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A Quarterly Newsletter from Aptivaa
2010 Volume 3

Regulatory Round-up

The latest on the regulatory squeeze from either side of the Atlantic – Dodd Frank in the US and Basel III in Europe. The way to safe banking?

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Banking Regulations - More is less

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Thomas Jefferson, the third President of the United States once said "Banking establishments are more dangerous than standing armies". Immediately after the crisis, the leaders and the regulators across the globe seemed to share the belief. This was reflected in the original drafts of the proposed banking regulations such as Basel's guidance in December last year and Vocker's rule in US. Fortunately, the final proposals are much diluted versions and it seems the bankers have succeeded in their lobbying effort.

Given the number of published regulatory proposals, we thought it would be appropriate to dedicate this issue to two important ones - the recent initiatives of the Basel Committee on Banking Supervision (Basel Committee), now commonly referred to as Basel III and secondly, the Dodd- Frank Act, both of which address many of the same issues and concerns including establishing additional prudential standards for large internationally active banks and setting contingent capital requirements. Unlike the earlier reforms like Basel I and Basel II, these reforms have received enormous publicity coming on the back of a debilitating economic and financial crisis.

Everyone believes in financial reform. Let's lose the Weapons of Money Destruction. Let's rein in the CDOs and other unregulated hedge funds and their exotic products. But there is a need to exercise caution and to make sure we do not throw the baby out with the bath water. The past few months have seen much haranguing from the bankers who have been crying hoarse about unintended consequences of reforms that have been suggested. This seems to have paid off since the Basel III agreement this September, prised out a few teeth from the fearsome array of fangs Basel bared in the December consultative papers. The Basel III reforms now appear much benign.

Much work will be needed to implement these reforms. The international agreements need to be more fully articulated as a concrete set of standards. In the US, there are also many details in terms of the interaction between the Dodd-Frank Act and Basel III provisions that need to be sorted out. The coming years will show how important these reforms are in ensuring financial stability to the system.

This issue of our magazine revolves around these regulatory issues and provides an analysis of the same. There are also articles on the path recent regulations have taken around liquidity risk management and a discourse on the issues surrounding model risk.

As ever, we eagerly await your feedback and strive to make this newsletter better each time.

In this issue

Dodd-Frank Act

Overhauling the Regulatory Landscape

The Dodd-Frank Act heralds a new era in the realm of financial sector regulation. This article is an attempt to parse and lay forth what is a long and unwieldy piece of legislation but is widely considered as the antidote to all that plagues the financial and banking sector

This article focuses on the following

- Changes pertaining to Banking Organizations
- Ramifications of the Volcker Rule
- Impact on Credit Rating Agencies
- Consumer and Investor Protection

The US Senate has passed the 2300 page landmark 'Dodd-Frank' bill which is touted as the biggest financial regulatory bill since those during the Great Depression. The Act touches upon almost every aspect of the US financial services and is intended to restore public confidence in the financial system and to prevent any other financial crisis and allowing any future asset bubble to be detected and deflated before it precipitates into another crisis. The Act imposes significant new regulations on banking organizations. In addition, for the first time, the Act will allow the Federal Reserve to regulate companies other than banks — such as insurance companies and investment firms — if they predominantly engage in financial activities. The Volcker Rule even in its much diluted form, places limitations on the banks and affiliates conducting proprietary trading and investing in hedge funds and private equity. Several large insurance companies will henceforth be designated as non banking financial companies and will be subject to oversight by the Federal Reserve. Systemically important financial market utilities and payment, clearing and settlements activities will be brought under the gamut of Federal Reserve supervision. The Act imposes a new regulatory regime on over-the-counter derivatives, which includes clearing, exchange trading and other requirements intended to increase transparency, liquidity and efficiency, and to decrease systemic risk. There is a retention percentage that will henceforth be involved in securitization transactions for a fixed period. The Credit Rating Agencies haven't escaped the scanner and litigation rules have been amended to bring in accountability. It also enhances the whistleblower program and provides the SEC with additional authority in the matter of investor protection. In addition, the Act mandates enhanced disclosure and has sought out a way to rein in executive compensation. Consumers have also received a shot in the arm by giving the Bureau of Consumer Financial protection broader powers to regulate retail financial products and services.

Effect on Banking Organizations

The Dodd-Frank Act makes numerous changes in the regulation of banks, thrifts, their parent companies and their affiliates. While it eliminates one regulator, it introduces several new agencies, bureaus and offices. This will increase the cost of doing business for the banking organizations. Some of the key aspects are outlined below:

Capital Regulation and Enhanced Supervision

The Act includes provisions related to capital standards affecting banking organizations, securities firms and nonbank financial companies designated by the Council and supervised by the Board of Governors. The overall theme underlying these provisions is to increase the amount of capital to be held by banking organizations and other systemically important firms. However, the Act largely avoids establishing substantive capital measures — leaving such measures for adoption and implementation by the regulators.

Collins Amendment requires that bank holding companies hold the same amount and same type of leverage and risk-based capital that is required of an insured depository institution. A key consequence of the Collins Amendment would be that trust preferred securities would get excluded from the regulatory capital of bank holding companies. A large number of banking organizations of all sizes rely on this type of capital at the holding company level. Another consequence of the Collins Amendment is to create a capital floor based on Basel I capital standards — even for those large banking organizations required to calculate capital under Basel II.

With regards to countercyclical buffers, the Act does not proffer any significant guidance. It has only hinted that countercyclical buffers need to be built, with respect to capital requirements

The Act establishes the Financial Stability Oversight Council ("Council") to monitor and manage systemic risk. The Act provides the Council with the authority to designate systemically significant nonbank financial companies for prudential supervision.

Limits made more stringent

The Act imposes a new limit on the size of any single banking organization or nonbank financial company designated by the Council. The idea of limiting the overall size of financial firms was originally proposed by President Obama as a key element of financial reform on the grounds that risk should not be concentrated in a handful of massive financial firms. It is also a nod to the idea that no institution should grow "too big to fail."

The Act will prohibit a banking organization or nonbank financial company designated by the Council from conducting a merger or acquisition if the total consolidated liabilities of the resulting company would exceed 10% of the aggregate consolidated liabilities of all financial companies.

The Act strengthens a number of existing laws that limit a depository institution's credit exposure to one borrower, to its affiliates and to its insiders. Many of these changes seek to address credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions. Current banking law limits a depository institution's ability to extend credit to one person (or group of related persons) in an amount exceeding certain thresholds. The Act expands the scope of these restrictions to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.

Changes in Deposit Insurance Coverage

The Act permanently increases the standard maximum federal deposit insurance coverage amount to $250,000. The Act makes this increase retroactive to January 1, 2008, with respect to insured depository institutions for which the FDIC was appointed receiver or conservator after that date. The FDIC has a set of regulations that provide formulae for determining the amount of an institution's deposit insurance premiums. Current law requires the FDIC annually to designate a reserve ratio for the Deposit Insurance Fund, which may not be less than 1.15% of the estimated amount of total insured deposits. The Act raises the minimum designated reserve ratio to 1.35%.

The Volcker Rule

The "Volcker Rule" prohibits an insured depository institution and its affiliates from engaging in "proprietary trading"; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or a private equity fund.

The Volcker Rule would prohibit any insured depository institution and its affiliates from engaging in "proprietary trading" of debt and equity securities, commodities, derivatives, or other financial instruments. In summary, investments made "for the trading account" would be deemed proprietary trading and therefore prohibited. The "trading account" definition only covers "near-term" transactions or transactions that involve "short-term price movements." Thus, this definition substantially limits the scope of prohibited proprietary trading. However, the Volcker Rule also provides the Regulators with the authority to determine that other accounts meet the "trading account" definition. The Regulators could use this authority to expand the scope of the prohibition.

