of EU legislation.<sup>8</sup>

Paragraph 1 of the Preamble to the Directive reads:

Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions, first Council Directive (77/780/EEC) of 12 December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions, second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions, Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, and Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions have been frequently and substantially amended. For reasons of clarity and rationality, the said Directives therefore, should be codified and combined in a single text.

The Revised Framework for the International Convergence of Capital Measurement and Capital Standards – known as Basel II, was transposed by the Capital Requirements Directive – which comprises the 2006/48/EC Directive<sup>9</sup> and the 2006/49/EC Directive.<sup>10</sup> Such an implementation resulted in amendments to the Consolidated Banking Directive. The 2006/48/EC Directive replicates the codified consolidated Banking Directive.

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<sup>7</sup> See W Hemetsberger and H Schoppmann, *European Banking and Financial Services Law* (2006) Kluwer Publishers at page 3

<sup>8</sup> See *ibid* and Paragraph 1 of the Preamble to the DIRECTIVE 2000/12/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions

<sup>9</sup> On the taking up and pursuit of the business of credit institutions

<sup>10</sup> On the capital adequacy of investment firms and credit institutions

## **Directive 95/26/EC (the "post BCCI" Directive)**

### **Aim of the Directive**

As well as the reinforcement of prudential supervision, the Directive is aimed at protecting clients of financial undertakings.<sup>11</sup> As illustrated by the BCCI case, “effective prudential supervision was handicapped by lack of information, an opaque conglomerate structure, and the difficulty encountered by various regulatory and other official bodies in exchanging information and cooperating satisfactorily, when the group ran into difficulties.”<sup>12</sup>

Furthermore, the role of an auditor in achieving the aims of the Directive is highlighted under paragraph 15 of the preamble to the Directive which states that:

„Whereas, for the purpose of strengthening the prudential supervision of financial undertakings and protection of clients of financial undertakings, it should be stipulated that an auditor must have a duty to report promptly to the competent authorities, wherever, as provided for by this Directive, he becomes aware, while carrying out his tasks, of certain facts which are liable to have a serious effect on the financial situation or the administrative and accounting organization of a financial undertaking“

### **Scope of the Directive**

The Post BCCI Directive is considered to have “considerably widened the scope of information exchange with other official bodies (within the EU) who are not responsible for prudential supervision”.<sup>13</sup> Such bodies include “bodies involved in the liquidation and bankruptcy of financial undertakings, authorities responsible for overseeing auditors, independent actuaries and their governing bodies, bodies responsible for the detection and investigation of breaches of company law, central banks and monetary authorities, public authorities responsible for payment systems, and bodies responsible for clearing or settlement services.”<sup>14</sup>

The scope covered by the Directive 95/26/EC (the "post BCCI" Directive) is also highlighted under Article 1 of the Directive. It extends to credit institutions, insurance undertakings, life assurance undertakings, investment firms and undertakings for collective investment in transferable securities.

### **Article 1 states that**

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<sup>11</sup> See Preamble to Directive – particularly paragraph 15

<sup>12</sup> Furthermore, “the existence of close links with natural persons” is considered to have presented specific problems in the BCCI case. See M Thorn „The Prudential Supervision of Financial Conglomerates in the EU“ North American Actuarial Journal Vol 4 No 3 at page 128

<sup>13</sup> *ibid*

<sup>14</sup> *ibid*

Wherever the term 'financial undertaking' is used in this Directive, it shall be replaced by:

- 'credit institution' where this Directive amends Directives 77/780/EEC and 89/646/EEC;
- 'insurance undertaking' where this Directive amends Directives 73/239/EEC and 92/49/EEC, and 'life assurance undertaking' where this Directive amends Directives 79/267/EEC and 92/96/EEC;
- 'investment firm' where this Directive amends Directive 93/22/EEC;
- 'undertaking for collective investment in transferable securities (Ucits) or an undertaking contributing towards its business activity' where this Directive amends Directive 85/611/EEC.

The Post BCCI Directive amended Directive 77/780/EEC and Directive 89/646/EEC.<sup>15</sup>

## **Directive 2006/49/EC**

The objectives of the Directive are highlighted under paragraph 5 to the Preamble:

„Since the objectives of this Directive, namely the establishment of the capital adequacy requirements applying to investment firms and credit institutions, the rules for their calculation and the rules for their prudential supervision, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and the effects of the proposed action, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve its objectives.”

In drawing attention to the weaknesses of Directive 2004/39/EC<sup>16</sup>, Directive 2006/49/EC highlights the importance of established common standards being in place. According to paragraphs 2 and 3 of the Preamble:

- (2) One of the objectives of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments is to allow investment firms authorised by the competent authorities of their home Member State and supervised by the same authorities to establish branches and provide services freely in other Member States. That Directive accordingly provides for the coordination of the rules governing the authorisation and pursuit of the business of investment firms.
- (3) Directive 2004/39/EC does not, however, establish common standards for the own funds of investment firms nor indeed does it establish the amounts of the initial capital of such firms or a common framework

## **Scope of the 2006/48/EC Directive**

Title I of the Directive deals with the subject matter, scope of the Directive and definitions found therein.

As well as certain institutions stipulated under the Directive,<sup>17</sup> the Directive does not apply to the

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<sup>15</sup> Which amends Directive 77/780/EEC

<sup>16</sup> of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments

<sup>17</sup> See Title 1 Article 2

central banks of member states and post office giro institutions.

