



RESHAPING FINANCE

The G20 summit this week will endorse tough new rules that will change the face of global financial regulation. Reuters explains what the new rules are set to be and how they will hit the financial sector.

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► AGENDA

- THE G20 FINANCIAL REGULATION AGENDA **3**

► WHAT'S IN BASEL III

- THE NEW RULES **5**
- IMPLEMENTATION KEY TO SUCCESS **7**

► THE IMPACT

- BREAKINGVIEWS: BASEL BUFFERS COULD BE PAINFUL FOR EUROPE'S BANKS **9**
- BANKS EYE SLIMMING PLANS AS RISK WEIGHT PILES ON **10**
- HOW BASEL HITS THE BANKS **12**

► STILL TO COME

- G20 PLANS FOR "TOO BIG TO FAIL" BANKS **14**

► OTHER KEY REFORMS

- HOW THE EU PLANS TO SHAKE UP FINANCIAL SERVICES **16**
- HIGHLIGHTS OF US FINANCIAL REGULATION REFORM BILL **18**
- REGULATING THE SHADOW BANKING SYSTEM **19**

SPECIAL REPORT

Global leaders meeting in Seoul are set to endorse tough new rules on bank capital and liquidity, marking the world's core regulatory response to the financial crisis.

The Basel III package on bank regulation starts rolling out in 2013 and will take full effect six years later.

But experts reckon top banks will want to show they can comply sooner rather than later as part of wider efforts by the sector to win back the public's trust.

World leaders will hold Basel III up as a milestone in financial regulation that was reached at breakneck speed – roughly a year compared with the decade of wrangling its tarnished predecessor took to agree.

But there is still plenty left to tackle on the G20's regulation agenda. The Financial Stability Board, which implements G20 regulatory measures, will present broad measures on how to deal with "too big to fail" banks but these are likely to be short on specifics.

Then France, the next G20 host, will be keen to push its proposals to implement curbs on commodity trading and rein in the influence of the "shadow banking" sector.



Office blocks are seen in the Canary Wharf business district in London January 19, 2009. REUTERS/Stephen Hird

FACTBOX

G20 FINANCIAL REGULATION AGENDA FOR SEOUL SUMMIT

By Huw JONES

Nov 5

LEADERS of the world's top Group of 20 (G20) economies meet in Seoul on Nov. 11-12. Among other issues, they will review their progress on pledges to tighten banking and market rules after the worst financial crisis since the Great Depression.

The leaders will review the pledges they have made on the following regulatory issues:

BASEL III

The G20 wants banks to hold more and better quality capital to withstand shocks without taxpayer help again.

The Basel Committee of global central bankers and regulators approved a "Basel III" package in September to toughen up global capital and liquidity requirements for banks from 2013 with full effect by 2019. It forms the cornerstone of the G20's reforms to apply lessons from the financial crisis.

The package is expected to be approved in its current form by the G20 summit and hailed as a major advance in financial stability.

TOO BIG TO FAIL

The Financial Stability Board (FSB), tasked by the G20 with implementing its regulatory pledges, will present recommendations on "systemically important financial institutions" or SIFIs – a reference to the world's 30 or so biggest banks whose failure could destabilise the broader financial system.

These pledges will make it mandatory for regulators to make sure there is a resolution regime for any big lenders in their country and that each of them must have a living will, or plan showing how a bank would be wound up without causing broader disruption to markets.

There will also be guidelines on ensuring such



financial institutions are subject to an increased "intensity" of supervision.

There is also broad agreement that these lenders should hold extra "loss absorption" capacity with national authorities setting some or a combination of the below requirements:

- capital surcharge: force big banks to hold a capital buffer on top of Basel III. Switzerland has already pushed ahead with topping up on Basel III, but Japan, Germany and France oppose surcharges on their big banks.
- contingent capital or "CoCos", a bond that converts into equity when an agreed trigger point is hit. Switzerland has approved CoCos for topping up capital of its two big banks, but some regulators question the market's appetite for such debt and its reliability in times of crisis.
- bail-in debt: a bank's creditors agree in advance to have a restructuring imposed on them if the firm starts becoming insolvent or its capital levels go below required levels.

The G20 is only expected to agree broad principles on SIFI next week due to disputes over many details, such as the need for surcharges,

The leaders of the Group of 20 pose for a photo at the G20 Summit in Toronto June 27, 2010.

REUTERS/Jim Young

who is in charge of pulling the trigger on CoCos and bail-ins, which banks can be deemed to be global SIFIs and therefore be subject to the extra safeguards.

This work will take at least until mid-2011 to complete and G20 countries will end up having a choice of options.

OVER-THE-COUNTER DERIVATIVES

The summit is expected to endorse a series of deadlines set by the Financial Stability Board for G20 countries to tighten supervision and ensure that as many contracts as possible in the \$615 trillion derivatives market are standardised so they can be centrally cleared and traded on exchanges.

It will also recommend that all over-the-counter derivative trades be reported to central depositories.

The United States has already adopted a law to this effect with the European Union on the same track.

Next step: G20 securities regulators to report in January on which derivatives contracts should be standardised and traded on a regulated platform.

CREDIT RATING AGENCIES

The FSB has proposed ways to reduce the “mechanical reliance on ratings”. It recommended that references to credit rating agencies in rules and regulations be removed or replaced wherever possible with suitable alternative standards of creditworthiness assessment.

This is aimed at reducing the so-called cliff effects caused by changes to credit ratings, which regulators have blamed for causing market instability.

The G20 is set to endorse these FSB principles.

The United States is already working on removing references to ratings in financial rules and the EU has just launched a public consultation on this.

ACCOUNTING

A G20 deadline of June 2011 for reaching a single set of global accounting standards will not be met in full as differences have emerged between the United States and others. The summit may put pressure on standard setters to



“The leadership in the global economy is being shifted from major economies to a broader set of countries including large developing economies.”

– Philip Suttle, Institute of International Finance

redouble their efforts to forge common rules by the end of 2011.

COMMODITIES

The G20 has already asked regulators to study transparency and volatility in commodity markets, such as oil, and consider ways to quell what some countries like France see as speculation pushing up food prices.

Regulators reported this week that transparency in oil markets has improved and signalled no need for any radical overhaul though they said physical commodity markets need to provide more pricing information.