The Volcker Rule prohibits insured depository institutions and their affiliates from "sponsoring" a hedge fund or private equity fund. It would not prohibit banking organizations from providing advice to such funds. If the banking organization makes a seed investment, it must seek unaffiliated investors to reduce or dilute the investment to not more than 3% of total ownership interest of the fund within one year after the date of establishment of the fund. In addition, the aggregate investment in all the investment interests in such funds may not exceed 3% of the Tier 1 capital of the banking organization.

The Volcker Rule flatly prohibits a banking organization (and any of its affiliates) that manages, sponsors, advises, or organizes and offers a fund from entering into a Section 23A covered transaction (loans to the fund and asset purchases from the fund) with such fund. This is considerably broader than the prohibition on sponsorship and effectively prohibits such transactions where the banking organization has nothing more than an advisory role.

"The "Volcker Rule" prohibits an insured depository institution and its affiliates from engaging in "proprietary trading"; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or a private equity fund. "

The Volcker Rule provides that no transaction, class of transaction, or activity by a banking organization may be deemed to be permitted to conduct certain permitted proprietary trading or fund sponsorship or investment if it would result in a material conflict of interest between the banking organization and its clients, customers, or counterparties; result in material exposure by the banking organization to "high-risk assets" or "high-risk strategies" (as defined by rules to be issued by the Regulators); pose a threat to the safety and soundness of the banking organization; or pose a threat to the financial stability of the United States.

Credit Rating agencies

The Dodd-Frank Act includes reforms that address credit rating agencies and the credit ratings they provide. The Act seeks to impose corporate governance guidelines, reduce conflicts of interest, and improve the rating process through enhanced controls and greater transparency. Furthermore, the Act will greatly expand the SEC's oversight and enforcement powers and seeks to make it easier for investors to bring civil lawsuits against rating agencies. In addition, the reforms seek to reduce reliance on ratings as a litmus test for credit quality in favor of broader standards that encompass multiple factors and credit criteria.

Importantly, the Act also includes a provision encouraging the SEC to adopt rules designed to reduce conflicts of interest by placing restrictions on the ability of rating agencies to provide services other than credit ratings. A newly created office of the SEC will administer standards relating to rating agencies and conduct periodic compliance examinations. In addition, the SEC will be permitted to suspend or revoke a rating agency's registration for a particular class of securities for failure to satisfy certain requirements.

Modifications to the Credit Rating Process

The Act imposes new rules relating to credit rating procedures and methodologies. To increase transparency in the ratings process, rating agencies will be required to use a standardized form to publicly disclose their rating methodology, a description of issuer data considered in the rating process and any additional information that the SEC may require. In addition, issuers and underwriters of asset-backed securities will be required to publicly disclose the findings of any third-party diligence reports they obtain, and the thoroughness of the review performed in producing such reports must be publicly disclosed and certified by the provider of the diligence service.

To facilitate comparisons among rating agencies, each agency will be required to periodically disclose information demonstrating, in hindsight, the degree of accuracy of its prior credit ratings.

Financial organization	Primary federal regulator	Balance sheet, funding and structure			Business and commercial activities			
		Capital	Liquidity	Legal entity structure	Consumer banking	OTC derivatives	Securitization	Proprietary trading
Bank Holding Company ≥ $50b	Federal Reserve	●	●	●		●	◐	●
Other Bank Holding Company	OCC/FDIC	◐	◐	◐	●	●	◐	●
National banks	OCC	◐	◐		●	●	◐	●
State banks	FDIC	◐	◐			●	◐	●
Designated NBFCs	Federal Reserve	●	●	●		●	◐	
Hedge funds/private equity funds	SEC			◐		●	◐	
Asset managers/ Broker-dealer	SEC		◐			●	◐	

Impact of Dodd-Frank Act ● Significant ◐ Moderate

Increased Potential Liability
Prior to the effectiveness of the Act, rating agencies were exempt from liability under Section 11 of the Securities Act. The Act rescinds this exemption, thus exposing rating agencies to expert liability if they consent to the inclusion of a credit rating in a registration statement. In order to defend against a Section 11 claim, a rating agency would be required to show that it had reasonable grounds to believe, and did in fact believe, that the included credit rating was accurate.

The implications of this reform could have profound effects on the securities offering process for rated securities, particularly structured finance products for which ratings have traditionally played a central role. It remains unclear how rating agencies will react to this change; however, rating agencies have successfully challenged claims on constitutional grounds in the past, arguing that ratings are protected by the First Amendment.

Sole Reliance on Credit Ratings
Prior to the effectiveness of the Act, institutional investors, including banks, insurers and money market funds were permitted to rely solely on credit ratings when making certain investment decisions. The Act seeks to compel such investors to conduct an independent investigation into the multiple factors that influence the risk profile of a security and thereby diminish their reliance on credit ratings. The Act seeks to achieve this objective by replacing references to credit ratings in certain federal laws with a requirement that such investors consider the creditworthiness of a security, thus encouraging these investors to consider factors beyond the security's credit rating.

Investor and Consumer Protection and SEC Enforcement

The Act has specifically made legislation relating to Executive compensation, Whistleblower Policies, and Consumer protection. Most of the latest legislation builds on earlier efforts in the similar direction.

Whistleblower Policy
In what may prove to be the provision that has the biggest immediate impact on the SEC's enforcement program, the Act provides the SEC with new authority to pay large cash awards to persons who provide original information that leads to a successful SEC enforcement action. The SEC is required to award such persons between 10% and 30% of monetary sanctions of over $1 million assessed by the SEC, the DOJ or other regulatory agencies in related enforcement actions. The whistleblower bounty program complements recent SEC efforts to encourage company insiders and other individuals to cooperate with enforcement investigations. The impact of this sustained effort to increase the flow of enforcement tips from potentially knowledgeable insiders is likely to lead to more investigative activity.

Executive Compensation
The Dodd-Frank Act requires enhanced disclosure of executive compensation matters; imposes certain substantive requirements on public companies, such as requirements for nonbinding shareholder votes on executive compensation programs ("say-on-pay"); mandates the independence of compensation committee members; requires "claw backs" of certain incentive compensation; and prohibits any incentive compensation arrangement by bank holding companies and certain other financial institutions that "encourages inappropriate risks." The Act requires disclosure of the relationship between executive compensation and financial performance.

Consumer Protection
The Dodd-Frank Act brings several important changes to the current system of regulating consumer financial products and services. It creates a new regulator, the Bureau of Consumer Financial Protection, with broad rulemaking and enforcement authority and the mandate to prevent "abusive" financial practices; enhances the ability of states to oversee federally chartered institutions; and imposes a number of enhanced data collection and reporting requirements. It prohibits or restricts many previously common mortgage lending practices, limits a lender's ability to compensate loan officers and brokers, and imposes new mandatory underwriting standards. These changes are likely to have significant short and long-term effects on the consumer financial services industry.

Conclusion

The Dodd-Frank Act is bound to have a massive impact on the regulation in the financial services industry. The Act gives the regulators more authority to cut delays and also provides them with discretion to draft new rules. Is this going to be a roaring success or a damp squib? Are there going to be unintended consequences like stifling innovation or will it actually be the game changer? Only the coming years will reveal the answers to these questions.