Under paragraph 6 of the Preamble to the Directive, the term „credit institution“ is used to denote „all institutions whose business is to receive repayable funds from the public, whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities and to grant credits for their own account.“ Exceptions are to be provided for in the case of certain credit institutions to which the Directive cannot apply.<sup>18</sup>

Under paragraph 16 of preamble to the Directive, mutual recognition shall be extended to „financial institutions which are subsidiaries of credit institutions, provided that such subsidiaries are covered by the consolidated supervision of their parent undertakings and meet certain strict conditions.“

Paragraph 17 of the preamble goes on to state that „the host Member State should be able, in connection with the exercise of the right of establishment and the freedom to provide services, to require compliance with specific provisions of its own national laws or regulations on the part of institutions not authorised as credit institutions in their home Member States and with regard to activities not listed in Annex I provided that, on the one hand, such provisions are compatible with Community law and are intended to protect the general good and that, on the other hand, such institutions or such activities are not subject to equivalent rules under this legislation or regulations of their home Member States.“

Paragraph 58 states that „In order to be effective, supervision on a consolidated basis should therefore be applied to all banking groups, including those the parent undertakings of which are not credit institutions. The competent authorities should hold the necessary legal instruments to be able to exercise such supervision.“

Title III Section 1 and Title III Section 2 of the Directive respectively define what activities are to be carried out by credit and financial institution, and how such activities are to be carried out.

### Principles of Prudential Supervision

According to Title V Chapter 1 of the Directive<sup>19</sup>, principles of prudential supervision include:<sup>20</sup>

- Competence of home and host member state
- Exchange of information and professional secrecy<sup>21</sup>
- Duty of persons responsible for legal control of annual and consolidated accounts

Informational disclosure will constitute the focus of study in this paper.

In relation to disclosure requirements, Chapter 5 Article 144<sup>22</sup> provides that:

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<sup>18</sup> According to paragraph 6 of the Directive, the provisions stated under the Directive „should not prejudice the application of national laws which provide for special supplementary authorisations permitting credit institutions to carry on specific activities or undertake specific kinds of operations.“

<sup>19</sup> 2006/48/EC

<sup>20</sup> see page 22 of 200 of Directive <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF>>

<sup>21</sup> See page 23 of 200 of Directive *ibid*

<sup>22</sup> See under Section 2 „Disclosure by Competent Authorities“. Also see Chapter 5 Articles 145 –148 for “Disclosure

Competent authorities shall disclose the following information:

- (a) the texts of laws, regulations, administrative rules and general guidance adopted in their Member State in the field of prudential regulation;
- (b) the manner of exercise of the options and discretions available in Community legislation;
- (c) the general criteria and methodologies they use in the review and evaluation referred to in Article 124; and
- (d) without prejudice to the provisions laid down in Chapter 1, Section 2, aggregate statistical data on key aspects of the implementation of the prudential framework in each Member State.

The disclosures provided for in the first sub paragraph shall be sufficient to enable a meaningful comparison of the approaches adopted by the competent authorities of the different Member States. The disclosures shall be published with a common format, and updated regularly. The disclosures shall be accessible at a single electronic location.”

The 2006/48/EC Directive expands on certain areas which were highlighted in the Post BCCI Directive. Such areas include activities subject to mutual recognition<sup>23</sup> and authorisation for credit institutions.<sup>24</sup>

Further, whilst paragraph 7 of the Preamble to the Post BCCI Directive states:

“Whereas the principles of mutual recognition and of home Member State supervision require that Member States' competent authorities should not grant or should withdraw authorization where factors such as the content of programmes of operations, the geographical distribution of the activities actually carried on indicate clearly that a financial undertaking has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within whose territory it carries on or intends to carry on the greater part of its activities.”

Paragraph 10 of the 2006/48/EC Directive expands on this, by adding that

“Where there is no such clear indication, but the majority of the total assets of the entities in a banking group are located in another Member State the competent authorities of which are responsible for exercising supervision on a consolidated basis, in the context of Articles 125 and 126 responsibility for exercising supervision on a consolidated basis should be changed only with the agreement of those competent authorities.”

However, the scope covered by the 2006/48/EC Directive in relation to close links is quite limited. As the disclosure of close links is intended to help the regulator identify any possible related sources of risk, and owing to the fact the 2006/48/EC Directive is supposed to be “evolutionary,”<sup>25</sup> it would have been expected that such evolutionary nature of the Directive would have taken into account the effects of increased conglomeration over the years, and the importance of systemic risk – particularly from unregulated (hedge funds) and non bank institutions. Prudential supervision appears to have dedicated overwhelming attention to capital adequacy requirements as a means of identifying risk – as reflected in the Directive.

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by Credit Institutions”

<sup>23</sup> See page 23 of 200 of Directive <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF>>

<sup>24</sup> see Title II Articles 6 – 17

<sup>25</sup> See paragraph 42 of the 2006/48/EC Directive



## II. Systemic Risk

One definition of systemic risk which incorporates the concept of financial instability is provided in the ECB's Financial Stability Review.<sup>26</sup> Systemic risk is used to refer to "the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially."<sup>27</sup> Three forms of systemic risk, which are not mutually exclusive, as identified in the review, include contagion risk, risk of macro shocks and the risk of imbalances that have been accumulated over time.<sup>28</sup>

It has been argued that even though regulation is required in order to ensure the workability of a market economy, "insight provides no necessary role for government intervention and that additional factors must be adduced to justify government intervention because markets evolve self-regulatory mechanisms"<sup>29</sup> The "too interconnected to fail"<sup>30</sup> or "too big to fail" nature of financial institutions such as banks, the insurance industry and the securities markets", a characteristic which in part is attributed to systemic risks, is evidential of the need for government or state intervention. Whether the greater extent of such regulatory functions should be entrusted to state regulators or conducted at federal level is a question which is assuming ever increasing importance, as illustrated by the recent financial crisis, and which is in need of redress – particularly in the US where a significant proportion of the regulation of the insurance industry has been carried out at state level since the 19<sup>th</sup> century.<sup>31</sup>

Whilst systemic risk related effects and corporate collapses in the US are attributed to its structure of financial regulation and the absence of a regulator at federal level for the insurance industry, the regulation of derivatives features prominently not only on the EU's agenda, but also globally.

