ABSTRACT

This paper is primarily aimed at highlighting the role and significance of asymmetric information in contributing to financial contagion. Furthermore, in emphasising the importance of greater disclosure requirements and the need for the disclosure of information relating to "close links", such disclosure being considered vital in assisting the regulator in identifying potential sources of material risks, it illustrates the fact that incentives (such as the reduction in the levels of capital to be retained by institutions), which have the potential to facilitate market based regulation (through non binding regulations), may not necessarily serve as suitable means in the realisation of some of Basel II's objectives – namely the achievement of "prudentially sound, incentive-compatible and risk sensitive capital requirements".

The paper also attempts to raise the awareness that the operation of risk mitigants does not justify a reduction in the capital levels to be retained by banks – since banks operating with risk mitigants could still be considered inefficient operators of their management information systems (MIS), internal control systems, and risk management processes. The fact that banks possess risk mitigants does not necessarily imply that they are complying with Basel Core Principles for effective supervision (particularly Core Principles 7 and 17) – as the paper will seek to demonstrate. Core Principle 7 not only stipulates that "banks and banking groups satisfy supervisory requirements of a comprehensive management process, ensure that this identifies, evaluates, monitors and controls or mitigates all material risks and assesses their overall capital adequacy in relation to their risk profile, but that such processes correspond to the size and complexity of the institution." Certain incentives which assume the form of capital reductions are considered by the Basel Committee to "impose minimum operational standards in recognition that poor management of operational risks (including legal risks) could render such risk mitigants of effectively little or no value and that although partial mitigation is rewarded, banks will be required to hold capital against residual risks".

Information disclosure should be encouraged for several reasons, amongst which include the fact that imperfect information is considered to be a cause of market failure – which "reduces the maximisation potential of regulatory competition", and also because disclosure requirements would contribute to the reduction of risks which could be generated when granting reduced capital level rewards to banks who may have poor management systems.

Key Words: incentives, risk, mitigants, Basel, regulation, regulatory competition

The Impact of Capital and Disclosure Requirements on Risks and Risk Taking Incentives

Marianne Ojo[1]

1. Introduction

One of the objectives which the Basel II framework was intended to achieve is the "alignment of capital adequacy assessment more closely with the key elements of banking risks and to provide incentives for banks to enhance their risk management and management capabilities."[2] The Basel Committee is of the opinion that "improved risk sensitivity in minimum capital requirements" with respect to greater recognition of credit risk mitigation techniques, has the potential to provide positive incentives to banks to improve risk measurement and management of risk mitigants.[3]

The role played by bank capital within the context of bank soundness and risk taking incentives and corporate governance are factors which are considered to contribute to its importance.[4] However, as revealed during the recent crisis, capital adequacy requirements on their own, cannot sufficiently address the problems generated as a result of the occurrence of systemic, liquidity risks and maturity mismatches. For this reason, an investigation into the possible impact of disclosure requirements on risk taking incentives and the effectiveness of such disclosure requirements would have important implications for the banking industry in particular. The impact of capital and disclosure requirements on risk taking incentives and risks will be approached from two dimensions:

1) Impact on management incentives
2) Impact on asymmetric information – given the fact that asymmetric information has the potential to trigger bank runs and systemic risks.

Hence section 2 will consider the impact of capital and disclosure requirements on management incentives. The impact of capital and disclosure requirements on asymmetric information will thereafter be considered in the first subsection to section 3 whilst the other subsection will comprise of a discussion on pro cyclicality – embracing a consideration of systemic related aspects and liquidity risks. The justification for regulation within the bank sector and the securities markets will be introduced under section 4. Under this section, three principal and traditional arguments which are considered insufficient in justifying capital regulation within the bank sector will be analysed. A further argument which relates to the potential of information asymmetry between bank managers and depositors to generate market failures, and which consequently provides the rationale for government or central bank

---

1 Researcher, Center for European Law and Politics (ZERP) University of Bremen, and Teaching Associate Oxford Brookes University.

2 See Consultative Document: Overview of the New Basel Capital Accord at page 1 < http://www.bis.org/publ/bcbsca02.pdf>

3 ibid at page 3

4 See J Santos „Bank Capital Regulation in Contemporary Banking Theory at page 3

intervention in the financial system, is one which is considered to be more convincing - even though such an argument also does not evade criticism entirely.

Sections 5 and 6 will deal respectively with disclosure requirements and the impact of remuneration policies on risk taking incentives. Section 7 will then introduce the concept, benefits and disadvantages of regulatory competition from a perspective which incorporates binding and non binding legislations. As well as elaborating on the advantages and disadvantages that are associated with binding and mandatory regulations, this section *inter alia* will attempt to draw a parallel between regulatory competition and Basel II. Focus will be dedicated to the effects of capital requirements – irrespective of whether they are binding or non binding in nature.

Efforts being undertaken to facilitate the imposition of binding obligations on credit institutions and investment firms, and reasons attributed to the importance of binding recommendations, will be considered before a conclusion is arrived at.

2. Impact of Capital and Disclosure Requirements on Management Incentives

By impacting management incentives (through disclosure requirements), the effectiveness of capital adequacy requirements will be enhanced. It has been argued that amendments to Basel II will have little impact unless management incentives can be projected in the right direction.