France takes over as G20 host and is expected to push for new global rules to crack down on commodity markets but some regulators say there is no big appetite and that transparency is already improving markedly.

SHADOW BANKING

The FSB’s big task for next year is to devise ways to improve oversight of the “shadow banking” system. The fear is that as banks face tighter scrutiny, credit activity will move to less regulated areas. Supervisors want to have powers to extend the “perimeter” of regulation quickly if they spot new risky activities.

(Reporting by Huw Jones; Editing by Hugh Lawson)

FACTBOX

BASEL III: THE NEW RULES

By Huw Jones

Oct 19

CENTRAL bank officials and regulators made a further change to the Basel III package that will force banks to more than triple to 7 percent the amount of top quality capital they must hold to withstand shocks without state aid.

The latest change by the Basel Committee will mean a softer phase-in for a new liquidity coverage ratio, with the rest of the Basel III package unchanged.

Leaders of the Group of 20 countries (G20), who called for the reform, are due to give final approval to the package at their meeting in Seoul

The following is the latest version of Basel III after the latest meeting of the Basel Committee:

TIER 1 CAPITAL

This refers to a bank's basic capital reserves, calculated according to the riskiness of the assets it has on its books.

Under Basel III, the Tier 1 capital ratio is pegged at 6 percent, with core Tier 1 made up of common equity at 4.5 percent.

Implementation will start in January 2013, when core Tier 1 rises from 2 percent to 3.5 percent, with full phase-in of the Tier 1 rules to be completed by January 2015.

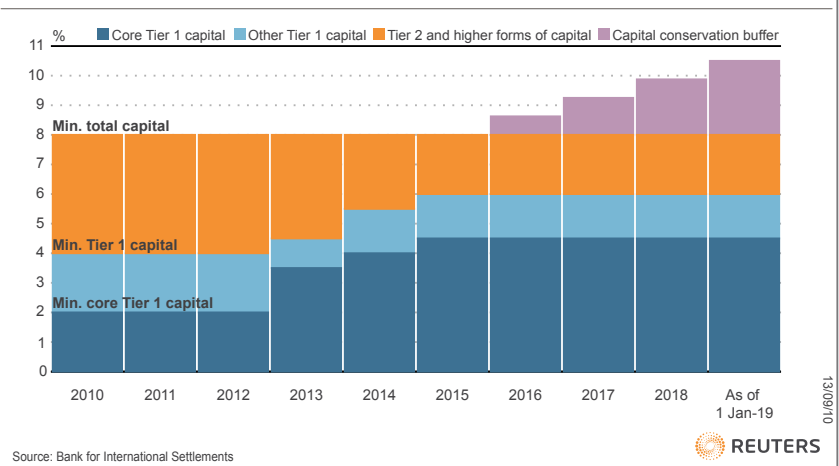
A bank must have a minimum total capital of 8 percent from January 2013, and after a capital conservation buffer is added in stages from 2016, will reach 10.5 percent by January 2019.

Deferred taxes, investments in other banks and mortgage-servicing rights will only be able to make up 15 percent of core Tier 1 capital – there was previously no limit. This will take effect in 2018.

Existing state capital injections into banks can be kept until January 2018.

ACTION POINT FOR BANKS: Banks falling short of the capital requirements will have to re-

Basel III capital requirements phase-in



tain more of their profits, raise additional capital or reduce their exposure to riskier assets.

CAPITAL CONSERVATION BUFFER

Basel III introduces a capital conservation buffer of 2.5 percent that will sit on top of Tier 1 capital. There was never such a requirement before. The new buffer will have to be composed of common equity, after the application of deductions like deferred taxes.

The buffer will be phased in from January 2016 and will be fully effective in January 2019.

ACTION POINT FOR BANKS: Any bank whose capital ratio falls below the buffer faces restrictions by regulators on payouts such as dividends, share buybacks and bonuses.

COUNTERCYCLICAL CAPITAL BUFFER

This new buffer is set at 0-2.5 percent of common equity or other full loss-absorbing capital.

The aim of the buffer is to force banks to start building up such an extra buffer when supervisors see excessive credit in the system that threatens to spark loan losses later on. Banks would then tap the buffer to offset such losses without having to raise fresh capital immediately.

ACTION POINT FOR BANKS: This is unlikely to be imposed in Europe, U.S. or Japan anytime

soon due to muted credit growth. Regulators in faster growing regions such as Asia may choose to impose the buffers, meaning some banks may be facing capital ratios in excess of 10 percent.

LEVERAGE RATIO

This aims to put a cap on build-up of leverage in the banking sector on a global basis for the first time.

A trial leverage ratio of 3 percent of Tier 1, meaning balance sheets cannot exceed 33 times Tier 1 capital, is to be trialled before a mandatory leverage ratio is introduced in January 2018.

This aims to lessen the risk that eventual deleveraging could destabilise the sector, as well as imposing an additional safeguard.

ACTION POINT FOR BANKS: As this is not measured on a risk-weighted basis, any banks with a ratio below 3 percent will have to shrink their balance sheets or boost their capital base even if they hold predominantly high-quality assets.

LIQUIDITY

The world's first set of common liquidity requirements aims to ensure banks have enough liquid or cash-like assets to tide them through a very severe short-term shock and for less severe conditions in the medium to longer term.

The short-term liquidity buffer – known as the liquidity coverage ratio – will require a bank to have enough highly liquid assets on its balance sheet to cover its net cash outflows over a 30-day period following a shock event such as a three-notch downgrade to its public credit rating. The assets will mainly have to be sovereign debt but may include some high-grade corporate debt as well.

The Basel Committee agreed on October 19 that the short-term liquidity buffer, known as the liquidity coverage ratio (LCR) should be trialled from 2011 rather than introduced formally. It will become a mandatory minimum standard from January 2015.

A one-year horizon liquidity buffer, known as a net stable funding ratio, will require bank assets to be funded by sources judged to be "stable". Different funding sources will be assigned different ratings as to how stable they are. This will be trialled from 2012 and become mandatory in January 2018.

European banks capital raising



The Basel Committee also announced on October 19 to introduce review clauses into the new liquidity standards so that supervisors can make changes if any "unintended consequences" emerge.