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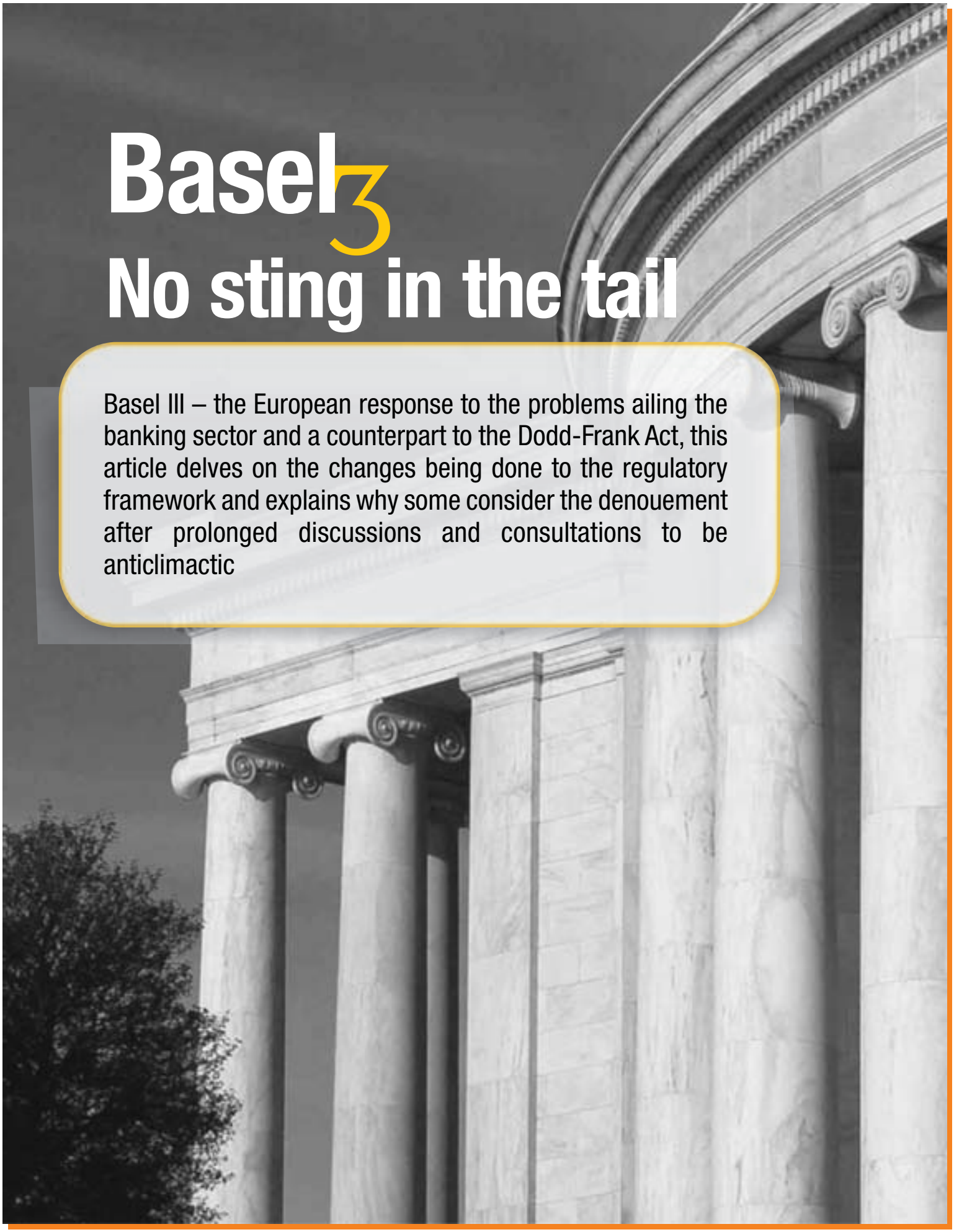
"The Act will greatly expand the SEC's oversight and enforcement powers and seeks to make it easier for investors to bring civil lawsuits against rating agencies"



Basel 3
No sting in the tail

Basel III – the European response to the problems ailing the banking sector and a counterpart to the Dodd-Frank Act, this article delves on the changes being done to the regulatory framework and explains why some consider the denouement after prolonged discussions and consultations to be anticlimactic

Close on the heels of the Dodd Frank Act in the US for financial reform, on the other side of the Atlantic, the Basel Committee, on 12th September announced several measures to strengthen the existing capital requirements for banks. A new regime of rules and regulations, now being referred to as Basel III, has been developed by regulators in order to strengthen the resilience of the banking sector against future shocks and to ensure that the current recovery is on a sure footing.

The world has been heaping scorn on the banking sector after the endless bail outs and their seemingly profligate ways and excesses. On the other hand, for a banking sector bracing itself for the worst, the endless lobbying has won them concessions in the form of long transitioning period over which the new regulations are to be implemented, so much so that they are being referred to as 'surprisingly accommodating'. Here's a look into banking regulations, as we'll know them in years to come.

"An additional conservation buffer of 2.5% has also been introduced, effectively bringing the common equity requirement to 7%"

The new Rules

The proposed Basel III raises the minimum core capital stipulation, introduces counter-cyclical measures, and enhances bank's ability to conserve core capital in the event of stress through a capital conservation buffer.

Tier I Capital

Currently, banks have to hold at least half of their regulatory capital as Tier 1 capital with the rest being made up of other items of lower loss-absorbing capacity. In addition, half of Tier 1 capital must be common equity. Other Tier 1 capital is also high-quality relative to other elements of the capital structure, but not of the same caliber as common shares and retained earnings. The requirement of minimum common equity (MCE) has been increased from 2% to 4.5% of risk-weighted assets (RWA). Member countries are to begin implementation on 1st January 2013 and hence must integrate the rules into national laws and regulations before this date. As of 1st January 2013, banks will be required to have 3.5% MCE of RWA, 4% on 1st January 2014 and 4.5% as of 1st January 2015. The sharper focus on common equity means that the Basel III framework puts greater emphasis on the minimum requirement for higher-quality capital. Shown below in Table 1 are the differences between Basel II and Basel III pertaining to Common Equity and Tier I Capital.

% of Risk weighted assets	Capital Requirements							Counter cyclical Buffer
	Common Equity			Tier I Capital		Total Capital		
	Minimum	Conservation Buffer	Required	Minimum	Required	Minimum	Required	Range
Basel II	2			4		8		
Basel III	4.5	2.5	7.0	6	8.5	8	10.5	0-2.5

Table 1: Basel II vs. Basel III Capital Requirements

The Tier-1 requirement will be increased from 4% to 6%. The phase-in arrangement is similar to that of common equity i.e. between 1st January 2013 and 1st January 2015. On 1st January 2013 Tier 1 will increase from the current level of 4% to 4.5%, and to 5.5% on 1st January 2014.Finally, on 1st January 2015 it will increase to 6% as stipulated. The total capital requirement remains unchanged at 8%, and hence does not need to be phased in. The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and other forms of capital. Shown below in Table 2 is the phasing in of changes pertaining to Common Equity Requirement and Tier I capital.

	1st January 2013	1st January 2014	1st January 2015
Common Equity Requirement	3% (Increased from the current 2%)	4%	4.5%
Tier-I Requirement	4.5% (Increased from the current 4%)	5.5%	6%

Table 2: Common Equity and Tier I Requirement under Basel III

Capital Buffer

An additional conservation buffer of 2.5% has also been introduced, effectively bringing the common equity requirement to 7%; reinforcing the changes in the definition of 'Capital' made in July 2010, along with the higher capital requirements for trading, derivative and securitization activities to be introduced at the end of 2011. The purpose of this buffer is to ensure that the banks have enough capital to absorb losses arising from extreme movements in markets. The phase in starts from 1st January 2016 and stretches up till 1st January 2019. Beginning with 0.625% of RWA on 1st January 2016, it will notch up each year by 0.625% reaching the final level of 2.5% of RWA on 1st January 2019.

