

Accepted Manuscript

Title: Supervisory perspectives

Author: Danièle Nouy

PII: S1572-3089(08)00059-4
DOI: doi:10.1016/j.jfs.2008.09.007
Reference: JFS 104

To appear in: *Journal of Financial Stability*

Received date: 7-4-2008
Revised date: 25-7-2008
Accepted date: 1-9-2008

Please cite this article as: Nouy, D., Supervisory perspectives, *Journal of Financial Stability* (2008), doi:10.1016/j.jfs.2008.09.007

This is a PDF file of an unedited manuscript that has been accepted for publication. As a service to our customers we are providing this early version of the manuscript. The manuscript will undergo copyediting, typesetting, and review of the resulting proof before it is published in its final form. Please note that during the production process errors may be discovered which could affect the content, and all legal disclaimers that apply to the journal pertain.



Title:

Supervisory perspectives

Author:

Danièle Nouy¹

Institution:

General Secretary of the French Commission Bancaire

Presented:

London, 3 March 2008

LSE Financial Markets Group and Deutsche Bank

The structure of regulation: Lessons from the crisis of 2007

Abstract:

Confidence in both financial institutions and markets must be re-built; this requires (1) better (model-based) valuation processes; (2) a more robust capital basis, including clarification and strengthening of the Basel II securitisation framework; (3) improving the liquidity regime; (4) greater transparency; notably relating to structured products and off-balance sheet vehicles; (5) improved information from CRAs. The need is to find a balance that still fosters innovation, without leaving the system vulnerable to excesses.

Classification Codes:

E58, G18, G28

Key Words:

transparency, liquidity, capital, valuation, Basel II

¹ Danièle Nouy

French Commission Bancaire

31 rue Croix des petits champs

75001 Paris

France

+33 1 42 92 59 05

daniele.nouy@c-ebs.org

Introduction

Over the past years, credit risk has become increasingly tradable, as shown by the significant increase in the volume and complexity of securitization and credit risk transfer markets (development of new asset classes, new products...). Simultaneously, investors became gradually more disperse and global, contributing to the emergence of the “originate-to-distribute model” (OTD) of financial intermediation.

The OTD model, however, failed to produce the right incentives. Originators, in particular, were not encouraged to assess risks properly. In the meantime, complex structuring generated information gaps and an over-reliance, by market participants, on external assessments and in particular those provided by credit rating agencies. The lack of transparency and disclosure contributed, for its part, to the decline in market confidence and therefore the drying up of global liquidity. Clearly, innovative products were created during a period of benign market conditions, i.e. in an environment of ample market liquidity and tight credit spreads, and were not tested during serious market downturns.

Given these elements, the turmoil has led to a continuing lack of investors' confidence, in particular about the assets' quality of financial institutions. As a consequence, banks and securities firms, which entered the crisis in relatively good financial shape with, in particular, capital ratios well above the regulatory minimum requirements, have been primarily hit, but with a different range of outcomes. This issue raises an obvious question for supervisors: what are the elements that enabled some firms to weather the turmoil better than others? In accordance with the first studies of the risk management practices of major financial institutions, four elements appear to have played a crucial role, i.e. (i) an effective, firm-wide risk identification and analysis, (ii) a consistent application of independent and rigorous valuation practices across the firm, (iii) effective management of funding liquidity, capital and balance-sheet and (iv) informative and responsive risk management systems.

After a period of difficulties and a long series of bad news, there is a need to rebuild confidence in the resilience of financial institutions and the creditworthiness of market instruments, in order to restore adequate market liquidity as well as market participants' ability to trade and distribute credit risk. While authorities should avoid hasty prescriptive measures, supervisors have identified four areas in which they can contribute to restoring confidence in the markets, either by taking actions themselves or by encouraging market participants to do so, through a mutually-reinforcing process : valuation of assets, capital requirements, liquidity (“funding risk”) and transparency.

I. Improving valuation standards and practices

The subprime crisis has cast a spotlight on the risks associated with the valuation methods used for complex structured products.

The evaporation of market liquidity thus triggered valuation challenges for instruments deemed to be liquid before the crisis (e.g. CDOs and ABSs with subprime mortgage loans as collateral, ABCPs...). Moreover, when banks decided to shift from a mark to market valuation to a mark to model one, they encountered several difficulties, the most important being on the assessment of the original transaction's credit risk, the appraisal of liquidity risk, the high degree of sensitivity of the value of structured products to inputs and parameters' assumptions. On the whole, with both mark to market and mark to model valuations, a key

weakness, that was a major driver of losses, was the use of inappropriate assumptions regarding the value of complex products.