In their final report, the Financial Crisis Advisory Group highlight the fact that prudential regulators is used to denote banking and insurance regulators – as opposed to securities and other market regulators.<sup>32</sup> This should not be interpreted to imply that systemic risks are only peculiar to the

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<sup>26</sup> See "The Concept of Systemic Risk" Financial Stability Review December 2009 <http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?a3fef6891f874a3bd40cd00aef38c64f> at page 134

<sup>27</sup> *ibid*; Furthermore such systemic effects are considered to originate from "exogenous shocks" or endogenously

<sup>28</sup> *ibid*

<sup>29</sup> See GP O'Driscoll Jr and L Hoskins „The Case For Market Based Regulation" at page 471

<sup>30</sup> These can generally be defined as "financial intermediaries like commercial banks which are engaged in activities whose failure poses a systemic risk or "externality" to the financial system as a whole. Such activities include the provision of loans, acceptance of deposits, investment bank activities related to money market funds, mutual funds, insurance firms and potentially even hedge funds and private equity funds." V Acharya, J Biggs, M Richardson and S Ryan "On the Financial Regulation of Insurance Companies" <http://w4.stern.nyu.edu/salomon/docs/whitepaper.pdf> at page 10 of 47

<sup>31</sup> For more information on this, refer to V Acharya, J Biggs, M Richardson and S Ryan "On the Financial Regulation of Insurance Companies" <http://w4.stern.nyu.edu/salomon/docs/whitepaper.pdf> at page 8 of 47

<sup>32</sup> See page 6 of the Final report. Furthermore they state that securities and other market regulators have "a direct role in enforcing the proper application of accounting standards by publicly traded entities and an oversight role

banking and insurance sectors - as will be illustrated in latter sections of this paper. The ensuing section will focus on systemic risks generated by the insurance sector.

#### A) Contribution of the Insurance and Investment Sectors to Financial Stability

According to the ECB's Financial Stability Review:<sup>33</sup>

“Insurance companies can be important for the stability of the financial system mainly because they are large investors in financial markets, because there are growing links between insurers and banks, and because insurers are safeguarding the financial stability of households and firms by insuring their risks.”

The role played by insurance policies and the insurance sector, in particular, in serving as a guarantee for credit risks and the fact that such guarantees triggered “huge losses and liquidity requirements” for mainly mono line insurers,<sup>34</sup> when the value of the guaranteed assets witnessed a steep decrease, was highlighted by Acharya et al in their report on fundamental issues which insurance regulators are confronted with in the post (2007/09) financial crisis period.<sup>35</sup> In their opinion, three principal forms whereby systemic risks can be generated by the insurance sector, include:<sup>36</sup>

Counter party risk: “If a financial institution is highly interconnected to many other financial institutions, then its failure could have a ripple effect throughout the system – for example OTC (over the counter) derivatives market.

Spill over risks: This constitutes a second means whereby systemic risks could “filter” through the market. These occur “where one institution’s trouble triggers liquidity spirals – resulting in decreased asset prices and the reluctance of lenders to provide funding which results in further price drops and funding illiquidity.”

“The third type of systemic risk arises from the fact that many financial institutions have fragile capital structures in that they hold assets with long duration or low liquidity but their liabilities are quite short term by nature. For example, the collapse of Lehman Brothers and the value of its short term debt resulted in a run on the entire financial system.

The systemic impact of the securities markets is also illustrated in the ECB’s report<sup>37</sup> on credit swaps and counter party risk.<sup>38</sup> As well as highlighting “the role played by credit default swaps (CDSs) in contributing to increased financial contagion”, the importance of counter party risk in

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over the accounting standard setters themselves.”

<sup>33</sup> See “The Importance of Insurance Companies for Financial Stability” December 2009  
<<http://www.ecb.int/pub/fsr/shared/pdf/ivefinancialstabilityreview200912en.pdf?3843b3ec94c7cbccf63a39de1092a674>> at page 160

<sup>34</sup> Monoline insurers and the AIG were primarily affected

<sup>35</sup> See Executive Summary, V Acharya, J Biggs, M Richardson and S Ryan “On the Financial Regulation of Insurance Companies” <http://w4.stern.nyu.edu/salomon/docs/whitepaper.pdf> at page 3 of 47

<sup>36</sup> see ibid at pages 10 - 12

<sup>37</sup> ‘Credit Defaults Swaps and Counter Party Risk’ ECB August 2009

<sup>38</sup> See particularly the executive summary of the report which highlights the contribution made by counter party risk in OTC markets; ibid.

over the counter markets is also emphasised.<sup>39</sup>

The importance the credit default swaps market and its associated risks were also highlighted in the European Commission's staff report.<sup>40</sup> One of the areas which the report indicates as being in need of consideration by regulators includes the necessity of increased disclosure and transparency in the evaluation of systemic risk.

## B) Managing Systemic Risks

In order to manage systemic risk with greater efficiency, four areas are considered to require enhancements and these are as follows:<sup>41</sup>

- i) Extended disclosure on counter party risk, including indicators of counter party concentration exposure, would be useful both for individual institutions and for the market as a whole
- ii) Differences between the major data sources in terms of their data coverage and methodologies should be bridged to allow market participants and regulators to obtain and benefit from a broad and consistent market overview.
- iii) Improvements could also be made in terms of public disclosure. The most active institutions could regularly disclose their total gross notional amounts and gross market values for purchased and sold CDSs, as well as net values for uncollateralised derivative transactions.
- iv) Since information relating to CDS prices remains a challenge for non dealer market participants, increased transparency with regard to sales volumes for trades is desirable for both non-dealer market participants and regulators .