According to Perotti and Suarez who put forward a proposal[5], "liquidity assistance to help banks cope with aggregate liquidity shocks is a good thing in principle, but has little value if banks are not given the right incentives to reduce the probability of such shocks in the first place".[6]

Such a proposal is aimed at providing banks with "the right incentives ex ante and at improving the resilience of the financial system to shocks ex post".[7] A mandatory liquidity insurance arrangement under which individual banks are obliged to pay a liquidity charge to the supervisory authority, will serve to supplement Basel II rules is also proposed.[8]

Certain schemes, whilst implemented with the aim of mitigating systemic and institutional risks, have also been known to contribute towards higher risk taking levels and the aggravation of risk levels. Two of such schemes will be considered in this paper. The first, namely, deposit insurance schemes will be considered in the following section whilst liquidity insurance arrangements will be considered under section seven of this paper.

Deposit Insurance Schemes

Deposit insurance schemes, whilst serving as a means of avoiding bank runs, have also contributed to higher risk taking levels by banks. It is argued that "deposit insurance (when not fairly priced), provides banks with an incentive to increase risk taking" – and that such

---

5 A combination of proposals attributed to Brunnermeier et al and Kashyap et al

6 "Is Basel II Procyclical?: A Selected Review of the Literature" Financial Stability Review 2009 ECB Publications pages 149

7 ibid

8 ibid

risk taking is facilitated by banks, through an augmentation of the risk of banks' assets or their leverage.[9] Such risk taking incentive, it is further argued, along with the "potential externalities resulting from bank failures", serves as one of the primary justifications for the regulation of bank capital.[10] Within such a context, greater disclosure requirements within the banking sector would generate immense benefits since it is contended that " the presence of information asymmetry might make the computation of reasonable premiums impossible or undesirable" – such reasonably priced premiums constituting a vital step towards the "elimination of risk shifting incentives."[11] Although the elimination of risk shifting incentives is a debatable aim[12], reasonably priced premiums would certainly contribute towards the mitigation of risk shifting incentives.

3. Impact of Capital and Disclosure Requirements on Asymmetric Information.

A. The Link between Systemic Risks and Asymmetric Information

The rationale for regulation constitutes the embodiment of two issues:

- Systemic risk
- Asymmetric information

Systemic risks are considered to be of greater relevance to the banking industry. This will be demonstrated through the relationship between systemic, liquidity risks and maturity mismatches, and the role assumed by central banks and banks in liquidity and maturity transformation processes. Since systemic risks are considered to be of greater relevance to the banking industry and since information asymmetry appears to be of greater relevance to the securities markets, it could be argued that the impact of capital regulation requirements on risk taking would be greater within the banking sector whilst disclosure requirements would impact risk taking to a greater extent in the securities markets (than within the banking sector). The expected impact of disclosure requirements and capital regulatory requirements on risk taking would be to mitigate incentives to take unduly high levels of risks, and not to eliminate risks completely.

However, there is growing justification for greater measures aimed at extending capital rules to the securities markets. This not only arises from increased conglomeration and globalisation – which increases risks attributed to systemic contagion, but also the fact that „the globalisation of financial markets has made it possible for investors and capital seeking companies to switch to lightly regulated or completely unregulated markets."[13] Furthermore, it is not only argued that „the fact that many banks in a number of countries have chosen to

---

[9] See J Santos, "Bank Capital Regulation in Contemporary Banking Theory" Financial Markets, Institutions and Instruments 2001 Volume 10(2)at page 17

[10] ibid at page 18

[11] ibid at page 15

[12] The elimination of risks or risk taking incentives is not only considered to be an unfeasible aim, it would also imply that no role exists for regulation – this being the case, since regulation serves the primary aim of regulating and managing risks. For this purpose, the mitigation of risks is considered to be a more desirable aim.

[13] See Deutsche Bundesbank , „Securities Market Regulation: International Approaches" Deutsche Bundesbank Monthly Report January 2006 at page 41

securitise assets is probably largely due to the capital requirements imposed on them", but also that present rules do not „explicitly cover risks other than credit and market risk".[14]

Systemic risks and the central role assumed by banks in relation to liquidity serves as greater justification for regulation with respect to banks. "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."[15]

In relation to the securities markets, information asymmetry appears to constitute a greater basis for regulation.[16] However, the existence of information asymmetry within the banking sector has the potential to generate systemic effects within the banking sector – consequences whose effects, it could be said, could have greater repercussions than if such were to originate from within the securities markets.

As illustrated in the previous section, systemic risks and asymmetric information are two concepts which do not operate in isolation. The importance and magnitude attached to the consequences of information asymmetry within the banking sector does not depend so much on information asymmetry on its own, but its link with systemic risks, the relationship between systemic, liquidity risks and maturity mismatches, and the role assumed by central banks and banks in liquidity and maturity transformation processes. The domino effect resulting from a combination of these contributes to its importance within the banking sector.