Supervisors need, therefore, to pay more attention to the robustness of banks' valuation processes. In this respect, strengthening the assessment of major risk factors in the valuation process, for example by including the results of stress testing in the estimation of prices - in particular regarding model risk, liquidity risk, volatility of correlation between an instrument and its hedge... - is essential. The enhancement of banks' control processes for valuation in order to reduce the confidence placed in external service providers, such as credit rating agencies or consensus prices services is also key, in the same way as ensuring consistency between accounting rules and best risk management practices. Clearly, supervisors should also work at improving banks' transparency on the methods used both for valuing positions and for recording earnings and to make sure that external auditors perform appropriate due diligence.

Banks, on their side, need to develop stronger model-based valuation processes. In this respect, more intensive efforts should be promoted in order to test and/or challenge the market prices that are used and, of course, to factor banks' position size into the internal valuation marks. The decision to shift to model valuation techniques needs also to be fully justified and documented. As regards the model valuation techniques themselves, all market factors and relevant risk, i.e. liquidity risk, counterparty risk (notably on the sellers of credit protection such as monolines) as well as model risk (for model error and uncertainty), should be fully incorporated. Model-based valuations should also be frequently backtested with market transactions or parameters. Notwithstanding these aspects, banks should also perform periodic reviews of existing models while new models need to be independently and appropriately validated.

For the future, actions should be taken to promote fair and transparent valuation of financial assets. In the current juncture, one of the main international initiatives has been the work undertaken by the Basel Committee on Banking Supervision (BCBS) since June 2007 on fair value measurement and modelling. In this regard, thirty banks were surveyed in late 2007. Since then, a follow-up meeting with the bankers took place on 25 February 2008, and key findings and proposed recommendations will have been presented at the March 2008 BCBS meeting. As regards the ongoing dialogue with accounting and auditing standard setters, FASB and IASB are encouraged to develop stronger accounting guidance for mark to model accounting (model adjustments) and disclosure (information on fair value hierarchy, clarification of the boundary between level I, II, III of SFAS 157 fair value hierarchy). IAASB is also encouraged to strengthen fair value auditing practices (application of ISA 540).

II. Strengthening the capital framework

A robust capital framework is key to creating adequate capital buffers in the system and appropriate incentives for risk taking and management. Looking at the origins of the turmoil, there are at least five reasons to ensure full implementation of Basel 2:

- Unlike Basel 1, Basel 2 includes under its pillar 1 a comprehensive capital treatment for securitisation and credit risk mitigation techniques (such as credit derivatives), which applies to banks acting as originators, investors or sponsors;
- By strengthening the connection of capital to risk, Basel 2 provides incentives to improve risk assessment and management;

- With pillar 2, supervisors are able to assess banks' specific risk profile better and to take into account all kinds of risks, including those not easy to measure, but likely to have significant impact during crisis times, such as funding risk or reputational risks;
- With respect to stressed situations, Basel 2 asks for comprehensive stress testing as part of firm-wide risk measurement and management;
- Pillar 3 of Basel 2 strongly seeks to improve qualitative and quantitative disclosure including in the securitization and risk mitigation area. This is important, as the turmoil suggests that more transparency in general, and notably about the nature and quality of assets in the conduits, would have been helpful.

The implementation of Basel 2 goes, however, hand-in-hand with a focus on certain issues. Supervisors should, in particular, make sure that banks' internal models do not underestimate risk, and keep pace with innovation and changes in financial markets and business models. They should also carefully analyze the methodologies used for recognizing the effect of collateral, in particular the correlations between the risk associated with the covered asset (the debtor) and the risk associated with the element providing the coverage (or the guarantor). This is important for the advanced approaches that place potentially no limit on the eligibility of collateral. Further work is also warranted on the correlation between PDs and LGDs for some assets such as subprime loans and real estate loans.

There may also be possibly an upgrade of the Basel 2 securitisation framework. Three main areas will be concerned, i.e. the clarification of the concept of "significant risk transfer", the application of the prudential treatment for "implicit support", and the review of capital requirements for some exposures, in particular off-balance sheet exposures, such as liquidity facilities. More globally, as one of the key weaknesses which appeared during the turmoil was the complex linkage between conduits or special investment vehicles (SIV) and sponsoring banks, there is also a need to realign lenders' incentives at the origination stage and to capture sponsoring banks' risk better at the distribution stage.