## III. Advancements in the Aftermath of the 2007/09 Financial Crises

### A. Improved European Supervisory Framework

The European Commission's proposals of an improved European financial supervisory framework consist of two new pillars:<sup>42</sup>

- A European Systemic Risk Council (ESRC)
- And a European System of Financial Supervisors

On the 23 September 2009, the European Commission adopted draft legislation aimed at consolidating the supervision of the financial sector in Europe.<sup>43</sup> Furthermore, the legislation will pave way for the creation of a new European Systemic Risk Council (ESRC) (whose functions will consist of "the monitoring and assessment of potential threats to financial stability which arise from macro-economic developments"<sup>44</sup>) , a European System of Financial Supervisors and three new

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<sup>39</sup> Ibid at page 4

<sup>40</sup> See 'Credit Defaults Swaps and Counter Party Risk' ECB August 2009 at page 6. Also see ,Ensuring Efficient, Safe and Sound Derivatives Markets.' European Commission, COM (2009) 332, 3 July 2009

<sup>41</sup> See 'Credit Defaults Swaps and Counter Party Risk' ECB August 2009 at page 6

<sup>42</sup> "European Financial Supervision : A New Supervisory Framework for the EU" page 4 of 18  
[http://ec.europa.eu/internal\\_market/finances/docs/committees/supervision/communication\\_may2009/C-2009\\_715\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf)

<sup>43</sup> See "Commission adopts Financial Supervision Proposals to Strengthen Financial Supervision in Europe"  
<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1347>

<sup>44</sup> See "European Financial Supervision : A New Supervisory Framework for the EU" page 4 of 18 <

supervisory authorities consisting of a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA).<sup>45</sup> Additional proposals aimed at strengthening financial supervision in Europe were adopted on the 26 October 2009.<sup>46</sup> The additional legislative proposals are not only aimed at consolidating the earlier proposals which were adopted on the 23<sup>rd</sup> September, but also to “provide greater detail about precisely what powers are proposed for the new European Supervisory Authorities and in what areas”.<sup>47</sup>

## B. Basel II's Response

Basel II's approach to credit derivatives exposures include the following :<sup>48</sup> Banks are required to capitalise 3 major types of risks: Credit risk, market risk and counter party risk. The level of capital required to cover these risks is dependent on a number of factors which include whether the instrument is accounted for in the trading book, the banking book or whether it is a legal entity that is not subjected to national prudential regulation.

However, problems have been highlighted with Basel II's approach to credit risk measurements - problems which include extremely sensitive internal credit risk models. Furthermore, the inability of capital requirements on their own to address funding and liquidity problems constitutes one of the vital lessons drawn from the recent crisis. The impact of extremely sensitive credit risk models on pro cyclicity, and other measures which have the tendency to induce pro cyclical effects will be considered in the following section.

## Pro cyclicity<sup>49</sup>

The promotion of financial stability through more risk sensitive capital requirements, constitutes one of Basel II's primary objectives.<sup>50</sup> However some problems identified with Basel II are attributed to pro cyclicity and to the fact that not all material credit risks in the trading book are adequately accounted for in the current capital requirements.<sup>51</sup> The pro cyclical nature of Basel II has been criticised since “capital requirements for credit risk as a probability of default of an exposure decreases in the economic upswing and increases during the downturn”<sup>52</sup> – hence

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[http://ec.europa.eu/internal\\_market/finances/docs/committees/supervision/communication\\_may2009/C-2009\\_715\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf)>

Such functions which relate to the macro economic developments within the financial system as a whole are referred to as “macro supervision” for which the ESRC would “provide an early warning of system wide risks”. For further information on this and other functions of the ESRC, see *ibid*.

<sup>45</sup> The European System of Financial Supervisors will serve the purpose of facilitating trust between national supervisors. Such an aim will be promoted by “ensuring *inter alia*, that host supervisors have an appropriate say in setting policies relating to financial stability and consumer protection – hence allowing cross border risks to be addressed more effectively.” See *ibid*

<sup>46</sup> For further information on this, see “Commission Adopts Additional Legislative Proposals to Strengthen Financial Supervision in Europe” < <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1582>>

<sup>47</sup> *ibid*

<sup>48</sup> See “General Capital Requirements to Cover Counter Party Risk Management Under Basel II” Credit Default Swaps and Counter Party Risk ECB at page 37

<sup>49</sup> Pro cyclicity is the tendency for periods of financial/economic downturns or booms to be further exacerbated by certain economic policies.

<sup>50</sup> For further objectives, see , Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies. <

[http://ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/impact\\_assesment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf) > at page 22 of 47

<sup>51</sup> See *ibid* at page 23 of 47

<sup>52</sup> See Annex on Proc cyclicity, Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and

resulting in capital requirements which fluctuate over the cycle. Other identified<sup>53</sup> consequential effects include the fact that fluctuations in such capital requirements may result in credit institutions raising their capital during periods when it is costly<sup>54</sup> for them to implement such a rise – which has the potential of inducing banks to cut back on their lending. It is concluded that “risk sensitive capital requirements should have pro cyclical effects principally on undercapitalised banks.”<sup>55</sup>

Regulators will be able to manage systemic risks to the financial system during such periods when firms which are highly leveraged become reluctant to lend where more market participants such as credit rating agencies, could be engaged in the supervisory process. The Annex to Pro cyclical in the Accompanying Document amending the Capital Requirements Directive<sup>56</sup> not only importantly emphasises the fact that regulatory capital requirements do not constitute the sole determinants of how much capital banks should hold, but also highlights the role of credit rating agencies in compelling banks to increase their capital levels even where such institution may be complying with regulatory requirements.

The association between systemic risks and liquidity risks and the rather apparent lack of due recognition accorded to liquidity risks under Basel II, constituted other reasons for the growing criticism of Basel II.

