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INTERNATIONAL BANKING

Expert Analysis

Panel Sets Eight 'Building Blocks' To Stem Economic Crisis

By **Kathleen A. Scott**

The worldwide economic crisis has led governments and international organizations to consider what additional laws, regulations and/or standards may be needed to first stabilize the financial system and then to improve it so as to avoid or lessen the impact of any future financial crisis. Many of these proposals could directly or indirectly impact banks that operate internationally.

This month's column will explore some of these proposals, which will undoubtedly be followed by many more.

The Comprehensive Strategy

The Bank for International Settlements (BIS) is the world's oldest international financial organization (founded in 1930) and serves several functions, including fostering international economic cooperation and promoting international policy dialogues. Its Basel Committee on Banking Supervision (Basel Committee), of which I have written before, is composed of representatives of 13 countries (including the United States, Japan and the United Kingdom) and develops proposed common banking standards and guidelines for adoption by all banking supervisors. It is the Basel Committee (its secretariat is at the Bank for International Settlements in Basel, Switzerland) that has worked to develop risk-based bank capital standards, including its latest effort, the Basel II capital standards.

On Nov. 20, 2008, as the economic crisis continued to worsen, the Basel Committee announced a "comprehensive strategy" to address weaknesses related to the regulation, supervision and risk management of internationally active banks. The Basel Committee set out eight "key building blocks" of the strategy, to be followed up by specific proposals:[1]

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- Strengthening the risk capture of the Basel II framework (in particular for trading book and off-balance-sheet exposures);
- Enhancing Tier 1 capital quality;
- Building additional shock absorbers into the capital framework that can be drawn upon during periods of stress and dampen procyclicality;
- Evaluating the need to supplement risk-based measures with simple gross measures of exposure in both prudential and risk management frameworks to help contain leverage in the banking system;
- Strengthening supervisory frameworks to assess funding liquidity at cross-border banks;
- Leveraging Basel II to strengthen risk management and governance practices at banks;
- Strengthening counterparty credit risk capital, risk management and disclosure at banks; and
- Promoting globally coordinated supervisory follow-up exercises to ensure implementation of supervisory and industry sound principles.

Assessing 'Fair Value'

In furtherance of the comprehensive strategy, on Nov. 28, 2008, the Basel Committee released a consultative document: "Supervisory Guidance for assessing banks' financial instrument fair value practices."[2] Comments are requested by Feb. 6, 2009. Citing the public attention that has been focused on bank valuations for complex or illiquid financial instruments, the document notes that it is critical for banks to have sound risk management and control processes for fair value measurements, and for banking supervisors to be able to effectively assess such processes. The guidance is aimed at all financial instruments that are measured at fair value, both in normal market conditions and at times of stress.

The document sets forth several supervisory expectations for banks to keep in mind as they improve their current fair value measurement systems and processes:

- Responsibility starts at the top—a bank's board and senior management should ensure adequate governance structures and bankwide, consistently applied fair value control processes that are integrated with the bank's general risk measurement and management processes;
- A bank should have the capacity to establish and verify valuations of the instruments involved in its activities;
- The bank should have policies for categorizing financial instruments on the balance sheet consistent with their management;
- There should be sound processes for the design and validation of methodologies used to produce valuations;
- A bank should maximize the use of relevant and reliable inputs and incorporate all other important information so that fair value estimates are as reliable as possible;
- A bank should have a rigorous and consistent review process to determine when valuation adjustments are necessary;
- Assessments of valuation uncertainty should be communicated to the board and senior management; and
- A bank's external reporting should promote transparency by providing timely, relevant, reliable and useful information.

External Auditors

• *And Banking Supervisors*

On Dec. 2, 2008, the Basel Committee issued a paper entitled "External Audit Quality and

Banking Supervision."[3] External audits are receiving much-closer scrutiny by banks' directors, management, shareholders, and regulators.

This paper describes the importance of the quality of external audits to the bank supervisory process. It notes that most of the world's banking assets are now being audited and that both banks and their banking regulators rely more heavily on external auditors' expertise and judgments. High quality audits are believed to enhance market confidence, particularly in troubled economic times. Bank regulators also increasingly are looking to high quality audits to complement their own examination and supervision regimes.

One concern raised, however, is that the major external audit firms operate on an international basis, with complex structures and a lack of transparency about their firm's corporate governance and financial positions.

The paper notes that it was a perceived lack of transparency about financial information from the financial system that contributed to the current crisis. The Basel Committee concludes the paper by providing a list of actions that it will take to support audit quality, including enhancing dialogue with audit firms and audit oversight authorities.