The link between liquidity and systemic risks as illustrated in the ECB's Financial Stability Review, is attributed to the "destruction of specific knowledge[17] which banks have about their borrowers and the reduction of the common pool of liquidity."[18] The importance of the link between liquidity risks and systemic risks within the banking sector is highlighted by the consequences attributed to the reluctance of banks to retain liquidity - given the cost of

---

14 Regulation, it is further argued, „may also impact on the relationship between banks and the securities market as a source of finance. So long as the banks are required to set aside 8% capital for loans to the financially soundest companies, direct borrowing in securities markets will probably be a cheaper form of funding for these companies". See „Basel Committee's Proposal for a New Capital Adequacy Framework"http://www.norges-bank.no/templates/article____15120.aspx

15 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 at page 24

16 According to the Bundesbank, „the economics of information, which is widely applicable to the financial markets, therefore eases the rigorous assumptions about information requirements and market perfection." See Deutsche Bundesbank , „Securities Market Regulation: International Approaches" Deutsche Bundesbank Monthly Report January 2006 at page 36

17 Since specific knowledge which banks possess about their borrowers is considered to be a factor which determines the illiquidity of bank loans; see "The Concept of Systemic Risk" ECB Financial Stability Review December 2009 at page 137<http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?05d3164914c6a14bb135222b5c3894fa>

18 ibid; According to the Review, the reduction in the common pool of liquidity also has the potential to trigger the failure of banks and could consequently lead to a devaluation of illiquid bank assets and further aggravation of problems within the banking sector.

holding liquidity.[19] The consequential shortfalls of liquidity as reflected by on and off balance sheet maturity mismatches accentuates the importance of the role assumed by central banks in the funding of bank balance sheets.[20]

B. Procyclicality – Systemic Aspects and Liquidity Risks

The three aspects to pro cyclicality[21] – as highlighted in the Impact Assessment Document amending the Capital Requirements Directive, have the potential to trigger a chain reaction. Starting with remuneration schemes, the impact of these on management incentives, could have a positive or negative effect on bank regulations (such as Basel II or the CRD). Such regulations could then mitigate or exacerbate pro cyclical effects – depending on the effectiveness of capital adequacy rules. A positive effect of such rules would reduce the tendency of banks to cut back on lending during economic "busts" whilst incentives to retain liquidity would be increased – hence reducing the likelihood of the occurrence of maturity mismatches.

Liquidity is considered to be "highly procyclical, growing in good times and drying up in times of stress."[22] During the build up to the present crisis, banks and other financial institutions had an incentive to minimise the cost of holding liquidity.[23] Given the fact that liquidity could also be pro cyclical and given its role in the recent crisis, perhaps four dimensions to pro cyclicality should have been introduced in the Impact Assessment Document[24] amending the Capital Requirements Directive – incorporating liquidity as a fourth heading.

According to the Financial Stability Forum (FSF), an earlier recognition of loan losses, which could have been facilitated by relevant disclosures about loan loss provisioning, could have reduced pro cyclical effects which occurred during the recent crisis.[25] Not only does the FSF propose that amendments be made to the Basel II framework - amendments which are aimed at reducing banks' disincentives to increase their level of provisions for loan losses, it is also of the opinion that measures aimed at improving market discipline could also help in reducing procyclicality and diversity.[26] Furthermore, incentives which would encourage banks to retain liquidity could be introduced – however , such incentives should be granted whilst striving to

---

19 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 at page 24

20 ibid

21 Namely: systemic aspects, bank regulations and remuneration policies

22 See Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System "Measuring and Funding Liquidity Risk" at page 24 http://www.financialstabilityboard.org/publications/r_0904a.pdf

23 ibid

24 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> See page 44-46

25 Report of the Financial Stability Forum on "Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk" at pages 20 and 22

26 ibid at pages 21 and 22

comply with the aims and objectives of Basel – particularly those aimed at enhancing a regulatory framework which is more aligned with economic and regulatory capital.

As well as drawing attention to the fact that capital buffers may not actually mitigate the cyclical effects of bank regulation,[27] regulators are also advised to give due consideration to the effects of risk weights on bank portfolio behaviour when implementing regulations.

4. Justification for Regulation within the Banking Sector and Securities Markets.

The "conventional justification" for regulation within the securities market is attributed to the fact that "exchanges on securities markets lead to external effects (for non participating and therefore non-considered third parties)".[28] Consequently public interest arises – which is aimed at "protecting potentially disadvantaged parties" (owing to reasons attributed to market structure and information asymmetry).[29]

The justification for capital adequacy regulation within the banking sector, on the basis of market failures, is considered to be unconvincing. According to Dowd, three principal and traditional arguments which he considers to be insufficiently justified include:[30]

- The argument that capital adequacy is required for prudential related reasons. He attributes the weakness in this argument to the fact that most of its proponents do not expand on the prudential need in the first place.
- The second argument relates to that which was put forward by Benston and Kaufman[31] which attributes the need for capital adequacy on the basis of its potential to address regulator- induced moral hazard problems. In Dowd's opinion, the weakness inherent in this argument stems from the fact that such an argument does not provide enough justification for a preference for capital regulation over that of *laissez faire*.
- The third argument which is considered by Dowd to be more popular in Europe, is namely, that capital adequacy regulation is required for the protection of small depositors. His criticism of such an argument relates to the lack of clarity and justification which exists in accounting for why such depositors should be accorded protection at the expense of taxpayers.