### Liquidity Risk

The definition of liquidity, as provided by the Bank of International Settlements (BIS), is “the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole.”<sup>57</sup>

In their report on “Addressing Pro cyclical in the Financial System: Measuring and Funding Liquidity Risk”, the Financial Stability Forum (FSF) noted that at the onset of the recent financial crises, the complex response of financial institutions to deteriorating market conditions, was to a large extent, attributed to liquidity shortfalls which reflected “on and off balance sheet maturity mismatches and excessive levels of leverage.”<sup>58</sup> This has resulted in an “increasingly important role

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remuneration policies. <

<sup>53</sup> [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assessment_en.pdf)> at page 46 of 47  
As identified in the Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies. See page 46 of 47

<sup>54</sup> Liquidity, a topic which will be addressed in the next section, is also considered to be “highly procyclical, growing in good times and drying up in times of stress.” During the build up to the present crisis, banks and other financial institutions had an incentive to minimise the cost of holding liquidity. See Report of the Financial Stability Forum on Addressing Pro cyclical in the Financial System “Measuring and Funding Liquidity Risk” at page 24 [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf)

<sup>55</sup> See “Is Basel II Pro Cyclical? A Selected Review of the Literature” Financial Stability Review December 2009 at page 150

<sup>56</sup> Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies.<  
[http://ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assessment_en.pdf)> See page 46 of 47

<sup>57</sup> Principles for Sound Liquidity Risk Management and Supervision Sept 2008  
<<http://www.bis.org/publ/bcbs144.htm>>

<sup>58</sup> Report of the Financial Stability Forum on “Addressing Pro cyclical in the Financial System: Measuring and Funding Liquidity Risk” [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf) at page 24

for liquidity provided by central banks in the funding of bank balance sheets.”<sup>59</sup> Furthermore, the FSF highlighted the urgency of both authorities, namely, supervisors (in their monitoring of liquidity risks at banks) and central banks (in their design and implementation of market operations) collaborating in order to “restore the functioning of interbank lending markets.”<sup>60</sup>

As identified in the ECB’s Financial Stability Review, “the specific knowledge that banks possess about their borrowers make bank loans particularly illiquid.”<sup>61</sup> The connection between liquidity and systemic risks is further highlighted in the Review where it elaborates on possible consequences resulting from a bank’s failure, namely:<sup>62</sup> The “destruction” of such specific knowledge which banks have about their borrowers and the reduction of “the common pool of liquidity.”<sup>63</sup> Such reduction in the common pool of liquidity may also trigger the failure of other banks – with the result that i) the value of such illiquid bank assets diminishes and ii) further problems within the banking systems are aggravated.<sup>64</sup>

“Endogenous risks” could also be generated depending on the type of information which the bank possesses about their borrowers and how the dissipation of such information to the public, if it has the potential to trigger a bank run, can be prevented.

#### According Greater Attention to Liquidity Risks

In February 2008, the Basel Committee on Banking Supervision published a paper titled “Liquidity Risk Management and Supervisory Challenges”, a paper which highlighted the fact that many banks had ignored the application of a number of basic principles of liquidity risk management during periods of abundant liquidity.<sup>65</sup>

An extensive review of its 2000 “Sound Practices for Managing Liquidity in Banking Organisations” was also carried out by the Basel Committee as a means of addressing matters and issues arising from the financial markets and lessons from the Financial Crises.<sup>66</sup>

In order to consolidate on the The BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008, which should lead to improved management and supervision of liquidity risks of individual banks, supervisory bodies will be required “to develop tools and policies to address the procyclical behaviour of liquidity at the aggregate level”.<sup>67</sup>

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<sup>59</sup> *ibid*

<sup>60</sup> „In order to counter the transfer of funding liquidity risk by systemically important financial institutions to the public sector“ ;*ibid*

<sup>61</sup> “The Concept of Systemic Risk” Financial Stability Review December 2009  
<http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?a3fef6891f874a3bd40cd00aef38c64f> at page 137

<sup>62</sup> *ibid*

<sup>63</sup> *ibid*

<sup>64</sup> *ibid*

<sup>65</sup> Principles for Sound Liquidity Risk Management and Supervision Sept 2008  
<<http://www.bis.org/publ/bcbs144.htm>>

<sup>66</sup> *ibid*

<sup>67</sup> “The FSF proposes that the BCBS and CGFS develop a joint research effort to address funding and liquidity risk, starting in 2009. A key component of this research agenda is to define robust measures of funding and liquidity risk, which could assist assessments of liquidity risk by the private sector. Stress tests to gauge the probability and magnitude of a liquidity crisis in different market environments will be considered in this light.” For further information on this, see Report of the Financial Stability Forum on Addressing Pro cyclicalities in the Financial System: Measuring and Funding Liquidity Risk” [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf) at page 24

In responding to the apparent gaps which exist with Basel II – as revealed by the recent crises, proposals which are aimed at imposing penalties for the occurrence of maturity mismatches<sup>68</sup> have been put forward.<sup>69</sup> The degree of disparity which exists between the maturity of assets and liabilities is crucial to determining the state of a company's liquidity. Such penalties aimed at deterring the occurrence of maturity mismatches could include “higher capital requirements for banks which finance their assets with overnight borrowing from the money markets than banks which finance similar assets with term deposits.”<sup>70</sup>

The inability of bank capital, on its own, to address funding and liquidity problems has been acknowledged by many academics. As a result, further proposals, in addition to the above mentioned amendment to Basel II, have been put forward. These include the coupling of the existing regulatory framework with capital insurance or liquidity insurance mechanisms.<sup>71</sup> Such proposals are aimed at “giving banks the right incentives *ex ante* and at improving the resilience of the financial system to shocks *ex post*.”<sup>72</sup> Furthermore, the ECB's Financial Stability Review also highlights proposals which are aimed at supplementing Basel II regulation through the establishment of a mandatory liquidity insurance arrangement - whereby each bank has to pay the supervisor a liquidity charge.<sup>73</sup>

#### IV. Mitigating the Procyclical Effects of Basel II

According to a report,<sup>74</sup> the two principal solutions which have been endorsed by the Turner Review and the DeLarosiére Report, and which are considered to have the potential to reduce pro cyclical effects<sup>75</sup> induced by the CRD and Basel II, include: 1) The requirement that banks “hold bigger reserves during good times - hence limiting credit and risk expansion in good times and storing up capital to be used during bad times” (2) “Increasing risk-weighting on a range of assets because this also restricts balance sheet expansion”.