ACTION POINT FOR BANKS: Boost holding of highly liquid assets such as government debt to meet the short-term requirement by 2015. For the one-year liquidity buffer, banks falling short of the requirement will have to either seek longer-term funding sources or reduce their level of longer-term lending.

RISK COVERAGE

These proposals aim to strengthen capital requirements for counterparty credit exposures arising from banks' derivatives, repo and securities financing activities.

They aim to apply capital buffers against these exposures and provide incentives to clear bilaterally traded derivative contracts in central counterparties.

There will be a risk weighting of 1-3 percent on banks' mark-to-market and collateral exposures to a central counterparty.

The risk weighting on non-centrally cleared contracts will be higher but has not been announced yet.

ACTION POINT FOR BANKS: Most banks will have to put most of their derivatives trades through clearing houses. Banks will have to ensure capital buffers are in place for dealing with counterparty credit exposures although most of the precise rules are still to be set.

ANALYSIS

IMPLEMENTATION KEY TO BASEL III SUCCESS

By **Huw Jones**
LONDON, Sept 12

THE global “Basel III” deal on bank capital standards was reached at lightning speed by usually glacial regulators – substantive negotiations took about a year, compared to a decade for the current Basel II rules.

But implementing the new standards consistently over the lengthy phase-in period will be a headache for national regulators, and determine whether Basel III succeeds better than its predecessor in reducing bank sector risk.

- The Basel III rules are much tougher than Basel II, which failed to ensure banks held enough capital to withstand the worst financial crisis since the Great Depression.

- Although Basel III more than triples the amount of top-quality capital that banks will have to hold in reserve, there are several potential pitfalls in timing and content that could undermine the reform’s effectiveness.

- The key aspects of the completed package will not all be phased in until the start of 2019, presenting a challenge for supervisors and their political masters to maintain momentum in their supervision of the sector. Lobbying by banks or an eventual return to boom times could blunt the will to enforce Basel III, as memories of the global credit crisis fade.

- The new capital conservation buffer of 2.5 percent, which is lower than some banks had feared, will not be fully in place until the start of 2019. At this time, the buffer plus the Tier 1 capital requirement will total 7 percent; in practice this is likely to become a solid floor for banks, because they will not want to face curbs on payouts such as bonuses, dividends and share buybacks. Falling below 7 percent could damage a bank’s reputation among investors and in the money markets.

- The new capital rules are not the only fresh burden on banks; they should be seen in conjunction with a range of regulatory initiatives



“The new Basel regulations will increase pressure on banks to lend more”

–Huw Jones

that together could have large and unpredictable effects on banks.

Banks will have to comply with the first new global liquidity standard from January 2015; this will increase pressure to build up reserves of cash-like assets.

Separately, regulators will introduce far tougher capital requirements on bank trading books from the end of 2011, and these will force some institutions to rethink whether they want to continue financial market trading.

Also, national regulators may still impose other surcharges on big, systemically important banks as they grapple with the “too big to fail” problem; this prospect could cause large banks to build up more capital than the Basel III rules, taken in isolation, appear to imply.

- But there are doubts about how effective the new countercyclical buffer will be, if and when it kicks in.

“You have a bald number to protect against excess credit but bubbles tend to affect individual

asset classes at different points in time so it's a blunt instrument. To manage risk you have to be more targeted," said Richard Barfield, director at PriceWaterhouseCoopers.

It will be up to each national supervisor to determine when banks on its turf should start building up a countercyclical buffer; in the past, this has been a recipe for widely different approaches by regulators.

- Implementation is likely to be more universal than it was under Basel II; this time the United States appears fully on board, after it failed to implement all of Basel II. However, the lengthy transition period means political and economic changes may have altered the intentions of U.S. regulators by the time compliance becomes mandatory.
- Some top banks already hold more high-quality capital than Basel III will require. But many banks may feel pressure to show investors they can comply with the new package sooner rather than later, in order to ensure they are not lumped in with the stragglers in raising capital.

"I expect that what will happen is that the larger banks will move towards these figures ahead of the timetable," said Barfield at PriceWaterhouseCoopers.

- There are still controversial loose ends for regulators to tie up to make the Basel III package fully effective.

The announcement of full details of a planned cap on leverage and new liquidity requirements were delayed in July this year; their implementation is not due until 2018 once full details have been fleshed out, which will not be easy.

- The consensus on Basel III could start to fall apart if unforeseen impacts or foot-dragging by some countries starts to give banks in certain places competitive advantages over peers elsewhere.

"There has been a tremendous focus on getting this done quickly and it has been done to the G20 timeframe, which is why we need this ongoing monitoring and ability for mid-course corrections," said Simon Hills, a director at the British Bankers' Association.

- Basel III is at the core of the G20's efforts to apply lessons from the global financial crisis, and the agreement will allow G20 leaders meeting in



Seoul in November to congratulate themselves by endorsing a major reform of banks.

But there is a risk that the G20 could put too much reliance on higher bank capital levels and not focus enough on strengthening other aspects of the financial system that were found wanting in the crisis.

"Apart from a consistent worldwide application, it's important that capital is just part of the process of improving financial stability. The other key factors are improved supervision, improved risk management and making those things happen as well as the difficult challenge," Barfield said.

(Editing by Andrew Torchia)

An exterior view of the Standard Chartered office in Hong Kong October 13, 2010. The bank is one of the first to announce a capital raising after the Basel III proposals. REUTERS/Bobby Yip

BREAKING VIEWS

BASEL'S BUFFERS COULD BE PAINFUL FOR EUROPE BANKS

BY PETER THAL LARSEN
LONDON, Sept 14

BASEL'S buffers could be painful for Europe's banks. Most of the continent's lenders are already comfortably above the new 7 percent minimum set by regulators. But a reserve designed to dampen the economic cycle, and an extra helping of capital for systemically important banks, could eat up much of the excess. Despite investors' relief at news of the rules, it's too early for banks to think about returning cash.

Even though lenders have been given until January 2019 to comply with the rules, a Breakingviews analysis shows that most European banks already exceed the new minimum of 7 percent equity capital as a proportion of risk-weighted assets. On KBW's 2011 forecasts for capital and risk-weighted assets, only five of Europe's top 50 banks fail to meet the threshold.

The main culprit is bailed-out Commerzbank. It has a shortfall of 9.5 billion euros, although it has a peculiar form of capital from the German government known as "silent participation", which it has until 2018 to repay.