---

27 See P Agénor and L Pereira da Silva , „Cyclical Effects of Bank Capital Requirements with Imperfect Credit Markets“ World Bank Policy Research Paper 5067 at page 36.They illustrate through their model that capital buffers, by lowering deposit rates, are actually expansionary and that hence, "if capital buffers are increased during an expansion, with the initial objective of being countercyclical, they may actually turn out to be procyclical." This, in their opinion, is an important conclusion, given the prevailing view that "counter-cyclical regulatory requirements may be a way to reduce the build up of systemic risks:if the signaling effects of capital buffers are important, "leaning against the wind" may not reduce the amplitude of the financial-business cycle."

28 See „Securities Market Regulation: International Approaches“ Deutsche Bundesbank Monthly Report January 2006 at page 36

29 ibid

30 See K Dowd, "Does Asymmetric Information Justify Bank Capital Adequacy Regulation?" Cato Journal Volume 19 No 1 1999 at page 39

31 GJ Benston and GG Kaufman, ''The Appropriate Role of Bank Regulation.'' (1996) Economic Journal 106 (May) 688–97.

The most important of all arguments, in Dowd's opinion, relates to that which was put forward by Miles[32], who suggested that an information asymmetry between bank managers and depositors had the potential to generate market failures which consequently provides the rationale for government or central bank intervention in the financial system.[33] Such an argument, still, does not evade criticism which draws from Dowd's opinion that it is not founded on the basis of market failure and that, rather, it is based on the government's failure (moral hazard created by regulatory authorities themselves).[34]

In relation to his criticism that failures related to information asymmetry are founded on governments' failures and in relation to the inherent potential of information asymmetry to generate genuine market failures, although moral hazard resulting from deposit insurance schemes is a consequence of regulators' failure to price premiums appropriately, genuine market failures attributed to the chain reaction generated between systemic risks, liquidity risks and asymmetric information justify the need for capital adequacy regulation within the banking sector. However, recent crisis has highlighted the fact that capital adequacy requirements on their own, do not suffice to counter problems attributed to systemic risks and liquidity risks. Furthermore, the reason for the restriction of regulation to the banking sector alone is not justified.

Disclosure requirements are not only considered best in addressing information asymmetry (a market failure which is very peculiar, but not restricted to securities markets), but also have the potential to exacerbate or prevent (through relevant disclosures about loan loss provisioning) systemic bank runs.

5. Disclosure Requirements

Recent amendments to Pillar 3 of Basel II, which include a statement that "banks need to make disclosures that reflect their real risk profile as markets evolve over time", are aimed at strengthening guiding principles of Pillar 3 (as provided for under paragraph 809).[35] As well as reflecting their real risk profiles, banks' responsibilities towards market participants are also emphasised by the Basel Committee.

Paragraph 809 of the Basel II framework not only highlights the objective of Pillar 3, namely, the supplementation of the minimum capital requirements under Pillar 1, as well as supplementing Pillar 2, but also draws attention to the Committee's endeavours to promulgate market discipline through the development of a set of disclosure requirements which will

---

32 D Miles, ''Optimal Regulation of Deposit Taking Financial Intermediaries'' (1995) European Economic Review 39: 1365–84.

33 K Dowd, "Does Asymmetric Information Justify Bank Capital Adequacy Regulation?" Cato Journal Volume 19 No 1 1999 at page 40; Such intervention, he adds, would assume the form of capital adequacy regulation – as a means of compelling banks to retain stronger capital positions than would otherwise have been; ibid

34 ibid; He concludes therefore by adding that "there is no compelling economic justification for capital adequacy regulation" since no one, as of yet, has been able to provide a convincing argument which is founded on the grounds of market failure; ibid

35 See Consultative Document of the Basel Committee on Banking Supervision "Proposed Enhancements to the Basel II Framework January 2009" < http://www.bis.org/publ/bcbs150.pdf> and the finalised proposals for enhancing the Basel II framework : "Enhancements to the Basel II Framework" July 2009 – particularly "Changes to the Pillar 3 Disclosure Requirements" at page 29 < http://www.bis.org/publ/bcbs157.pdf>

enable market participants to evaluate fundamental sets of information on the scope of application, capital, risk exposures, risk assessment processes – hence the capital adequacy of the institution.[36] In the Committee's opinion, such disclosures are considered particularly relevant within the framework where "reliance on internal methodologies gives banks greater discretion in assessing capital requirements."[37] The additional text to paragraph 809 of the Basel II framework, reads as follows:

"The Committee emphasises, that beyond disclosure requirements, as set forth in Part 4 Section II of the framework, banks are responsible for conveying their actual risk profile to market participants. Furthermore, information disclosed by banks should be adequate to meet this objective."[38]

Other measures aimed at enhancing disclosure requirements relate to areas which include "securitisation exposures in the trading book and sponsorship of off balance sheet vehicles."[39] According to the Summary of the Impact Assessment Document, such amendments are not only aimed at improving investors' understanding of risk profiles of banks, but also aimed at reinforcing bank risk management incentives – by allowing market participants to exercise discipline.[40]