Another proposal put forward as an optimal means of rectifying Basel II's procyclical effects – as illustrated through the “amplification of business cycle fluctuations”, involves the utilisation of a

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<sup>68</sup> A situation which could occur where an undertaking possesses more short term liabilities than short term asset. It could also occur where more assets are held (than liabilities) for medium and long term obligations.

<sup>69</sup> See “Is Basel II Pro Cyclical? A Selected Review of the Literature” Financial Stability Review December 2009 at page 148 and particularly Brunnermeier et al whose proposal includes the requirement of greater capital, “not only against the risk of assets, but also against the risk of funding such assets.”

<sup>70</sup> Ibid at 148

<sup>71</sup> Brunnermeier et al, Kashyap et al, and Perrotti and Suarez are all of the opinion that even though liquidity assistance to help banks cope with aggregate liquidity shocks is commendable, it would generate minimal benefits where such banks are not provided with the right incentives to reduce the probability of such shocks in the first place. For further information on this, see “Is Basel II Pro Cyclical? A Selected Review of the Literature” Financial Stability Review December 2009 at page 149

<sup>72</sup> Ibid

<sup>73</sup> Ibid

<sup>74</sup> The Turner Review :Key Elements of the Turner Review (page 2 of 4)§ <<http://www.dlapiper.com>>

<sup>75</sup> Exacerbated strains on bank capital is the term used to denote procyclicality ; see *ibid*  
International Accounting Standards are also considered to have had a pro-cyclical impact. It is stated that “in particular moving to marking to market accounting, rather than the more traditional marking to maturity, exacerbated volatility in the accounts of banks – with valuation becoming practically impossible for some securities as the market in them disappeared.”; *ibid*

“business cycle multiplier of the Basel II capital requirements that is increasing in the rate of growth of the GDP”. Under such a scheme, it is argued, riskier “banks would face higher capital requirements without regulation exacerbating credit bubbles and crunches.”<sup>76</sup>

Other mechanisms provided under the CRD as means of mitigating pro cyclicalities within the capital requirements framework include:<sup>77</sup>

- The use of downturn Loss Given Default (LGD) estimates, PD estimates being based on long data series, technical adjustments made to the risk weight function, stress testing requirements and Pillar 2 supervisory review process. It is acknowledged, however, that more measures may be required to mitigate the procyclical effects of the capital requirements framework. Options provided include those aimed at reducing its cyclical risk sensitivity, measures which enhance its risk capture, and the intentional introduction of counter-cyclical buffers (comprising capital and/or provisions).

#### Financial Stability Forum Recommendations Aimed at Mitigating Procyclicality

In its report<sup>78</sup> on “Addressing Procyclicality in the Financial System”, the Financial Stability Forum’s recommendations to mitigate mechanisms that amplify procyclicality was extended to three areas:<sup>79</sup>

i) bank capital framework, ii) bank loan loss provisions as well as iii) leverage and valuation issues.

A summary of the recommendations relating to capital, as provided in the Report of the Financial Stability Forum is as follows:<sup>80</sup>

- That the Basel Committee on Banking Supervision (BCBS) should strengthen the regulatory capital framework so that the quality and level of capital in the banking system increase during strong economic conditions and can be drawn down during periods of economic and financial stress;
- That the BCBS should revise the market risk framework of Basel II to reduce the reliance on cyclical VAR-based capital estimates;
- The BCBS should supplement the risk-based capital requirement with a simple, non-risk based measure to help contain the build-up of leverage in the banking system and put a floor under the Basel II framework;
- Supervisors should use the Basel Committee's enhanced stress testing practices as a critical part of the Pillar 2 supervisory review process to validate the adequacy of banks’ capital buffers above the minimum regulatory capital requirement;

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<sup>76</sup> R Repullo, J Saurina, and Carlos Trucharte, “How to Mitigate the Procyclical Effects of Capital Adequacy Rules” <<http://www.eurointelligence.com/article.581+M5ff0e4ba595.0.html>>

<sup>77</sup> See the Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assessment_en.pdf) Page 46 of 47

<sup>78</sup> “Report of the Financial Stability Forum on Addressing Pro cyclicalities in the Financial System” [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf)

<sup>79</sup> Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assessment_en.pdf) page 46 of 47

<sup>80</sup> See “Report of the Financial Stability Forum on Addressing Pro cyclicalities in the Financial System” at pages 2 and 3 [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf)



That the BCBS should monitor the impact of the Basel II framework and make appropriate adjustments to dampen excessive cyclicality of the minimum capital requirements;

That the BCBS carry out regular assessments of the risk coverage of the capital framework in relation to financial developments and banks' evolving risk profiles and make timely enhancements.

## **V. The Role of Market Participants in Assisting Supervisory Authorities in Better Management of Systemic Risk and other Supervisory Functions.**

The potential of market discipline to “reinforce capital regulation” and hence prudential supervision, and to “promote the safety and soundness of banks and financial systems” is acknowledged by Pillar 3 of Basel II.<sup>81</sup>

**“Market discipline** imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner. It can also provide a bank with an incentive to maintain a strong capital base as a cushion against future losses arising from its risk exposures.”<sup>82</sup>

As highlighted by the Annex to Pro cyclicality in the Accompanying Document amending the Capital Requirements Directive,<sup>83</sup> regulatory capital requirements do not constitute the sole determinants of how much capital banks should hold. Credit rating agencies also assume a vital role in compelling banks to increase their capital levels even where such institution may be complying with regulatory requirements.