Add in the counter-cyclical buffer, however, and the picture worsens. This allows regulators to demand up to 2.5 percent more capital, depending on the economic cycle. Assuming a mid-cycle figure of 1.25 percent was in place by end-2011, 22 of Europe's top 50 banks – including Intesa Sanpaolo, BBVA and Erste Bank – would need to strengthen their balance sheets.

But it is the extra charge for systemic banks that could really prove painful. Though regulators have given few clues about how such a buffer would work, it would make sense for it to be on a sliding scale, so that the charge rises as balance sheets grow.

Assume that banks would have to hold an extra 0.2 percentage points of capital for each additional 100 billion euros of risk-weighted assets. On that basis, most of Europe's largest banks – including BNP Paribas, Santander, Barclays,



"On our number crunching... you would find that 30 of the biggest 50 banks in Europe would not have enough capital."

–Hugo Dixon, Editor, Breakingviews

Unicredit, Credit Agricole, and Societe Generale, – would face a shortfall at the end of 2011.

Even if the charge were reduced to 0.1 percentage points for each 100 billion euros of RWA's, half of the top 50 banks would need extra capital. Among the biggest banks only HSBC, RBS, Lloyds Banking Group and UBS would still have a comfortable excess.

Of course, regulators will probably give banks plenty of time to build up their buffers. That should allow them to make up the shortfall with retained earnings rather than raising extra capital. Banks may also be allowed to use different forms of capital, such as contingent convertible bonds, to fill the buffer.

Nevertheless, the market's reaction to the Basel rules shows that investors expect banks to meet new targets today, even if they do not come into force for many years. Until Europe's lenders have some clarity on the new buffers, it would be premature for them to think about returning spare capital.

(Editing by Hugo Dixon and David Evans)

39	HSBC
40	BNP Paribas
41	Santander
42	Barclays
43	RBS
44	Lloyds
45	Un
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50	De
51	BBVA
52	Commerzbank
53	Credit Suisse
54	Standard Chartered
55	UBS
56	Nordea

CLICK FOR
A BASEL
CALCULATOR

ANALYSIS

BANKS EYE SLIMMING PLANS AS RISK WEIGHT PILES ON



The logo of Swiss bank Credit Suisse is pictured at the company's headquarters in Zurich February 3, 2010. REUTERS/Arnd Wiegmann

- **Risk-weighted assets could double for some under Basel III**

- **Mitigating action could halve that impact but dent profits**

By **STEVE SLATER**
LONDON, Oct 13

BANKS, fixated on boosting their capital for over two years, may next be forced to trim their balance sheets to stay on the right side of stringent new rules that massively inflate their assets.

The Basel III rules laid out for banks a month ago held a double whammy: they tightened the definition of what counts as capital, and increased the risk weighting on many assets, cumulatively pressuring the capital ratio, a measure of a bank's strength.

Standard Chartered said an increase in risk-weighted assets (RWA) under Basel III would shave its capital ratio and contributed to its need for a \$5.3 billion rights issue.

Banks are worrying about how RWA inflation can be mitigated – and the impact on earnings, dividends and returns.

"It's a trade-off. There's no way out of it, they can reduce their RWA but in doing so, some of the impact will hurt earnings," said Andrew Lim, analyst at Matrix in London.

Banks in Europe with big trading asset books such as UBS, Credit Suisse, Deutsche Bank and Barclays will be most affected by the new rules.

But there is scope for them to mitigate the impact by as much as half by cutting securitisation exposure, opting for exchange-traded rather than over-the-counter (OTC) derivatives or slimming down other parts of the balance sheet.

The calculation on risky assets is complex and will not be finalised until G20 leaders meet in Korea next month. The changes are broadly known and banks are offering some clues on the impact, but they may be reluctant to give many more details at third-quarter results over the

- **UBS, C.Suisse, Goldman, M.Stanley will see big RWA jump**

next month.

The changes should almost double UBS's risk-weighted assets, while Credit Suisse's RWA is set to jump over 70 percent and Deutsche Bank's may rise by half.

Wall Street rivals like Goldman Sachs and Morgan Stanley will also be hit, with RWAs potentially rising by about 80 percent. JPMorgan estimates its RWA will be inflated by \$400 billion, or 36 percent.

ASSETS/REVENUE TRADE-OFF

There are three main areas where banks face a surge in RWAs: they will have to apply more stressed assumptions on the market risk of securities; for counterparty risk; and a change in how illiquid exposures are handled, such as securitised products.

Their options to limit the rise include running down or selling assets in the riskiest areas or using structured products to move assets off-balance sheet.

But each has a price. Moving OTC derivatives onto centrally cleared exchanges will need a margin outlay that will shave profits, for example, while banks are being encouraged to keep a slice of securitisation exposure on deals for clients.

Most banks have rebuilt capital to above a new minimum core Tier 1 ratio of 7 percent laid out by regulators, but much higher RWAs would drag the ratio of many back near the minimum.

That could crimp their ability to pay dividends and hurt returns and keep them in capital conservation mode for longer than investors expected.

As a result banks will want to limit the balance sheet inflation, especially in countries such as Switzerland and Britain, where capital rules will be made even tougher.

"The ability of banks to optimise their balance sheet in a stable regulatory environment should not be underestimated," said Daniel Davies, analyst at Credit Suisse.



Banks are wary of raising expectations too high on what they can do, but are saying they will have some success.

A clock is seen beside the logo of Swiss bank UBS at the Paradeplatz square in Zurich October 16, 2008. REUTERS/Arnd Wiegmann

UBS has provided the most clarity. Its RWA would have jumped to about 400 billion Swiss francs under Basel III rules, from 205 billion. It reckons it can cut that to 300 billion by taking action.

That would still be a 46 percent rise, however, and it has warned it won't pay dividends for some time.

Credit Suisse said its RWA would also rise to about 400 billion Swiss francs under Basel III from 233 billion and Barclays has said its RWA would rise by 150 billion pounds from 395 billion, but both expect to take mitigating action.

"The question investors have is what is the revenue cost of that mitigation," said Jon Peace, analyst at Nomura.

"The investment banks are trying to persuade us it will be mitigated with very little revenue attrition and investors are worried it will be more than that," he said.