6. Impact of Remuneration Policies on Risk Taking Incentives

In acknowledging the impact of remuneration policies on risk taking incentives in the financial sector, paragraph 5 of the introductory section to the Recommendation on Remuneration Policies,[41] highlights the fact that "creating appropriate incentives within the remuneration system itself should reduce the burden on risk management and increase the likelihood that such systems become effective." Relevant information on remuneration policies and any updates where a change in policy occurs constitute vital elements which should be disclosed – as provided for under section 3 paragraph 7 of the Recommendation. Furthermore, paragraph 7 of the third section highlights the importance of disclosing such information (which may assume the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements), in a "clear and easily understandable way" to applicable stakeholders.[42]

---

36 "Enhancements to the Basel II Framework" July 2009 – particularly "Changes to the Pillar 3 Disclosure Requirements" at page 29 < http://www.bis.org/publ/bcbs157.pdf>

37 ibid

38 ibid

39 See Summary of Impact Assessment document amending Capital Requirements Directive on trading book, securitization issues and remuneration policies – particularly section 5.3 on "Disclosure of Securitization Risks" at page 5 <http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/summary_en.pdf>

40 ibid

41 See Commission Recommendation on Remuneration Policies in the Financial Sector <http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf>

42 A list of information which should be disclosed is provided under Section 3 paragraph 8 and are as follows:

- Information concerning the decision making process – used in determining the remuneration policy
- Information on linkage between pay and performance
- Information on criteria used for performance measurement and risk adjustment
- Information on the performance criteria on which the entitlement to shares, options or variable components is based; and

Paragraph 2 of the Commission Recommendation on Remuneration Policies in the Financial Sector[43] acknowledges that whilst "inappropriate remuneration practices" in the financial services industry was not the principal cause of the recent financial crisis, that it is widely agreed that it fuelled excessive levels of risk taking – hence contributing to huge losses for major financial undertakings. Furthermore, the failure of financial undertakings and systemic problems which arose throughout the EU and worldwide, are attributed to "excessive risk taking" in the financial services industry.[44]

According to the Summary of the Document amending the Capital Requirements Directive,[45] proposed amendments to the CRD will ultimately result in "more effective risk management incentives and practices, more adequate and less volatile bank capital requirements and enhanced disclosure of bank risk positions to market participants."[46]

7. Regulatory Competition, Binding and Non Binding Legislation

The impact of binding and mandatory capital and disclosure requirements will be considered from the context of regulatory competition and Basel regulations.

A. Importance of Binding Legislation

In considering the role of the regulatory capital regime, it is argued[47] that even if capital requirements are not binding, they do affect the transmission process of monetary policy (transmission process of exogenous shocks to bank interest rates, prices, and economic activity). The "sizeable real effects" of binding capital requirements, regardless of the regulatory regime, has constituted the focus of discussion – such sizeable real effects being demonstrated through the possible lending restrictions (via interest rate hikes), which banks may be compelled to implement as a means of complying with such requirements. [48] The different effects generated by different types of bank capital regulations in the transmission process of exogenous shocks to bank interest rates, prices, and economic activities has also been illustrated.[49] Furthermore it was demonstrated that, even if capital requirements are not binding, a "bank capital channel" may operate through a signalling effect of capital buffers on deposit rates".[50]

- The main parameters and rationale for any annual bonus scheme and any other non cash benefits

43 < http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf>

44 In particular, in banks and investment firms. See paragraph 1 of the Commission Recommendation

45 Impact Assessment document amending Capital Requirements Directive on trading book, securitization issues and remuneration policies http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/summary_en.pdf

46 See ibid at pages 6 and 7

47 See Agénor P and Pereira da Silva L, „Cyclical Effects of Bank Capital Requirements with Imperfect Credit Markets" World Bank Policy Research Paper 5067 at page 27

48 See ibid at pages 35 and 36

49 ibid

50 It is argued that under non binding capital requirements and with respect to both Basel I and Basel II, the impact of an increase in the central bank refinance rate on the risk premium is amplified by the bank capital channel whilst its impact on prices are mitigated . However Basel II is considered to impart less pro cyclical effects on the risk premium in comparison to Basel I;ibid at page 27

Proposals put forward by Kashyap et al[51], which are aimed at complementing the existing regulatory framework with capital insurance or liquidity insurance mechanisms, comprise of the establishment of a private insurance scheme funded by investors whereby banks subject to capital regulation would be given the option to purchase this insurance. A decision to opt for such an insurance scheme; in their opinion, should be rewarded by lowering a bank's capital ratio.[52]

In terms of increasing flexibility (with meta regulation being accorded greatest flexibility), enforced self regulation[53] lies between mandatory regulation and meta regulation (an example being provided by Basel II). Banks subject to capital rules, but which still have the option of choosing certain schemes could be classified under enforced self regulation or meta regulation depending on whether such rules are imposed by the State or by such standard setters such as the Basel Committee. Whether (or not) management's incentives could best be impacted through binding legislation, enforced self regulation or meta regulation, depends on the degree of fettered and unfettered discretion which should be accorded to firms – which should be determined based on individual firm circumstances. In relation to the previous paragraph, rewarding banks which have decided to opt for an insurance scheme (through a reduction of the bank's capital ratio), serves as a commendable way of stimulating such banks' incentives, facilitating market based regulation – whilst attempting to deal with liquidity and funding problems. The governing regulation (whether enforced self regulation or meta regulation) would depend on whether the banks are subjected to capital rules imposed by their jurisdictions or to those of standard setters such as the Basel Committee. Where such banks are governed by rules prescribed by their national authorities and given the presumption that enforcement mechanisms operating in such jurisdictions are reasonably effective, then such a decision to provide such banks with the option to purchase capital insurance or liquidity insurance mechanisms would certainly appear to be the right way forward.