To prevent excessive growth of credit within the banking sector, if regulators see free flowing credit they can also impose a countercyclical buffer within a range of 0% to 2.5% of common equity or other fully loss absorbing capital.

There is concern that the Basel Committee's approach to capital buffers is leading to extensive double-counting, increasingly complex calculations and lack of transparency. The effect of such a mechanistic approach to capital buffers may move decision-making on risk and capital away from banks into the hands of regulators and may result in moral hazard. Moreover, the countercyclical buffer will be applicable to all banks in a particular country, whether or not those individual banks, or even the banking sector as a whole, caused the excessive credit growth. This violates the fundamental concept of capital requirements proportionality to risk.

Definition of Capital

Hybrid capital, which includes a form of debt that covers instruments that are not purely equity but have been deemed close enough to it, was counted towards Banks' Tier 1 capital ratio earlier. Basel III will require banks to stop using hybrid capital and also make deductions including deferred tax assets and mortgage servicing rights from their capital. 1. Hybrid Capital had hitherto been a favored route for raising capital with about $1 trillion being issued since 1999.

Table 3 below provides comparison of Deductions from Capital between Proposed and Existing Basel Norms.

	Proposed Basel III Guidelines	Existing Basel II Norms	Impact
Limit on deductions	Deductions to be made from common equity by 01Jan 2018, if the amounts exceed aggregate 15% limit (10% at individual item level) for • significant investments in financial institutions, • mortgage servicing rights and • DTA that arise from timing differences	All deductibles to be deducted.	Positive
Deduction of investments from Tier I and Tier II	All the above deductions will begin at 20% of the regulatory deductions from common equity on 01 Jan 2014, 40% on 01 Jan 2015, 60% on 01 Jan 2016, 80% on o1 Jan 2017 and reach 100% on 01 Jan 2018. The remainder not deducted from common equity will continue to be subject to existing national treatments.	50% of the deductions from Tier I and 50% from Tier II (except goodwill wherein 100% deduction is done from Tier I capital)	Negative
Treatment of significant investments in common shares of unconsolidated financial institutions	Any investment exceeding 10% of issued share capital to be counted as significant and therefore deducted	Investments deducted in full	Positive

Table 3

The proposal envisions that all non-common tier 1 and tier 2 instruments in a bank's capital structure would have a clause in their terms and conditions that require them to be written off or converted to common stockholders' equity on the occurrence of a trigger event. This requirement would have a profound impact on the markets that could constrain the ability of banks to raise capital, negatively impacting safety and soundness as well as the health of the broader financial system.

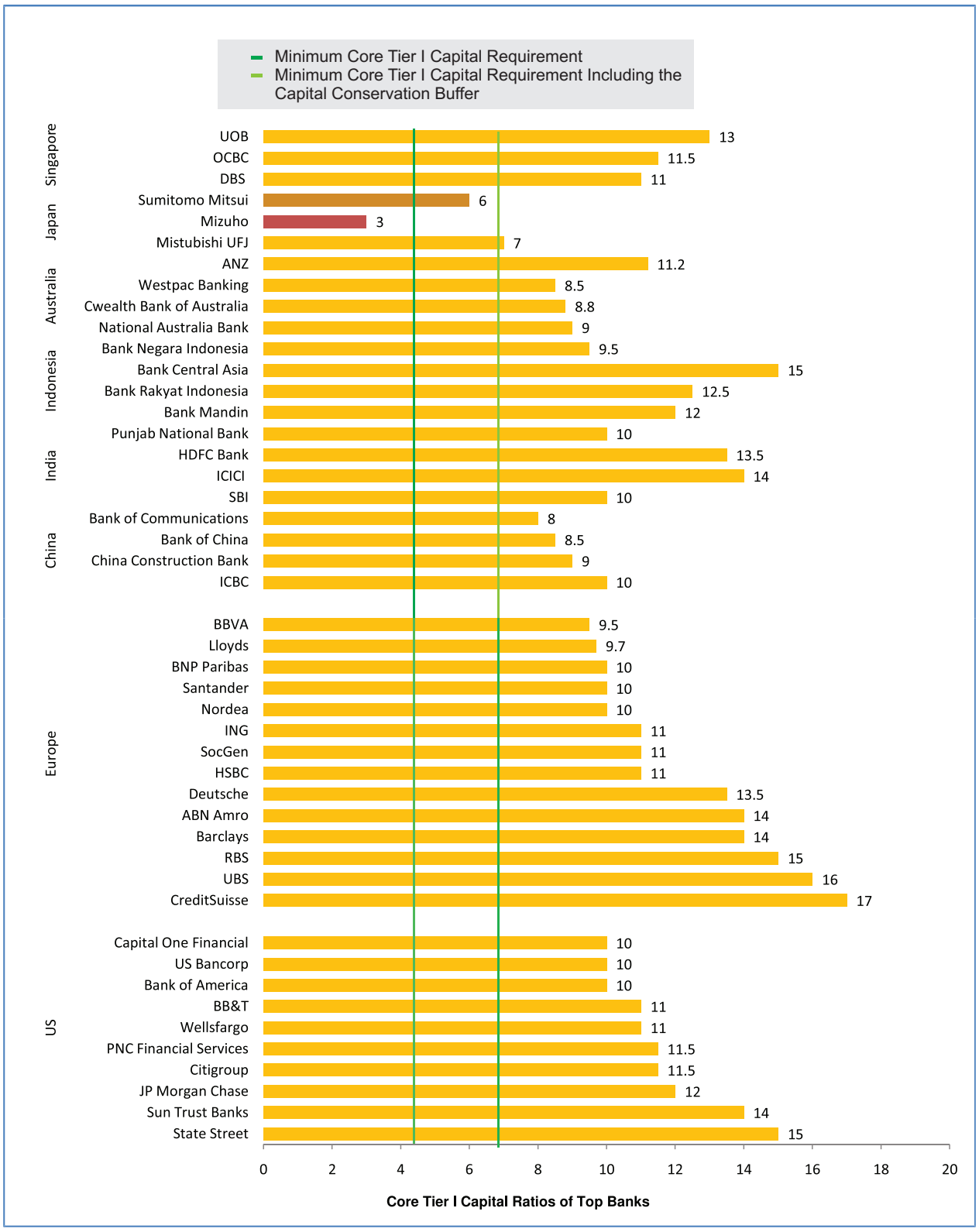
Leverage ratio

The capital requirements mentioned above are also supplemented by a non-risk based leverage ratio. In July, it was agreed to test a minimum Tier-I ratio of 3%. Under the new rules the same will be tested during the parallel run period between 2013 and 2016 and on the basis of the results, final adjustments will be made in the first half of 2017, with the aim of migrating to Pillar-I treatment by January the 1st, 2018.

The Liquidity Coverage Ratio (LCR) is also set to be introduced on 1 January 2015, after an observation period beginning in 2011. The revised Net Funding Stability Ratio (NFSR) will move to a minimum standard by January 1, 2018. The Committee intends to put in place various means and processes of review, in order to fully comprehend the implications of these financial standards.

Shown below is the Tier I capital ratios of various banks across continents to gain an understanding of the impact of Basel III on them.

Core Tier I Capital Ratios Percentage (%)



Banks in Japan might struggle to meet the new regulatory requirements, while banks in Europe and the US are expected to meet the new requirements.

Phase-in arrangements of new capital rules under Basel III

Despite the drastic increase in the amount of regulatory capital, UBS' opinion of the guidelines being "surprisingly accommodating" sums up the general response. The impact on lending ability has been controlled to a great extent by a transitional arrangement of implementation, which gives banks an adequate amount of time to comply with these guidelines, as illustrated below in Table 4.