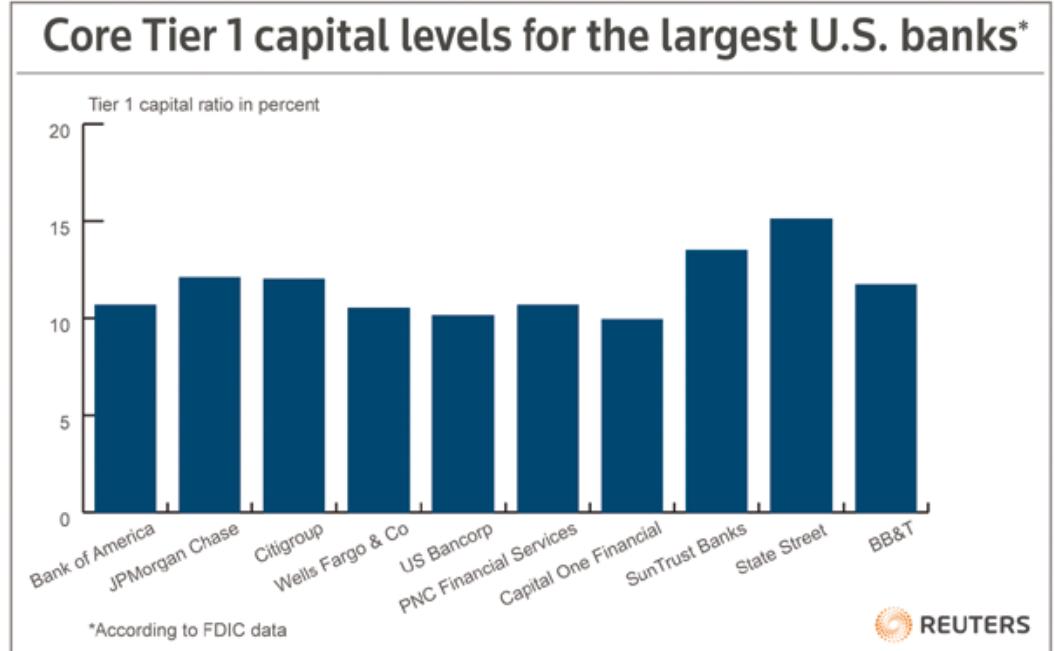
Sceptics say banks may have cut their balance sheets since 2008 but if it was an easy process more would have been done already, and many assets can take years to run off.

(Editing by Sitaraman Shankar)

HOW BASEL HITS BANKS

US

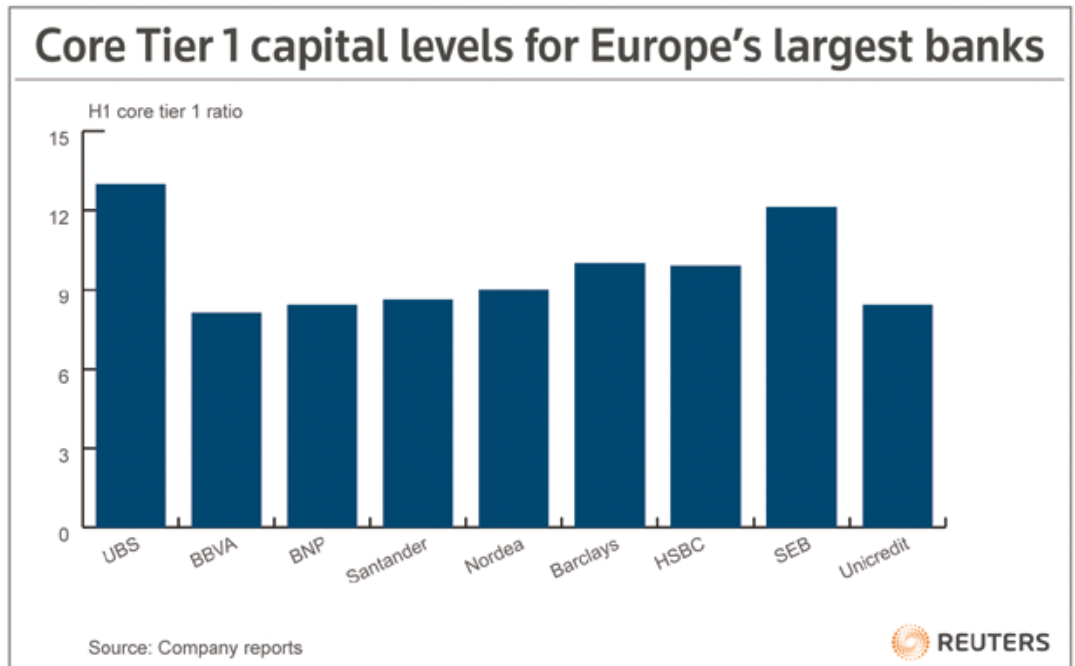
U.S. banks are unlikely to be compelled to raise additional capital under the new global Basel banking regulations. U.S. banks generally hold more capital now than is expected to be required under the new standards, and are expected to be largely unaffected by the pending rule changes.



EUROPE

European banks are likely to feel the most impact of the new Basel III rules. Germany's Deutsche Bank is to raise 10.2 billion euros in a share issue to bolster its capital position as well as to finance its acquisition of Deutsche Postbank. Other German banks are expected to follow suit.

National Bank of Greece has launched a rights issue and other lenders in Greece, Spain, Portugal and Italy could tap investors for funds, analysts estimate.