However where such banks are subject to capital regulation under (Basel II) the Basel Committee, whose enforcement mechanisms are considered to be weak, then a decision to grant further options to such banks should require that such schemes not only be monitored at greater level than presently operates, but also enforced with greater degree than is presently the case. Where options are granted to banks which are subject to Basel II regulations, clear rules (as prescribed by the Basel Committee or other standard setters – where Basel II rules do not operate) defining the boundaries of such schemes should exist.

In relation to proposals which involve options to purchase capital insurance or liquidity insurance mechanisms, a decision to reward such banks (who opt for such schemes) with lower levels of capital should be considered on the basis of certain criteria which include inherent institutional risks attributed to such institutions – including risks which could arise from operational risks and poor management of internal controls. One of the objectives which

---

51 "Is Basel II Procyclical?: A Selected Review of the Literature" Financial Stability Review 2009 ECB Publications pages 148 and 149 A. Kashyap, J. Stein and R. Rajan, "Rethinking Capital Regulation", Jackson Hole conference paper, 2008.

52 "Is Basel II Procyclical?: A Selected Review of the Literature" Financial Stability Review 2009 ECB Publications at page 149

53 With Enforced Self Regulation, regulation is „enforced" in two senses. Firstly, the firm is required by the State to self-regulate. Secondly, privately written rules are publicly enforced. For more on this and on Enforced Self Regulation, see I Ayres and J Braithwaite Responsive Regulation: Transcending the Deregulation Debate Oxford University Press (1992) at page 101

the Basel II framework was intended to achieve is the “alignment of capital adequacy assessment more closely with the key elements of banking risks and to provide incentives for banks to enhance their risk management and management capabilities.”[54] The Basel Committee is of the opinion that “improved risk sensitivity in minimum capital requirements” with respect to greater recognition of credit risk mitigation techniques, has the potential to provide positive incentives to banks to improve risk measurement and management of risk mitigants.[55]

Furthermore, it recognises the fact that “whilst new proposals provide capital reduction for various forms of transactions that reduce risk, they impose minimum operational standards in recognition that poor management of operational risks (including legal risks) could render such risk mitigants of effectively little or no value and that although partial mitigation is rewarded, banks will be required to hold capital against residual risks.”[56]

Rewards accorded to banks, that is the lowering of such banks’ capital ratios, may not necessarily facilitate a realisation of some of Basel II’s objectives – namely the achievement of “prudentially sound, incentive-compatible and risk sensitive capital requirements” – for which the Basel Committee made provision for an evolutionary, progressive approach to calculating Pillar One capital charges.[57] As illustrated, the fact that certain banks have implemented or operate with risk mitigants does not necessarily serve as a reliable indicator or calculative basis that risks within such institutions are being managed and controlled effectively – neither does it justify a reduction in the level of capital levels to be retained by such banks. Furthermore, such options have the potential to facilitate practices associated with regulatory arbitrage since the alignment of regulatory and economic capital is considered to essential in mitigating such practices.[58]

In what way could disclosure requirements contribute in helping to reduce risks of granting reduced capital level rewards to institutions who may have poor management systems?

Banks opting for insurance schemes should be subject to mandatory disclosure requirements which should reveal information helpful in determining whether or not they are eligible for such schemes and for reduced capital levels. Reasons for opting for such schemes – backed up by banks' current financial statements, as well as detailed information relating to the management information systems, internal controls and other risk management processes which operate within such banks should be disclosed in order to assist in the identification of potential sources of risks. Risk management processes of banks and banking groups should not only be proven to be complying with supervisory requirements of a “comprehensive management process”, and that such processes “identify, evaluate, monitor and control, or mitigate all material risks and assesses their overall capital adequacy in relation to the risk profile” of banks and banking groups, but that such risk management processes correspond to the size and complexity of the institutions.[59] With respect to internal controls and audits, supervisors should not only ensure that bank internal controls operate within the banks and

---

54 See Consultative Document: Overview of the New Basel Capital Accord at page 1 < http://www.bis.org/publ/bcbsca02.pdf>

55 ibid at page 3

56 ibid

57 Such evolutionary approach, according to the Basel Committee, “allows banks that meet incremental minimum capital requirements to avail themselves of more risk-sensitive methodologies” in calculating regulatory capital”; ibid at page 7

58 See F Heid, „Cyclical Implications of Minimum Capital Requirements“ Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No 06/2005 at page 2