	2011/12	2013	2014	2015	2016	2017	2018	As on 1st Jan 2019
Leverage Ratio		Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1		
Minimum Common Equity Capital Ratio		3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer					0.625%	1.25%	1.875%	2.50%
Minimum Common equity plus capital Conservation Buffer		3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from Common Equity T1			20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital		4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital		8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus Conservation Buffer		8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Liquidity coverage ratio	Observation period begins			Introduce minimum standard				
Net stable funding ratio								Introduce minimum standard

Table 4: Phase-in arrangements (shading indicates transition period) All dates are as of 01 January

Other Key Points

- **Liquidity concerns:**
  In the face of criticism that the proposed liquidity ratios (NSFR and LCR) could jeopardize economy with capital being trapped in liquidity buffers, the committee has watered down the proposal and is phasing in the requirements only by 2015.

- **Focus on Common Equity:**
  Post financial crisis, some banks were observed to be taking advantage of profits from low cost government bailouts to prop up the common equity base. If this continues, it could mark the beginning of another crisis. In order to avert it, Basel III focuses on raising capital through common equity.

- **Role of External Ratings:**
  While the Frank-Dodd Act in the United States has tried to bring in accountability to the rating agencies by making them liable for the ratings issued; it has also mandated that sole reliance on external ratings would not be allowed. The new Basel III regulation remains silent on any of these issues

- **Leverage Ratio:**
  The risk weight prescribed by the Committee earlier was maligned as one of the reasons for the financial crisis, allowing banks extremely high leverage. The committee has not junked the methodology but has introduced a simple leverage ratio of Common Equity to Total Assets which has been set at 3%. This is still too low and allows banks to lend 33 times its capital.

- **Valuation of assets:**
  While the common equity requirement has been defined in terms of the risk weighted assets, a significant contributing factor to the problem has been the valuation of assets and the corresponding risk weights applied. No changes have been made to the valuation of the denominator i.e. the risk weighted assets

- **Accountancy standards:**
  There is no harmonization of accounting standards on all the non-banking entities like SPVs, pension funds, derivatives netting etc, with accounting practices varying so greatly that it doesn't lend itself to any reasonable comparison or comprehension.

The above analysis is based on the press release of the Group of Governors and Heads of Supervision which will be presented to the G20 Leaders in November and finalized subsequently. A detailed update will be published in the January Anniversary Issue.

What Lies Beneath

The unmodeled dangers of model risk

- by Andrew Aziz

The financial and economic crisis saw an unprecedented erosion in the practitioners' trust of models. This article delves into the various aspects of model risk and the pitfalls of over reliance on assumptions that shaped any model especially in the case of big market movements or dislocations.

Risk measures based on full valuation across scenarios are powerful tools in risk management. As the driving force behind such measures as stress testing, event analysis and value-at-risk (VaR), a full-valuation approach offers the advantage of decoupling scenario generation from security valuation. This separation allows both for unconstrained shocking of risk factors as well as the deployment of highly sophisticated pricing models that can capture all the non-linearity embedded in the individual securities.

For example, consider two securities, a treasury bond and a senior tranche of a Collateralized Debt Obligation (CDO). Let's assume we have deployed state-of-the-art pricing models to assess the risk of each of the two securities. A battery of scenario-based risk measures has been deployed including stress testing, event analysis and VaR. The scenarios contain all appropriate market risk factors that are required as inputs to both the bond and CDO pricing models. Extreme risk factor shocks have been used for the stress test scenarios and appropriate joint risk factor distributions have been used to construct scenario sets for both a standard VaR and a stressed VaR. The combined analyses indicate that the risk of each security is precisely equivalent. If a risk grade were applied to each security, they might both be rated as triple A.

But what does your intuition tell you? Are you comfortable that the risks of the two securities are truly equivalent? Are all risks really being captured in this analysis? Let's drill down a bit further into the details.

On the one hand, we are confident that the full-valuation approach generally works quite well. This is especially true in normal markets, but also applies in markets that suffer a significant shock. Because pricing models represent "hard and fast" relationships between the security's projected value and one or more underlying risk factors, most of the attention is therefore spent on selecting the appropriate risk factor shocks. However, a problem occurs when the pricing models themselves break down and the relationships between security values and risk factors no longer hold. Such a collapse tends to occur during extreme scenarios or market dislocations; in other words, precisely when everything else goes wrong.

What causes an otherwise robust pricing model to become suddenly unreliable or unpredictable just when you need it to work the most? One relevant aspect many pricing models have in common is their reliance on the no-arbitrage argument. Although no-arbitrage defines one of the most important relationships in security valuation, it contains many assumptions that are often taken for granted, or ignored, when risk factors are shocked beyond a certain tolerance level. As a result, model breakdown can be caused not by a flaw in the model's construction, but rather by the assumptions upon which the model was built.

If the goal of risk management is to examine how portfolios of financial securities respond to various scenarios, then some of the assumptions underlying risk models should also be shocked. And if the goal of a stress test is to look at extreme scenarios, then the kinds of models and assumptions that are most likely to be affected by the deterioration of normal markets should be considered as well.

The Appeal of No-arbitrage Models

The no-arbitrage principle is based on the replication approach to valuation, which is often referred to as the law of one price. Very simply, the idea is that if you can replicate a new security perfectly in terms of its returns or its payments with a portfolio of traded securities, then the price of the new security should be the same as the price of the constructed portfolio. Valuation models driven by the no arbitrage principle comprise most of the models used to price bonds, FX contracts, options and structured products, and, by extension, provide the framework for scenario-based risk measures, such as stress testing and VaR.

No-arbitrage can take the form of a static replication. When the no-arbitrage argument is used to price a new bond, for example, a portfolio of bonds trading in the market can be constructed that will replicate the future coupon and notional payments of the new bond. This replication is considered static, as the portfolio never needs to be rebalanced through time in order to match each future payment of the bond.

In many other cases, replication can only be achieved dynamically. This means that the portfolio must be rebalanced through time, sometimes continuously, in order to match each future payment under all possible outcomes. Nonetheless, as long as you don't have to inject more cash, i.e., the rebalancing is self-financing, then the price of the new security should still equal the price of the initial replicating portfolio. This is the premise underlying all the well known derivatives pricing models from Black-Scholes onward.

Initial Assumptions

Models based on the no-arbitrage argument require certain assumptions to be made. The first assumption involves investor behavior, and assumes simply that investors prefer more to less. In theory if the prices of securities trading in the market are such that you can generate riskless cash at no cost, then people will invest in whatever strategy necessary to take advantage of this arbitrage opportunity.

"Model breakdown can be caused not by a flaw in the model's construction, but rather by the assumptions upon which the model was built."

As this is the only behavioral assumption required, it makes no-arbitrage pricing models particularly attractive in comparison to other pricing models. You don't have to try to gauge or measure investor attitudes towards risk nor need to quantify the trade-off between risk and return. Investor attitudes to risk are already reflected in the prices of the traded securities. As a result, the behavioral assumption underlying no-arbitrage models is the first, and probably the easiest, assumption to live with.

The second assumption is based on market dynamics. Although the behavioral assumption says that investors have an objective to take advantage of arbitrage, the market dynamic assumption defines the world in which investors can take those actions. Market dynamic assumptions are often captured under the umbrella term of Perfect Capital Markets (PCM). PCM ensures the creation of a well functioning and perfectly fluid market by combining the following assumptions:

- **Frictionless markets** assume that securities are perfectly divisible, meaning that they can be bought and sold in any fraction or multiple, and that there are no constraining regulations on trading, such as limits on short selling. It is also assumed that the market is free of transaction costs or taxes, although the taxation assumption can be relaxed if there is no differential taxation across investors.