The European Supervisory Authorities are to be given the responsibility for the authorisation and supervision of certain entities such as credit rating agencies and EU central counter party clearing houses, entities which have “pan-European reach”.<sup>84</sup>

“These responsibilities could include such powers as those of investigation, on-site inspections and supervisory decisions. These responsibilities would be defined in sectoral legislation (e.g., the Regulation on Credit Rating Agencies). Apart from reinforcing the effectiveness of supervision, this could enhance efficiency by creating a 'one-stop shop' for these supervised institutions.”<sup>85</sup>

### **Managing Credit and Counterparty Risks**

Paragraphs 3-5 of Annex V<sup>86</sup> to the 2006/48/EC Directive consist of stipulated criteria which should

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<sup>81</sup> “Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk” [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf) at page 22

<sup>82</sup> *ibid*

<sup>83</sup> Accompanying Document to the Proposal for a Directive of the European Parliament and of the Council amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies. See page 46 of 47

<sup>84</sup> [http://ec.europa.eu/internal\\_market/finances/docs/committees/supervision/communication\\_may2009/C-2009\\_715\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf) page 12 of 18

<sup>85</sup> *ibid*

<sup>86</sup> Technical Criteria Concerning the Organisation and Treatment of Risks

be followed and applied as means of managing credit and counter party risks more efficiently.

Paragraphs 3-5 provide that:

- 3.Credit-granting shall be based on sound and well-defined criteria. The process for approving, amending, renewing, and re-financing credits shall be clearly established.
- 4.The ongoing administration and monitoring of their various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, shall be operated through effective systems.
- 5.Diversification of credit portfolios shall be adequate given the credit .

## **VI. Link between Prudential Regulation and Financial Reporting: The Importance of Financial Disclosure**

According to the Final Report of the Financial Crisis Advisory Group(FCAG), accounting standard setters fulfil their roles by facilitating the reporting of information related to the performance and financial condition of institutions - information which should be objective, transparent and applicable, whilst prudential regulators are concerned in the mitigation of risks arising from organisational failures and ensuring the “safety and soundness” of financial institutions.<sup>87</sup> Despite these distinct functions, it is furthermore argued that both roles are similar in that they are committed towards the goals of promoting public interests, attaining financial stability and both are dependent on financial reporting in their decision making processes.<sup>88</sup> The tendency of interests of financial market participants and prudential regulators to overlap, and the fact that prudential regulators are considered by the FCAG to be important users in financial reporting generates beneficial outcomes for the financial system since “ regular discussions are initiated between accounting standard setters and prudential regulators about potential changes to accounting standards.”<sup>89</sup>

However, financial reporting cannot be relied upon on its own. Even though it serves as a means whereby transparency of market information is facilitated, the information it provides is based solely on the business performance and condition of an entity for a limited duration of time.<sup>90</sup>

### **A. Widening the Scope of the Present Directives: According Greater Attention to Regulation in the Securities Markets**

The ineffectiveness of market discipline to limit risk taking outside the banking sector, an underestimation of the systemic importance of some non banks institutions, and the fact that regulators (and supervisors) failed to take adequate account of the systemic risks presented by the interaction between regulated and unregulated institutions activities (such as hedge funds), and

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<sup>87</sup> See Final Report of the Financial Crisis Advisory Group page 6

<sup>88</sup> *ibid*

<sup>89</sup> *ibid* at page 7 - “For example, prudential regulators could benefit from the insight of accounting standard setters in making regulatory requirements (such as the Basel ratios) more transparent.” See *ibid*

<sup>90</sup> See Final Report of FCAG July 2009 at page 9 <

[http://www.fasb.org/cs/ContentServer?c=Document\\_C&pagename=FASB/Document\\_C/DocumentPage&cid=1176156365880](http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB/Document_C/DocumentPage&cid=1176156365880)>

markets constitute some vital lessons from the 2007/09 Financial Crisis.<sup>91</sup> The unregulated hedge fund industry in particular, constitutes a source of major concern for many jurisdictions. The draft legislation adopted by the Commission in September 2009<sup>92</sup> will pave way for the creation of a European Securities and Markets Authority (ESMA). Whilst the Eurozone has responded to the need to facilitate measures aimed at fostering greater prudential supervision of the securities market, and whilst the Turner Review signifies a turning point in the regulation of the hedge fund industry in the UK, the approach adopted by the European Commission to the regulation of the hedge fund industry, has been considered “mild” – given the fact that such an industry will be permitted greater access to European markets.<sup>93</sup> This being the case even though the European Commission proposed a set of rules which require mandatory registration and disclosure of hedge fund activities to regulators.<sup>94</sup> An obligation for EU managers of so-called “alternative investment funds” to register and disclose their activities, a measure which is aimed at enhancing supervision and avoiding systemic risks, constitutes the “principal regulatory component” of the proposed legislation.<sup>95</sup>

#### B. Credit Default Swaps<sup>96</sup> and Counter Party Risk<sup>97</sup>

The European Central Bank’s report on “Credit Default Swaps and Counter Party Risk” identifies asymmetrical information as constituting a challenge for non-dealer market participants since in its view, price information is currently limited - as dealer prices are typically set on a bilateral basis and are not available to non-dealers.<sup>98</sup> Furthermore, the report also identifies the role played by credit default swaps in the recent financial crises, highlights the contribution of counter risk management in the collapse of Bear Stearns and Lehman Brother, and also the challenges relating to the management of counter party risk exposures which arise from Credit Default Swaps (CDSs) and other (“over the counter”)OTC derivatives.<sup>99</sup>