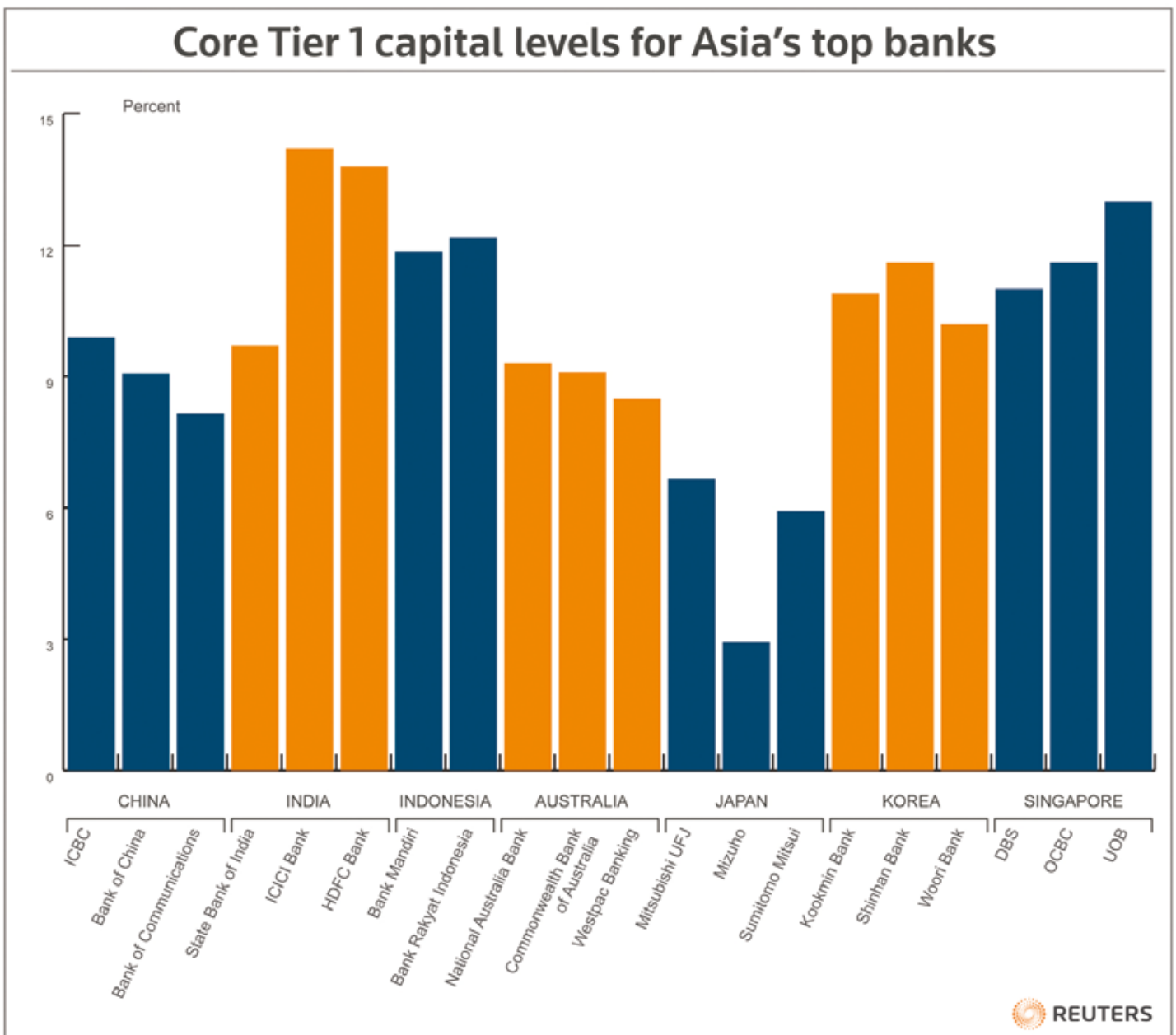


ASIA

Most Asian banks already hold Tier 1 capital well above the expected minimum levels, though some in Japan may find it tougher to meet the new requirements.

Analysts now expect the clarification of the new rules to help them use surplus capital to accelerate lending in the region's fast-growing economies or scout for acquisitions.

Banks in Indonesia and Singapore look to be in the strongest position, having an average core Tier 1 ratio of around 12.5 % and 11.9 %, respectively.



Q+A

G20 PLANS FOR "TOO BIG TO FAIL" BANKS

LONDON, Oct 21

THE Group of 20 leading economies (G20) holds a summit in Seoul on Nov. 11-12 where it is expected to make some progress on dealing with "too big to fail" banks.

The aim is to ensure that if any of the world's 30 or so top "systemically important" financial institutions (SIFIs) get into trouble, they can be dealt with quickly at no cost to the taxpayer and without disrupting the broader financial system.

The G20 is expected to endorse a broad package of reforms on banks but is unlikely to come up with any specific measures until later in the year.

WHO IS DRAFTING THE PACKAGE?

The G20 has tasked the Financial Stability Board (FSB), made up of central bankers, regulators and treasury officials from its member countries, to draft the package.

The Basel Committee of banking supervisors and central bankers is providing some of the detailed technical work.

It has become clear that next month's summit will endorse a set of broad recommendations rather than a complete package.

WHAT'S IN IT?

- A capital surcharge on SIFIs
- A requirement that SIFIs should have extra "loss absorbency" capacity, which could comprise hybrid debt such as bail-in and contingent capital (CoCos) which convert into equity and boost a bank's capital when it gets into trouble.
- More intensive supervision of SIFIs
- A mechanism to resolve a struggling SIFI without disruption to the financial system or taxpayer support
- Use of central counterparties for off exchange trading of derivatives by SIFIs.



Bank of Italy Governor Mario Draghi arrives at his news conference at the IMF headquarters building in Washington October 10, 2010. REUTERS/Yuri Gripas

WHERE ARE THE DISAGREEMENTS?

- What criteria do you use to define a SIFI? Some countries don't accept that some of their leading banks are global SIFIs and therefore subject to extra curbs. The FSB has said it will determine which banks the measures will apply to mid-way through 2011 but will not make any list public.
- No consensus over capital surcharge: Some regulators have indicated it could be 2-3 percent on top of the minimum requirements for all banks. Japan, Germany and France oppose surcharges on their big banks.

Switzerland has already pushed ahead with topping up on the new global minimum capital



requirements known as Basel III with a “Swiss finish”. Britain and United States also want a belt and braces approach to capital levels.

A European Union position paper for the G20 put emphasis on a combination of bail-in, levies, resolution and enhanced supervision with extra capital “where appropriate” rather than mandatory.

- Questions over converting debt: When would the debt convert to equity? Is there enough investor appetite for this riskier type of bond? Would they really work in a crisis? The Basel Committee said this week it will finalise its work on this by the middle of next year.

- Resolution: Is it possible without major changes in national laws to put in place an effective mechanism to resolve problems in big cross-border banks and prevent collapses?

IMPLEMENTATION

The aim is for all G20 countries with a global SIFI to select options from the FSB package. A common global approach appears to have been shelved with FSB Chairman Mario Draghi saying that the application of any of the elements in the package will differ from country to country. It’s expected that the FSB will recommend the specific types of measures to apply to SIFIs by the end of 2011.