- **Perfect competition** assumes that no single investor can affect prices on the basis of the volume of their trade. Equilibrium prices are assumed to result from the dynamics of the collective as described by Adam Smith's "unseen hand" of market behavior. Another implication of this assumption is that there is always perfect liquidity in the market.

- **Informational efficiency** assumes that all relevant information determining security prices is both costless and simultaneously available to all investors. In the context of no-arbitrage pricing models, this assumption suggests that future payments for each possible outcome have been agreed upon and are transparent to all investors Unfortunately, PCM, in the strict sense, rarely exists even in the world's most liquid markets. Markets are never completely frictionless, actions of large institutions do affect market liquidity and information is not always transparent. However, it can usually be argued with justification that, under normal conditions, markets behave as if PCM were valid. In other words, even though it is true that the average investor cannot always take advantage of an arbitrage opportunity, those trading at the margin in relatively liquid and normal markets, namely, traders at large investment banks, are better able to do so. Given these conditions, a practical justification can be made for assuming PCM more broadly.

Even still, the extent of PCM's validity is dependent on the characteristics of the market, and the further you move from markets that are open, transparent and support robust trading activity, the less valid they become. It is typically accepted that North American and Western European markets are representative of PCM – at least in normal times – with emerging markets less so.

Completing the Market

The third key assumption, following investor preferences and the ability to transact seamlessly, is the assumption of complete markets. In a complete market there are enough securities available to accomplish any required replication.

This condition is met when there are as many independent securities available for replication as there are possible future payments that need to be replicated, often expressed as having enough independent securities to "span" the payments of the thing you want to replicate.

It is difficult to achieve because even in the most robust markets, such as the US treasury market, you really never have completeness. There are usually many more possible coupon payments than there are unique bonds available in the market to span them. And given that we already know that there are, in reality, transaction costs,

"Although the behavioral assumption says that investors have an objective to take advantage of arbitrage, the market dynamic assumption defines the world in which investors can take those actions"

liquidity costs and different levels of informational efficiency, it would appear that, in theory, the entire no-arbitrage argument breaks down right from the beginning.

To overcome this fundamental shortcoming of the no-arbitrage approach, additional conditions, some realistic, some not, are imposed to force completion of the markets. In the case of bond pricing, for example, the imposed condition is that only the interest rates associated with the bonds' notional dates are deemed to be independent. Interest rates associated with all other coupon dates are determined as some function of the independent interest rates. As each bond has a single notional payment, this extra condition nicely forces market completion in the static sense, as there are now enough independent bonds to span the market.

Dynamic replication is even more challenging. In the case of option pricing, constraints on the process followed by the underlying security or factor through time must now be imposed to complete the market in a dynamic sense, with Markov-type processes being the most commonly deployed. For more complex products with multiple underlyings, additional assumptions describing the joint behavior of the underlying factors must also be incorporated to achieve the complete market condition. In many cases, the conditions imposed on these processes are chosen to enable simple distributional statistics, such as volatility and correlation, to be used in valuation models that, in addition to completing the market, produce analytical tractability.

The good news is that, despite these significant obstacles, no-arbitrage pricing models have proven to be quite robust in well functioning markets under normal market conditions, even if the required assumptions do not hold in the strict sense. In other words, in normal markets, the pricing models behave as if markets are complete and PCM is valid, even if we know that it isn't really the case. The real problem is, for risk management purposes, it is usually when an extreme scenario associated with a big market move or market dislocation occurs, that the models can fall apart, exasperating any losses that may occur even if the model remained intact.

Model Risk in Practice

The credit crunch illustrated two sides of model risk. First, the assumption of perfect liquidity in the market was clearly compromised. The liquidity issue has been discussed in great detail, but not as much in the context of its impact on no-arbitrage models. Under extreme liquidity shocks the ability to trade, let alone go short when desired, is questionable. The implication is that the entire premise behind prices adjusting to preclude arbitrage, as supported by the PCM assumption, falls apart.

"The good news is that, despite these significant obstacles, no-arbitrage pricing models have proven to be quite robust in well functioning markets under normal market conditions, even if the required assumptions do not hold in the strict sense."

Second, simplifications used to force market completion in the models can also cause significant errors, which may be magnified dramatically when the market dislocates. Returning to the CDO example in the introduction, the complete markets condition was achieved by imposing the assumption of a single correlation across all counterparties in the underlying basket. While this assumption may be reasonable enough in normal markets, it may prove to be completely invalid in a market dislocation when the default behavior across counterparties can change dramatically. Furthermore, the extent of model risk becomes a function of the differences in complexity across securities, the relative robustness of the imposed modeling constraints and the types of markets in which they trade.

Despite using models of differing complexity, it might very well be the case that, under normal conditions, it is reasonable to conclude that the senior tranche of the CDO and the treasury bond behave similarly. If we look more closely at the two securities, however, we see that the senior tranche of the CDO is trading in a less robust market and, at the same time, is obviously relying on more heroic assumptions to justify the complete market condition. If model risk were to be incorporated into the analysis, it seems intuitive that the true risk of each of the two securities shouldn't be equivalent, and as the credit crisis has shown, particularly in a market dislocation when some key modeling assumptions fall apart. A small shock to the base correlation parameter in the CDO model can very quickly push the triple-A rating to non-investment grade. A VaR calculated in the standard manner for this security would ignore this risk altogether, as it would assume its risk is only impacted by changes in the underlying market risk factors.

Living With Model Risk

No-arbitrage pricing models usually behave quite well in normal markets, where liquidity is plentiful, where the imposed conditions to force market completion are reasonably valid, and where the parameters can be calibrated with confidence to the recent past. However, if underlying modeling assumptions are left unchallenged during market dislocations, particularly when liquidity dries up and correlations converge, the risk analysis can fail spectacularly.

In the same way that stress testing is meant to deal with extreme situations, it can and should be used

Liquidity Risk

Taking the Middle Path

Never before has liquidity risk and the regulations surrounding the same received such great publicity. But there is also a distinct lack of consensus on how to deal with the issue. This article explores the various changes in regulation that have taken place with respect to liquidity risk and its management

"Liquidity is of critical importance to the companies in Financial Services Sector. Most failures in financial services sector have occurred in large part due to insufficient liquidity."
- Goldman Sachs.

Liquidity – The new Solvency !!

Since the advent of Basel I in 1988, globally the importance of solvency gained recognition and financial institutions started maintaining capital in proportion to the risk carried on their books. The Basel Committee in repeated attempts emphasized the importance of own/loss absorbing capital for financial institutions' stability and some where solvency appeared as the single most important parameter in determining any FI's health status. But all changed with the sub prime crisis and subsequent global slow down when even the most healthy (Adequately Capitalized) FIs appeared struggling to sustain few weeks and many were either wiped out or forced to make compromises ranging from hostile takeover, stake selling to Govt., changing business model etc. Cases of so many banking failures in such little time, and that too years after Basel II's adaptation by many FIs worldwide, shook the faith over the holy Capital Adequacy Ratio.