Improved Stress Testing

On Jan. 6, 2009, the Basel Committee issued a consultative paper on stress-testing: "Principles for Sound Stress-Testing Practices and Supervision."[4] Comments are due by March 13, 2009. The paper proposes principles for the governance, design and implementation of stress-testing programs at banks. Such programs should be part of a bank's overall risk management program and used in capital and liquidity planning as well as in setting the bank's general risk tolerance. For purposes of this consultative paper, the term "stress testing" is used to refer to the entire environment within which the stress tests are developed, evaluated and used within the decision-making process.

The paper notes that stress testing is especially important after long periods of "benign" conditions. The current financial crisis has highlighted weaknesses in stress-testing practices employed during the period of benign or good conditions previous to the start of the crisis:

(i) use of stress testing and integration in risk governance;

(ii) stress-testing methodologies;

(iii) scenario selection; and

(iv) stress testing of specific risks and products.

The paper notes that previous stress testing had insufficiently addressed both the behavior of complex structured products under stressed liquidity conditions and liquidity (and other) risks.

The paper sets forth 21 recommendations for banks and their supervisors. Responsibility for a bank's strong stress-testing program starts at the top, with the involvement of the board and senior management. A bank's comprehensive stress-testing program should be part of its overall risk management program and cover a wide range of risks, business areas, and scenarios, with written policies and procedures governing the program that call for a regular review, including external review.

A bank's current stress-testing program should be reviewed to ensure that it includes complex financial products, highly leveraged counterparties and the effect of reputational risk.

> The Basel Committee's document, "Supervisory Guidance," is aimed at all financial instruments that are measured at fair value in normal market conditions and at times of stress.

On their part, regulators need to regularly test and assess the banks' stress-testing programs, including the underlying scenarios used in developing the program. The results of that review should be used when considering the bank's capital adequacy and liquidity management, and the regulators should require corrective action if they find material deficiencies in the program or find that the bank has not adequately considered the program in its decision-making processes.

An Update

Finally, in my Nov. 19, 2008, column (New York Law Journal, "International Banking," at p. 3) regarding the ability of the U.S. offices of non-U.S. banks to participate in the various U.S. federal economic initiatives, I discussed the FDIC's Temporary Liquidity Guarantee Program (TLGP), under which the FDIC was guaranteeing non-interest-bearing transaction deposit accounts and newly issued "senior unsecured debt" issued by "Eligible Entities" such as FDIC-insured depository institutions (the "debt guarantee program"). An interim FDIC rule had excluded insured branches of non-U.S. banks as Eligible Entities for the debt-guarantee portion of the TLGP, even though the definition of "insured depository institution in the Federal Deposit Insurance Act specifically includes insured U.S. branches of non-U.S. banks. The Institute for International Bankers (IIB), trade association for international banks with U.S. operations, had commented on that exclusion to the FDIC, pointing out potential competitive disadvantage issues that could arise from this exclusion.

On Nov. 26, 2008, the FDIC published its final TLGP regulations.[5] The final rule continues to exclude debt issued by insured U.S. offices of non-U.S. banks. In the portion of the Supplementary Information accompanying the text of the final rule that discusses various comments, it noted:

> A commenter requested explanation for the exclusion of an insured branch of a foreign bank from the definition of Insured Depository Institution for the purposes of the Debt Guarantee Program. The commenter expressed concern that excluding insured branches placed them at a potentially serious competitive disadvantage relative to other insured institutions. The FDIC intended for the Debt Guarantee Program to be available to insured depository institutions and other eligible entities that are headquartered in the United States. The FDIC did not intend to guarantee debt issued by foreign entities, including domestic branches of foreign banks or foreign subsidiaries of eligible U.S. entities. Foreign entities may be eligible for similar debt guarantee programs available in the countries in which they are domiciled.[6]

However, the FDIC has confirmed that U.S.-dollar-denominated deposits maintained in insured U.S. banks that are owed to U.S. branches or agencies of non-U.S. banks are covered under the debt-guarantee program regardless of whether the branch or agency is FDIC-insured. Deposits denominated in other currency are excluded from the debt-guarantee program.

Conclusion

We still live in uncertain times, but when we do enter back into economic stability, there likely will be a regulator waiting with new laws, regulations and guidelines, hoping that the new measures can ward off another crisis such as the present one.

1. http://www.bis.org/press/p081120.htm.
2. http://www.bis.org/publ/bcbs145.pdf?noframes=1.
3. http://www.bis.org/publ/bcbs146.pdf?noframes=1.
4. http://www.bis.org/publ/bcbs147.pdf?noframes=1.
5. 73 Fed.Reg. 72244.
6. 73 Fed. Reg. at 72254.