59 Core Principle 7, Basel Core Principles for Effective System of Banking Supervision

that these are adequate for the size and complexity of their business, but should also include clear arrangements for delegating authority and responsibility, delineate between certain functions,[60]but ensure that reconciliation of processes exist, as well as confirm that banks' assets are safeguarded with appropriate independent internal audit and compliance functions.[61]

Section 3.4 of the Summary of the Impact Assessment Document[62] highlights the need for a "legally binding EU instrument" which would reinforce the role of supervisors and empower them in their assessment of remuneration schemes of certain regulated financial institutions within a broader context of sound risk management. Such an argument, "within the context of prudential supervision", has been advanced, not only because of "the importance of achieving relevant objectives more effectively", but also given the fact that recommendations are not legally enforceable instruments.[63] Furthermore, the need to discourage practices related to regulatory arbitrage, practices which could occur in the event that companies decide to relocate to jurisdictions where a recommendation[64] does not apply, and in the absence of a binding EU legislation, constitutes another reason for introducing a legally binding instrument.[65]

B. The Theory of Regulatory Competition

Whilst some apparent advantages are associated with binding and mandatory regulations, the disadvantage inherent in mandatory regulation – when compared with the form of regulation synonymous with regulatory competition, is namely, the fact that mandatory regulation does not provide the choice of legal regimes which is offered to market participants under the theory of regulatory competition. It is contended that mandatory regulation, by compelling market participants to comply with a legal regime, generates "sub-optimal" benefits whilst the availability of choice accorded by the theory of regulatory competition, provides the potential to generate optimal regulation.[66]

---

60 Functions which involve committing the bank, paying away its funds, and accounting for its assets and
liabilities; See Core Principle 17, Basel Core Principles for Effective System of Banking Supervision

61 ibid

62 See Summary of Impact Assessment document amending Capital Requirements Directive on trading book, securitization issues and remuneration policies at page 4
http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/summary_en.pdf

63 ibid

64 In this case , the Commission Recommendation on remuneration policies

65 See Summary of Impact Assessment document amending Capital Requirements Directive on trading book, securitization issues and remuneration policies at page 4

66 „A possible problem with a mandatory disclosure regime is that all issuers must reveal the same information about themselves, without consideration of their individual characteristics or the needs of their target investors. Given that preparing a disclosure statement is costly, particularly for an initial public offering, these mandatory disclosure rules may price out some issuers from making offerings that are desirable to the market." See EJ Pan, "Harmonization of U.S.-EU securities regulation: The case for a single European securities regulator". Law and Policy in International Business at page 3 FindArticles.com.
http://findarticles.com/p/articles/mi_qa3791/is_200301/ai_n9192864/

Other benefits attributed to the theory of regulatory competition include:[67]

- By modifying their regulations to optimally match the interests of those that bear the cost and incur the benefit of regulation, regulators would be able to facilitate more superior regulation
- Regulatory competition permits the creation of a single market without requiring member states to forfeit their regulatory power.

C. Criticisms of the Theory of Regulatory Competition

The main criticism which the theory has generated relates to the fact that "unfettered regulatory competition" would result in a "race to the bottom" whereby regulators, in competing for their interests, minimise rules to such an extent that the resulting outcome and benefits generated by such rules are minimal than required.[68] Furthermore, it is argued that "regulatory co-opetition" is preferable to regulatory competition, not only because it offers a model through which optimal governance could be achieved (in a world where some degree of market failure will certainly almost exist), but also given the fact that "optimal governance requires a flexible mix of competition and co operation between governmental actors, as well as between governmental and non governmental actors."[69]

Many similarities exist between Basel II and the form of regulation which is synonymous with the theory of regulatory competition. Basel II could also be considered to "optimally match the interests of those that bear the cost and incur the benefit of regulation"[70]– given its flexibility, its advanced and highly collaborative approach in generating rules. Basel II also allows for a choice of legal regimes- even though banks are still subjected to some degree of mandatory legislation.

Proposed amendments to the Capital Requirements Directive (CRD), as stipulated in the Summary of the Document amending the Capital Requirements Directive, are intended to "impose a binding obligation on credit institutions and investment firms to have remuneration policies which are consistent with effective risk management."[71] The expected result of making relevant principles (which are to be set out in the CRD) binding, will be the

[67] ibid ;The existence of three elements, on which regulatory competition is dependent are as follows: diversity of legal regimes, entity mobility, and governmental responsiveness; see ibid at page 3

[68] ibid at page 4

[69] See D C Esty and D Geradin, "Regulatory Competition and Economic Integration: Comparative Perspectives" Oxford University Press 2001 at page 31; Furthermore, Esty and Geradin argue that whilst proponents of regulatory competition may contend that co-opetition leads to increased regulatory "capture" by interest groups – hence reduced governmental transparency and accountability, that "pitting environmental NGOs, industry associations, and other interests against each other, works out to flesh out viable policies, induce investment in the creation of policy analysis and other valuable information"- factors which, in their opinion, provide a watch dog mechanism and consequently serve as a check on regulatory capture; see ibid at page 45