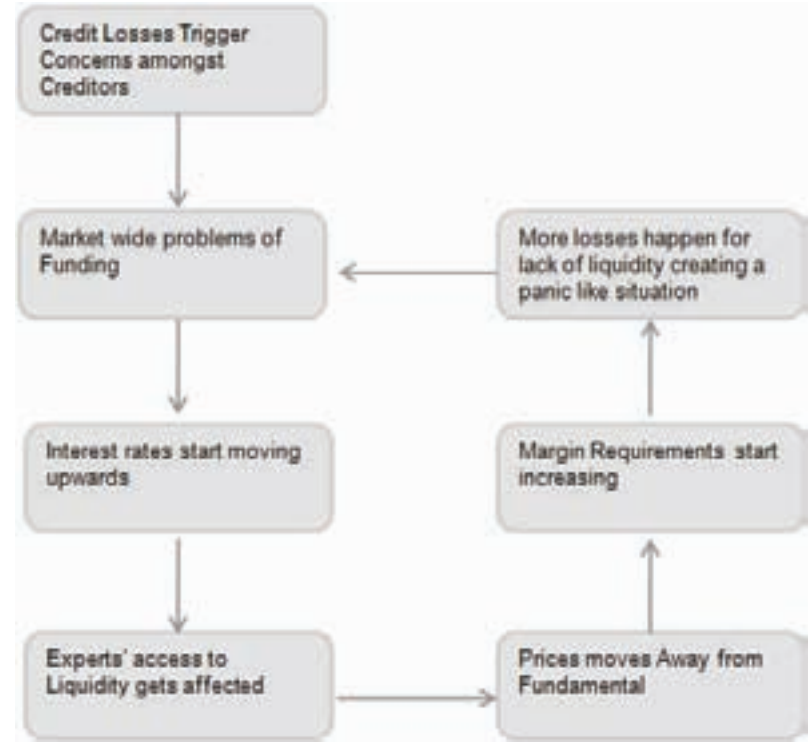
Lehman is a case-in-point. On September 10, 2008, Lehman reported 11% "tier one" capital and very conservative "net leverage". On September 15, 2008, Lehman declared bankruptcy. Despite reported shareholder's equity of $28.4B just prior to the bankruptcy, the net worth of the holding company in liquidation is estimated to be anywhere from negative$20B to $130B, implying a swing in value of between $50B and $160B. No wonder the recent economic crisis lead to a second approach of defining more accurate factors of stability determination and Liquidity or the ability to sustain troubled weather is definitely the front runner here.

Deciphering 2007-09 Financial Crisis

It's been widely accepted that inadequate liquidity risk measures taken by banks were amongst the major factors contributing to the Global Financial Crisis post the sub prime crisis in US. Two trends in the banking industry contributed significantly to the lending boom and housing frenzy that laid the foundations for the crisis. First, instead of holding loans on banks' balance sheets, banks moved to an

"originate and distribute" model. Banks repackaged loans and passed them on to various other financial investors, thereby off-loading risk. Second, banks increasingly financed their asset holdings with shorter maturity instruments. This change left banks particularly exposed to a dry-up in funding liquidity. Post crisis investigation have revealed that leading up to the crisis commercial and investment banks were heavily exposed to maturity mismatch both through granting liquidity backstops to their off-balance sheet vehicles and through their increased reliance on repo financing. Any reduction in funding liquidity leads to significant stress for the financial system, as we witnessed starting in the summer of 2007.

The diagram below illustrates the viscous cycle of liquidity crunch:



Increasing Concurrency on importance of Liquidity

"Liquidity is of critical importance to the companies in Financial Services Sector. Most failures in financial services sector have occurred in large part due to insufficient liquidity." Goldman Sachs.

"One of the important lessons of financial crisis since 2007 is that the foundation of financial institution management could be threatened by a liquidity crunch, even though the financial institution had a solid capital base. Appropriate liquidity risk management is vital both for achieving sound management of financial institutions and for maintaining financial system stability." Bank of Japan

"One problem with financial crises is that perfectly healthy companies, perfectly healthy financial institutions can go bankrupt just because they temporarily lack the funds to pay their creditors. This is what the lack of liquidity in financial system can do. The real problem of crisis is that healthy institutions are often dragged down with unhealthy ones, leading to a dead weight loss and a negative feedback loop in the real economy." The Economics

"Bear Stearns did not collapse because the sub-prime mortgages that it did so much to invent and promote became worthless. It collapsed because of the plunging market value of ultra-safe assets, such as the bonds issued by Fannie Mae and Freddie Mac, the US government-sponsored enterprises (GSEs). These triple-A bonds have, until recently, been treated as risk free assets almost interchangeable with US government obligations." The Times, UK.

Aftermath of the Crisis

Regulators worldwide reacted swiftly and efforts are being made to strengthen the regulation around liquidity risk carried by financial institution. As managing liquidity risk is bit subjective, different regulators came up with different approaches to address the same. A major difference from the way solvency is being addressed is that unlike on solvency, regulators and market participants have yet to reach a single approach or methodology to address this issue. Hence, it's not a surprise that different regulators have come up with

BCBS (Basel Committee)

Understanding the requirement of strict measures to enforce banks to maintain adequate liquidity, Basel Committee came up with a consultative paper in December, 2009. The main highlight of this paper was two new ratios proposed to determine the liquidity position of a financial institution:

- **Liquidity Coverage Ratio (LCR)** This is aimed to determine the amount of high quality funding assets a financial institution holds and its ability to handle acute crisis in short term.
- **Net Stable Funding Ratio (NSFR)** NSFR targets to determine the long term funding sources an institution holds with respect to the liquidity profiles of its assets. This ratio is more to reflect long term ability of an institution to run its business smoothly.

The Committee of European Banking Supervisors (CEBS)

CEBS in its recognition of the importance of liquidity risk faced by financial institutions has issued 6 point guidelines to calculate liquidity buffer. Buffer represents an institutions ability to survive for a period of 30 days in case of acute crisis. In its guidelines, CEBS in addition to setting standard in SLR and ALM reporting has also included a third component, namely Counterbalancing Capacity, which is a plan to hold or have access to excess liquidity over and above business plan for short, medium and long term.

Financial Service Authority (FSA)

FSA has dedicated significant portion of its handbook on the management of liquidity risk by institutions. This includes a set of detailed reports to be filed periodically which also include stringent stress tests and scenario analysis specified clearly in FSA handbook.

Federal Reserve Bank

Federal Reserve's approach towards monitoring and controlling liquidity risk for financial institutions is driven primarily by Contingency Funding Planning (CFP) which demands institutions to maintain a buffer of liquid assets

that are of such high quality that they can be easily and immediately converted into cash.

Other Regulators
A lot of other regulators have also issued guidelines at local level adopting one or combination of the approaches defined above. Most of them include qualitative or quantitative measures to detect and control liquidity risk faced by financial institutions in their jurisdiction.

Market Views on the Proposed Regulations

Though there's a wide spread agreement on the importance of liquidity risk management and need to increase regulatory control of the same, the jury is still out on the best practices in this field. No wonder the Consultative Paper issued by BIS, "International framework for liquidity risk measurement, standards and monitoring" is one of the most commented documents on their website. Some salient points explaining the dissonance are as follows:

- Majority of experts have expressed their reservation over standardizing the liquidity calculations as they don't believe liquidity can be defined as easily or directly as solvency.
- Experts also believed that hard coding ratios itself creates a window of playing out the numbers and leads FIs into trouble in long term.
- Having a common procedure for all jurisdictions and similar looking multiples is also something of a concern with market participants as this can lead to concentration in few instruments, which has its own repercussions
- Bankers are also worrying on the preparation time required for such practices/framework to become reality as at present not many are storing information required for these calculations.
- Economists have expressed fear that few segments/instruments may face crowding out of the good credit options for their lesser demand or illiquid markets. This in turn may leave them only with unviable option to pick from.
- Procyclicality: The narrow eligible-assets definition of the LCR and the rigidity of the NSFR would increase procyclicality because wholesale investors tend to reduce the term of their investments in an emerging systemic crisis, putting pressure on banks to compensate for deteriorating LCR and NSFR by reducing other illiquid assets, including loans. Banks would be induced to sell the same assets at the same time, and to adjust lending and portfolios in the same direction simultaneously, contributing further to cyclicality.
- Compared with the typical ratios that we see in banks' internal treasury models today, after the worst liquidity crisis in generations, the proposed NSFR implies much greater liquidity than what most banks currently consider a prudent funding position. This may force banks to restructure their liquidity portfolios and may also have an impact on issuers.