Exterior view of the Lehman Brothers world headquarters in New York September 12, 2008. REUTERS/Staff Photographer

FACTBOX

HOW THE EU PLANS TO SHAKE UP FINANCIAL SERVICES

Huw Jones
Oct 19

EUROPEAN Union finance ministers have reached a compromise on the bloc's first set of rules to directly supervise managers of hedge funds, private equity groups and other alternative investment funds from 2013.

The new rules are part of a slew of regulatory measures that implement pledges the EU made at the global Group of 20 leading countries level to introduce reforms by the end of 2012.

The United States this summer approved a reform of Wall Street that turned the G20 pledges into law in one fell swoop.

Here is a guide to the overhaul being authored by the bloc's executive European Commission and approved by EU states and the European Parliament:

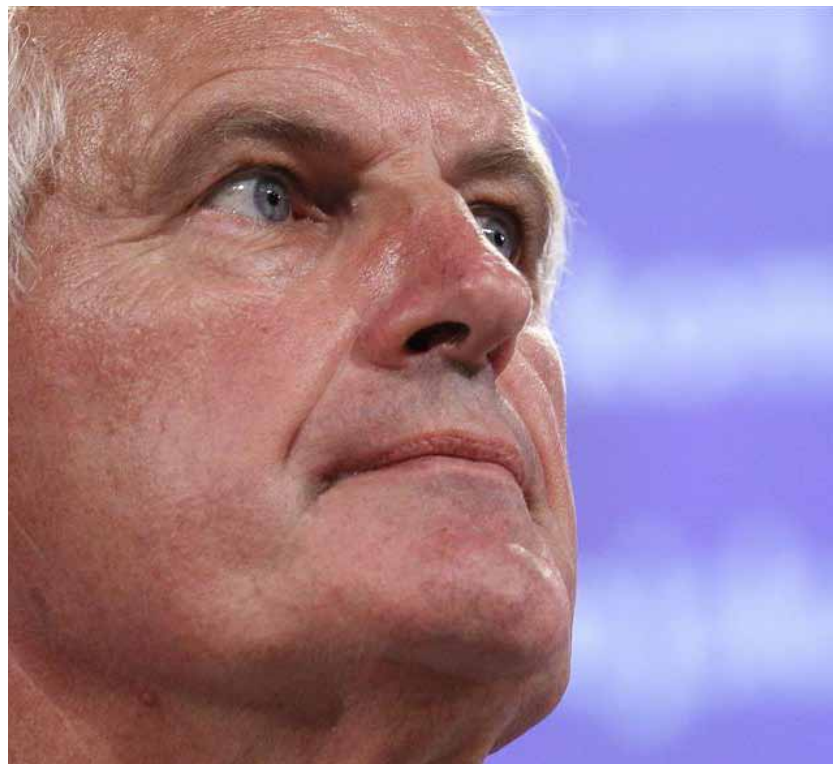
HEDGE FUNDS/PRIVATE EQUITY

The Commission has proposed a draft law to regulate managers of hedge funds, private equity groups and other alternative investments to curb risks and excessive pay. It requires registration and regular disclosure of information.

The final version of the regulatory regime was finally agreed after France backed down on a demand to give the new EU markets watchdog responsibility for issuing licences for foreign funds to work across the EU. In return, Britain agreed to delay the start of the licensing scheme for foreign-based funds until 2015.

DERIVATIVES

The European Commission proposed a draft law in September to force more transparency in the \$615 trillion off-exchange derivatives market. Traders will have to standardise and centrally clear as many of their contracts as possible and record all trades.



SUPERVISION

The EU has approved the creation of three new EU authorities with binding powers to supervise banks, insurers and markets from January. A fourth to monitor system-wide risks will be based at the European Central Bank in Frankfurt.

BANK TRADING AND BONUSES

The EU is finalising new rules that will give supervisors tough new powers to curb excessive pay at banks and other financial institutions to limit risk-taking.

The rules will also increase how much capital banks must set aside to cover resecured products they hold on their books.

Michel Barnier, the EU commissioner in charge of reform of financial services, holds a news conference at the European Commission headquarters in Brussels September 15, 2010. REUTERS/Yves Herman

The Commission will propose another round of amendments to EU bank capital rules in December or early 2011 to implement the "Basel III" bank capital and liquidity reforms agreed in September at the global level.

SHORT SELLING

The European Commission has proposed controls for short selling of shares and naked selling of credit default swaps in government debt – a form of insurance. The draft law also includes powers to ban short selling for temporary periods.

Policymakers say they want to rein in financial speculators whom they blame for worsening the debt situation of countries like Greece.

CREDIT RATING AGENCIES

The Commission has proposed changes to new EU rules to regulate credit rating agencies that are now coming into effect.

Under the planned changes, rating agencies like S&P, Moody's and Fitch would be supervised centrally in the EU and be subject to possible investigations and on-site inspections from 2011.

BANK TAX

EU finance ministers have agreed in principle on a bank tax to pay for future bailouts but there is no consensus yet on how it should be structured. The European Commission has also floated ideas for a financial transactions tax.

TRADING RULES

The Commission is set to propose changes to the bloc's securities trading rules in early 2011. Reform of the markets in financial instruments directive (MiFID) will reflect a push for greater transparency in areas such as dark pool or anonymous trading venues for shares.

MARKET ABUSES

The Commission will propose changes in De-



"There have been some studies that have shown that public disclosure actually discourages short selling, in fact we see that investors short sell up to the threshold and won't go beyond it."

–Kevin McNulty, ISLA

ember to toughen up the EU's rules for tackling market abuses by including stronger sanctions.

BANK RESOLUTION

The Commission is due to present a policy paper on crisis prevention and management in October and will propose a draft law next year which aims to ensure all EU states have effective resolution mechanisms for ailing banks and that they can work together in cross-border cases.

HOUSING MARKET

Next year the Commission will propose measures to make lending for home purchases more responsible and promote cross-border competition in mortgages.

BANK ACCOUNTS

The European Commission is expected in early 2011 to come forward with a draft law to make it easier for everyone to have a basic bank account, irrespective of credit history or income.