The implementation of adequate capital treatment for default risk in the trading book is also at the top of the agenda. Indeed, trading activities include more and more complex credit-related and highly structured products, resulting in increased default risk in the trading book. This can also lead to an escalation of other risks, including operational risk, liquidity risk, concentration risk and correlation risk, which are not fully addressed in the current regulation on market risk. In the face of these developments, the Basel Committee issued in October 2007 a consultative document developing guidelines for computing capital for incremental default risk in the trading book. An impact study is also currently being carried out, so as to clarify and calibrate the requirements.

Performing a comprehensive review of all risks under Pillar 2 is also essential. Pillar 2 refers, in particular, to the structured dialogue between a financial institution and its supervisor, aimed at setting the level of capital appropriate to the risk profile of the institution. It also provides a necessary framework for addressing, in a non-mechanistic approach, the challenges raised by risks not easily quantifiable but fully part of financial institutions' risk profile, such as tail risks under Pillar 1, strategic and reputation risk, as well as risks arising from asset management activities. While such risks may not have a strong direct impact on financial institutions' ultimate solvency, they may severely affect solvency buffers in a going

concern format and stakeholders' confidence, and hence have a bearing on other risks, such as liquidity risk.

Further improvement and development of stress testing is also needed. Under Pillar 2, supervisors should continue to work closely with financial institutions to improve the frequency and quality of stress tests. In particular, the possibility of chain reactions and contagion to other markets should be better considered and extreme assumptions on liquidity withdrawal and increase of volatility should be included. Last but not least, supervisors need to make sure that banks' management acts proactively in response to stress tests results.

III. Improving the liquidity regime

The recent crisis highlighted the crucial role of liquidity for the soundness and stability of the banking sector. In particular, ensuring a high level of liquidity is of paramount importance in the context of the OTD model, since this model assumes sufficient liquidity in both agents and markets. Upgrading financial institutions' risk management practices for liquidity/funding risk and the supervisory framework has therefore become an obvious necessity.

Indeed, regulations dealing with credit and market risk have undergone profound changes, becoming more risk-sensitive and better adapted to the level of sophistication of the institutions. In comparison, the supervision of liquidity remains very basic and national. It is, therefore, crucial to accelerate the current work being conducted at European and international levels. Following the approach adopted for other risks, this evolution could involve the use of internal approaches by the most sophisticated banks, and some kind of standardized approach for smaller and less complex institutions.

The focus of the review of the regulatory/supervisory framework should be on (i) proper assessment of both funding risk and market liquidity risk, as well as of potential interactions between these two elements, (ii) larger and more robust liquidity buffers, (iii) stress tests including assumptions of severe liquidity shortage/ market liquidity drying up, and (iv) plans for business continuity including robust systems and procedures related to liquidity provisions.

IV. Enhancing transparency

Transparency is key to restoring confidence and ensure proper functioning of the OTD model. In this respect, financial institutions need to improve the usability of disclosed information about risk exposures and valuations, including those related to structured products and off-balance sheets vehicles. Supervisors, investors and auditors should work together to identify relevant and useful disclosures, in particular regarding valuation methodologies, valuation assumptions, and drivers of changes in value.

For banks, enhanced transparency also means prompt and comprehensive implementation of Pillar 3. In particular, banks involved in the OTD chain should pay specific attention to disclosure relating to securitisation and risk transfer activities, for which Basel 2 requires both qualitative and quantitative information disclosures. Supervisors and central banks could/should also work together to examine how aggregate information on CRT markets may allow for more effective oversight and less uncertainty in the market place.

As regards the credit rating agencies (CRAs), financial institutions and investors proved too willing to rely on their risk assessments, instead of exercising proper due diligence. CRAs need, therefore, to improve the information they provide to investors on structured products and to clarify their models and methodologies. CRAs should also address concerns about conflicts of interest arising from their role in the process of structuring transactions and the large share of profits that they draw from this activity. Moreover, it may also make sense to require CRAs to differentiate the ratings assigned to structured products from those assigned to more traditional instruments.

Conclusion

With market conditions still evolving, it is too early to draw final lessons, especially as it is already obvious that there is no quick fix and no single fits all solution to such a multi-dimension crisis.

In the current juncture, supervisors (BCBS, CEBS, IOSCO...) are working jointly, under Financial Stability Forum coordination, to address the numerous issues flagged by recent events. The challenge is to find the balance that fosters innovation, without leaving the system too vulnerable to the excesses and risks that tend to go with fast innovation and large structural changes.