[70] EJ Pan, "Harmonization of U.S.-EU securities regulation: The case for a single European securities regulator". Law and Policy in International Business at page 3

[71] See pages 5 and 6 of the Summary of the Document amending the Capital Requirements Directive (section 5.4 "Supervisory Review of Remuneration Policies")

enhancement of compliance with such principles.[72] It is also emphasised that a more effective implementation of the relevant principles of the Recommendation on remuneration policies would imply a "trade off which includes long – term benefits for the industry" which are attributed to improved risk management results, and of greater importance, broader benefits which relate to a "more stable and less pro cyclical financial system."[73]

8. Conclusion

One vital reason why information disclosure should be encouraged lies in the fact that imperfect information is considered to be a cause of market failure which reduces the maximisation potential of regulatory competition.[74] With regulatory competition, „efforts to outdo each other in reducing regulatory standards can trigger a downward spiral, also known as a "race to the bottom", at the end of which only minimum regulatory standards, at best, can be enforced, making market events increasingly opaque and risky.“[75] A consideration of the advantages and disadvantages of regulatory competition would appear to suggest that the regulatory co-optition model should be adopted. Even though such a model is considered by proponents of regulatory competition as having the potential to result in increased regulatory "capture" by interest groups – hence resulting in less governmental transparency and accountability, proponents of co-opetition argue that, amongst other benefits, it would result in the "fleshing out of viable policies and generate countervailing forces" which would not only serve as a watch dog mechanism, but also as a check on "capture".[76]

Justification for greater enforcement with Basel II (than is presently the case), arises from the fact that whilst state imposed rules are obligatory, Basel II rules are persuasive by nature. Although Basel II and the regulatory competition theory facilitate market based regulation and harmonisation, once a member state has opted to be bound by certain rules, then such rules should be enforced in their entirety. The freedom to opt – through an initial decision, should not imply a freedom to decide at convenience. Even though a firm is still offered choices under Basel II, choices which are intended to best match their needs, such choices should still be made in accordance with guidelines prescribed by the standard setters (compliance) and enforced accordingly. In other words, such choices are still limited by boundaries stipulated by law.

---

72 ibid

73 ibid

74 D C Esty and D Geradin, "Regulatory Competition and Economic Integration: Comparative Perspectives" Oxford University Press 2001 at page 35

75 Deutsche Bundesbank , „Securities Market Regulation: International Approaches“ Deutsche Bundesbank Monthly Report January 2006 at page 41

76 D C Esty and D Geradin, "Regulatory Competition and Economic Integration: Comparative Perspectives" Oxford University Press 2001 at page 45

REFERENCES

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>

Agénor P and Pereira da Silva L , „Cyclical Effects of Bank Capital Requirements with Imperfect Credit Markets“ World Bank Policy Research Paper 5067

Ayres I and Braithwaite J, Responsive Regulation: Transcending the Deregulation Debate Oxford University Press (1992)

Benston GJ and Kaufman GG, ‘‘The Appropriate Role of Bank Regulation.’’ (1996) Economic Journal 106 (May) 688–97

Bank for International Settlement, "Enhancements to the Basel II Framework" July 2009 "Changes to the Pillar 3 Disclosure Requirements" < http://www.bis.org/publ/bcbs157.pdf>

Bank for International Settlements, Basel Core Principles for Effective System of Banking Supervision http://www.bis.org/publ/bcbs129.htm

Commission Recommendation on Remuneration Policies in the Financial Sector <http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf>

Consultative Document: Overview of the New Basel Capital Accord at page 1 < http://www.bis.org/publ/bcbsca02.pdf>

Consultative Document of the Basel Committee on Banking Supervision "Proposed Enhancements to the Basel II Framework January 2009" < http://www.bis.org/publ/bcbs150.pdf>

Deutsche Bundesbank , „Securities Market Regulation: International Approaches“ Deutsche Bundesbank Monthly Report January 2006

Dowd K, “Does Asymmetric Information Justify Bank Capital Adequacy Regulation?” Cato Journal Volume 19 No 1 1999

European Central Bank, “Is Basel II Procyclical?: A Selected Review of the Literature” Financial Stability Review 2009 ECB Publications

European Central Bank, “The Concept of Systemic Risk” ECB Financial Stability Review December 2009

Heid F, „Cyclical Implications of Minimum Capital Requirements“ Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No 06/2005

Miles D, ‘‘Optimal Regulation of Deposit Taking Financial Intermediaries’’ (1995) European Economic Review 39: 1365–84

Kashyap A, Stein J and Rajan R, “Rethinking Capital Regulation”, Jackson Hole conference paper, 2008.

Pan EJ, "Harmonization of U.S.-EU securities regulation: The case for a single European securities regulator". Law and Policy in International Business at page 3 FindArticles.com. http://findarticles.com/p/articles/mi_qa3791/is_200301/ai_n9192864/

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

Santos J „Bank Capital Regulation in Contemporary Banking Theory” Financial Markets, Institutions and Instruments 2001 Volume 10(2)

Summary of Impact Assessment document amending Capital Requirements Directive on trading book, securitization issues and remuneration policies – particularly section 5.3 on “Disclosure of Securitization Risks” <http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/summary_en.pdf>