"The narrow eligible-assets definition of the LCR and the rigidity of the NSFR would increase procyclicality because wholesale investors tend to reduce the term of their investments in an emerging systemic crisis, putting pressure on banks to compensate for deteriorating LCR and NSFR by reducing other illiquid assets, including loans."

Basel III: The Middle Path!

Finally on 12th, September, Basel Committee declared its new banking capital requirements-known as Basel III – which turned out to be much less severe than expected. Many believe this to be a result of open disagreement amongst central regulators on multiple aspects with liquidity risk control being a key point in it. Many Central Banks have given stress on the difference in liquidity scenario present in local economy and global markets and thus they are not keen on adopting any ratios without wide spread and extensive calibration of the assumptions and results. Thus to many it didn't come as surprise when BCBS announced:

- The liquidity coverage ratio ("LCR") from 1 January 2015 and
- The revised net stable funding ratio ("NSFR"), as a minimum standard by 1 January 2018, in each case following an observation phase.

Road Map to Liquidity Risk Management

Though BCBS has softened its stance on the liquidity risk management by deferring the roll out of proposed ratios, national supervisors globally had taken multiple measures to tighten the reporting structure around liquidity position of FIs. Banks' risk management teams are thus busy in planning structural and data warehouse related changes in order to enable them to create better insight of their actual position of liquidity and to meet the increase scope of both internal and external reporting. Regulators have already issued guidelines to increase depth of periodic reporting of position and also have given more emphasis on liquidity risk in their Supervisory Review and Evaluation Process (SERP), under Pillar 2 of Basel Accord. Some of the steps which a Bank desired to improve its liquidity management and reporting should take are as follows:

- Moving from tactical stop-gap solutions to a long-term strategic model for risk management, and cascading the new governance structure through all levels of management.
- Committing resources to implement needed changes in liquidity risk management and regulatory compliance.
- Improving MIS to capture more information to meet the Liquidity Ratios proposed by BCBS, as they will become regulation by year 2015.
- Re-thinking the viability of a business operating model that has traditionally relied on the wholesale funding markets to fund business growth. This is applicable more for banks concentrated in particular geography or economic segment as they are more prone to systematic risks carried by their lenders.
- Integrating stress-testing (vs. using a siloed stress-test approach) when complications arise between intra-day, short-term scenarios vs. longer term scenarios.
- Integrating Balance sheet management and Stress testing in order to create early warning signals to avoid getting into skewed positions in dried out situations.
- Avoiding concentration on the asset side as large portfolios are difficult to liquidate irrespective of their constituents' liquidity.

"Moving from tactical stop-gap solutions to a long-term strategic model for risk management, and cascading the new governance structure through all levels of management."

Regulatory Update

FSA outlines a fundamental review of trading activity regulation

The Financial Services Authority (FSA) has published a discussion paper that considers fundamental changes to the regulation of trading activities – one of the key recommendations of the Turner Review following material trading losses incurred during the crisis.

The DP sets out a number of recommendations which are grouped into three key areas:

- Valuation: FSA recommends an increased regulatory focus on the valuation of traded positions and think there is a need for a specific assessment of valuation uncertainty.
- Coverage, coherence and the capital framework: It recommends changing the structure of the capital framework to bring greater coherence and reduce the opportunities for structural arbitrage within the banking sector and the wider financial system.
- Risk management and modelling: FSA recommends specific measures aimed at improving firms' risk management and modelling standards, and ensuring that these are aligned with regulatory objectives.

For more details, please visit http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/136.shtml

CEBS publishes its revised Guidelines on stress testing

The Committee of European Banking Supervisors (CEBS) published the final text of its revised Guidelines on stress testing which takes into the account the results of the earlier public consultation. The revised guidelines replace the Guidelines on technical aspects of stress testing under the supervisory review process that were published on 14 December 2006 and complement the principles set out in CEBS's Guidelines on the Application of the Supervisory Review Process under Pillar 2.

The revised guidelines draw on the experience that supervisors have obtained by reviewing institutions' stress tests in recent years, and take account of the revised principles for sound stress testing practices and supervision published by the Basel Committee of Banking Supervision (BCBS).

For more details, please visit http://www.c-ebs.org/News--Communications/Latest-news/CEBS-today-publishes-its-revised-Guidelines-on-str.aspx

Aggregate outcome of the 2010 EU wide stress test exercise coordinated by CEBS in cooperation with the ECB

The Committee of European Banking Supervisors (CEBS) was mandated by the ECOFIN of the European Council to conduct in cooperation with the European Central Bank (ECB), the European Commission and the EU national supervisory authorities a second EU-wide stress test exercise. The aggregate results suggest a rather strong resilience for the EU banking system as a whole and may appear reassuring for the banks in the exercise, although it should be emphasized that this outcome is partly due to the continued reliance on government support for a number of institutions. However, given the uncertainties over the actual path of the macro-economic recovery, the result should not be seen as a reason for complacency

For more details, please visit http://stress-test.c-ebs.org/documents/Summaryreport.pdf

Microfinance activities and the Core Principles - Basel Committee issues final paper

The Basel Committee on Banking Supervision issued the final version of its paper entitled Microfinance activities and the Core Principles for Effective Banking Supervision. The Basel Core Principles for Effective Banking Supervision (the Core Principles) are the global de facto standard for sound prudential regulation and supervision of banks.

For more details, please visit www.bis.org/press/p100830.htm

Revised Guidelines on Concentration Risk by CEBS

CEBS published its revised Guidelines on the management of concentration risk under the supervisory review process and Position paper on the recognition of diversification benefits under Pillar2. In its revised Guidelines, CEBS takes a broader approach to concentration risk management and suggest that there be an analysis of concentration risk not only within a risk type (intra-risk analysis), but also across risk types (inter-risk analysis), including credit, market, operational and liquidity risks. With respect to capital, institutions should take concentration risk into account in their assessment of capital adequacy under ICAAP, and be prepared to demonstrate that its internal capital assessment is comprehensive and adequate to the nature of concentration risk.

For more details, please visit http://www.c-ebs.org/News--Communications/Latest-news/CEBS-draft-guidelines-on-concentration-risk.aspx

Principles for enhancing corporate governance issued by the Basel Committee

To address fundamental deficiencies in bank corporate governance that became apparent during the financial crisis, the Basel Committee on Banking Supervision has issued a final set of principles for enhancing sound corporate governance practices at banking organisations. The Committee's guidance assists banking supervisors and provides a reference point for promoting the adoption of sound corporate governance practices by banking organisations in their countries. The principles also serve as a reference point for the banks' own corporate governance efforts.

For more details, please visit http://www.bis.org/press/p101004.htm

CEBS publishes for consultation its draft Guidelines on Remuneration Policies and Practices

CEBS had already published a set of High-level Principles for Remuneration Policies on 20 April 2009 aimed at assisting in remedying unsound remuneration policies. Under the revised CRD III, as agreed upon by the European institutions, CEBS is required to elaborate and issue guidelines on sound remuneration policies in the financial sector in order to facilitate the compliance of the remuneration principles in CRD.
The remuneration requirements included in the CRD are divided into three blocks:

- Governance
- Risk alignment
- Transparency

For more details, please visit http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP41-CP50/CP42.aspx

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