As was highlighted under the introductory section, the European Commission attributed a lack of transparency within the securities markets to the fact that many securities were traded “over the counter” (OTC).<sup>100</sup> Further it stated that derivative traders and other market participants as well as authorities and supervisors were not aware of the derivative trading activities which were taking place and how “a complex web of mutual dependence between market operators was being created, how to disentangle such interdependent market, and how to manage markets in case which involved defaults and non payments by major derivative participants.”<sup>101</sup>

However some commentators are of an entirely different opinion as regards the need for greater transparency. Such commentators argue that increased transparency could actually impede proper functioning of the market – particularly where limited liquidity was available for a contract and

<sup>91</sup> See A Carvajal and others ‘The Perimeter of Financial Regulation’ (2009) SPN/09/07 at page 4 of 17 <<http://www.imf.org/external/pubs/ft/spn/2009/spn0907.pdf> >

<sup>92</sup> See “Commission adopts Financial Supervision Proposals to Strengthen Financial Supervision in Europe” <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1347>

<sup>93</sup> See „McCreedy Spares Hedge funds From Tight Regulation“ 30 April 2009 <http://www.euractiv.com/en/financial-services/mccreedy-spares-hedge-funds-tight-regulation/article-181867>

<sup>94</sup> *ibid*

<sup>95</sup> *ibid*; Furthermore, the Commission adds that “such obligations within the proposed legislation are not to be applied to the funds themselves, but only to their managers – since the manager is responsible for key decisions”.

<sup>96</sup> „Derivative instruments which enable market participants to transfer or redistribute credit risk.“ See Executive Summary of „Credit Default Swaps and Counter Party Risk“ European Central Bank 2009 at page 4

<sup>97</sup> Risk that a counter party would default

<sup>98</sup> „Credit Default Swaps and Counter Party Risk“ European Central Bank 2009 at page 62

<sup>99</sup> *ibid* at page 36

<sup>100</sup> See “An Oversight of Selected Financial Reforms on the EU Agenda: Towards a Progressive European Response” September 2009 at page 22 of 76.

<sup>101</sup> *ibid*

where the disclosure of volume and price data could reveal a firm's business strategies.<sup>102</sup> It is however contended that greater transparency would enhance price and volume data – which would provide a better picture of the liquidity of a product and aid market participants in adjusting their positions and related capital or collateral.<sup>103</sup> Furthermore, the ECB report highlights the CESR's observations that most market participants would welcome increased transparency with regards to CDSs – as long as this would provide information on the volume of credit transfers (which would also generate liquidity).<sup>104</sup>

## VII. Conclusion

A huge step towards greater extension of prudential supervision to the securities markets comprises greater information disclosure and hence, improved transparency. Progress in achieving such a goal is evidenced by the recent efforts of bodies such as the Financial Stability Board, the IASB and the Basel Committee on Banking Supervision<sup>105</sup>. Even though considerable progress has been achieved in areas relating to pro cyclical and liquidity risks, particularly during the aftermath of the recent financial crisis, further work is required in the following areas:

- Increased transparency of information in relation to Credit Default Swaps
- More stringent measures aimed at regulating the hedge fund industry
- Disclosure requirements within the IASB accounting standards with respect to the main counterparts for derivative transactions - “added disclosures for large counter parties and those that exceed certain thresholds which would enable market participants to better assess their counter party risk and the potential for systemic spill over effects”. Such requirements as identified by the ECB, do not currently exist within the IASB framework.
- In its report on “Addressing Pro cyclical in the Financial System: Measuring and Funding Liquidity Risk”, the Financial Stability Forum also highlights the need for supervisors to intensify efforts relating to the oversight of maturity and liquidity mismatches.<sup>106</sup> Furthermore, the FSF highlights the need to undertake more intensive research in areas which involve the definition of maturity and liquidity mismatches at the systemic level – owing to its more complex nature at such a level (this being attributed to the cross links between financial firms).<sup>107</sup>

As well as the need to give greater attention to disclosure requirements as a means of facilitating prudential supervision, more extensive involvement of market participants in the supervision process has the potential to contribute to the regulator's ability to manage systemic risks more efficiently – since capital adequacy requirements do not constitute the sole determinants of capital levels to be retained by banks and since market participants such as credit agencies, whose

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<sup>102</sup> „Credit Default Swaps and Counter Party Risk“ European Central Bank 2009 at page 85

<sup>103</sup> *ibid*

<sup>104</sup> The potential negative impact on liquidity has been emphasised by some market participants who are in favour of self regulatory initiatives, *ibid*.

<sup>105</sup> See also “Enhancements to the Basel II Framework” July 2009 Bank of International Settlement Publications <http://www.bis.org/publ/bcbs157.htm> and Revisions to the Basel II Market Risk Framework July 2009 Bank of International Settlements Publications <http://www.bis.org/publ/bcbs158.pdf>

<sup>106</sup> It also adds that where thresholds for indicators of such mismatches are breached, that supervisory checks should be carried out. See “Report on the Financial Stability Forum on Addressing Pro cyclical in the Financial System: Measuring and Funding Liquidity Risk” [http://www.financialstabilityboard.org/publications/r\\_0904a.pdf](http://www.financialstabilityboard.org/publications/r_0904a.pdf) at page 23

<sup>107</sup> In this respect, the FSF makes reference to Recommendation 3.2 which states that „The BCBS and CGFS should launch a joint research program to measure funding and liquidity risk attached to maturity transformation, enabling the pricing of liquidity risk in the financial system.“ ;*ibid*

expectations and actions may compel banks to raise capital levels (even where such institutions are complying with regulatory requirements), also have a role to play in the supervisory process.

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