FACTBOX

HIGHLIGHTS OF US FINANCIAL
REGULATION REFORM BILL

July 21

PRESIDENT Barack Obama has signed into law a sweeping overhaul of the U.S. financial regulatory system.

The following are the key proposals.

SWAPS PUSH-OUT: Wall Street firms that dominate the \$615 trillion over-the-counter derivatives market will have to spin off dealing operations in some swaps, but can keep many swaps in-house, including derivatives to hedge their own risk.

Much of OTC derivatives trading will be redirected through more accountable channels such as exchanges and clearinghouses. Many OTC contracts end-users will be able to carry on as before.

VOLCKER RULE: A new rule will bar proprietary trading by banks for their own accounts unrelated to customers; limit the growth of the biggest banks; and curb banks' involvement in private equity and hedge funds, except for small investments allowed by a loophole added to the rule late in debate.

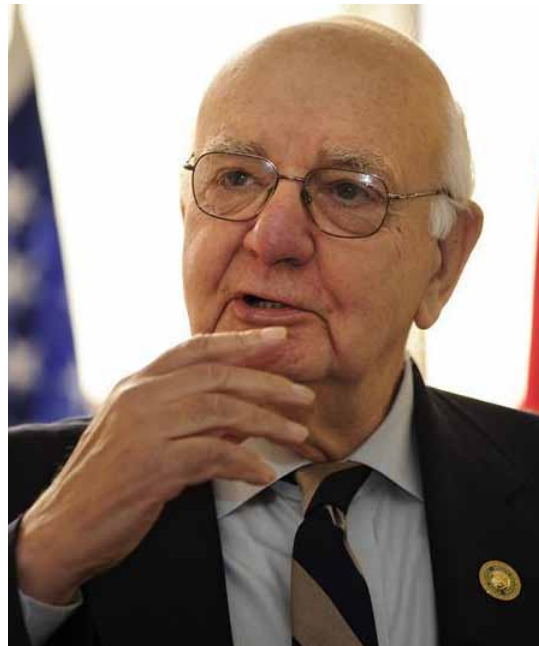
Some big banks' profits will be pinched by both the Volcker rule and the Lincoln swaps plan, with a few Wall Street giants potentially facing structural changes.

WALL ST 'DEATH PANEL': Aiming to prevent massive bailouts like AIG's and disastrous bankruptcies like Lehman Brothers', the bill creates a new government "orderly liquidation" process for financial firms on the verge of collapse.

Authorities will be able to seize and liquidate them, with costs covered by sales of assets and fees on other firms if needed.

CONSUMER WATCHDOG: Protection of financial consumers will be enhanced by increased government regulation.

The bill will set up a new bureau in the Federal Reserve to regulate mortgages and credit cards.



The watchdog has sharp teeth, but won't be able to bite car dealers, who won an exemption.

THE BIG PICTURE: A new council of federal regulators will try to monitor the entire financial forest, not just the trees. High-risk firms can be singled out for stricter policing.

BEHIND THE HEDGE: Private equity and hedge funds will have to register with regulators and open their books to scrutiny. Not so for venture capital funds, which are exempt.

INSURANCE COPS: The first federal monitor for state-policed insurers will be formed. It's not federal regulation – yet.

BANK CUSHIONS: Banks will have to set aside more capital to ride out tough times, but will get several years to comply.

FED SCRUTINY: The Fed's emergency lending during the crisis will be reviewed, but not its decisions on interest rates.

DEBIT CARDS: Fees charged on debit card transactions will be reduced – a victory for retailers over the banks.

Paul Volcker, former chairman of the U.S. Federal Reserve and Chairman of President Barack Obama's Economic Recovery Advisory Board, addresses Canadian business leaders during the Changing Fortunes Round Table on economic recovery at Spruce Meadows in Calgary, Alberta, September 10, 2010.
REUTERS/Todd Korol

Q+A

REGULATING THE SHADOW BANKING SYSTEM



BY RACHEL ARMSTRONG

Oct 4

A GLOBAL regulatory body tasked by the G20 with devising ways to prevent a repeat of the financial crisis says improving oversight of the “shadow banking” system will be one of its main priorities in 2011.

Mario Draghi, head of the Financial Stability Board, argues that credit provision in the shadow banking system – conducted by loosely regulated non-bank financial firms – was a key contributor to the crisis.

But as banks face tighter supervision and tough new capital rules, there are fears that more credit activity will move out of the regulated banking industry and into this shadow system.

WHAT IS THE “SHADOW BANKING” SYSTEM?

On a basic level shadow banking refers to any provision of credit that takes place outside of the traditional deposit-funded bank lending system. This includes institutions as diverse as pawnbrokers and consumer finance companies to securities dealers and firms issuing corporate bonds.

However regulators say they are most concerned with the system of firms, instruments and markets that “mirror” commercial banking by enabling funds borrowed from short-term sources such as the money markets to be invested in longer-term, less liquid assets.

A city worker is silhouetted in front of the ‘Gherkin’ building in London January 21, 2010. REUTERS/Luke MacGregor

The web of institutions engaged in this form of shadow banking ranges from hedge funds, investment banks and consumer finance companies to the complex world of structured investment vehicles and asset backed commercial paper issuers.

HOW DOES IT CREATE CREDIT?

Rather than the traditional bank model of using deposits to fund loans, much of the shadow banking system creates credit through a complex process of securitisation, the use of commercial paper and the repo market.

Securitisation enables fairly illiquid assets such as mortgages to be converted into tradable asset-backed securities.

Shadow banks can use these securities as collateral to borrow short-term money in the repo market or from money market funds. and then use this cash to fund other lending activities.

HOW BIG IS SHADOW BANKING?

While a precise estimate is impossible, research from the Federal Reserve Bank of New York estimated that there was around \$16 trillion worth of liabilities in the shadow banking system during the first quarter of 2010, exceeding the size of the traditional banking system, which is estimated at about \$13 trillion.

This, though, is lower than the size of the market before the global financial crisis, when as much as \$20 trillion was thought to be involved.

WHY ARE REGULATORS WORRIED?

Whereas bank "runs" can usually be prevented by deposit-protection schemes, there is no such safety net for the shadow system. But it was a "run" on the shadow banking system that arguably triggered the global financial crisis.

When U.S. sub-prime mortgages began to default in 2007, shadow banks found it increasingly difficult to use securities linked to these mortgages as collateral in the repo market, meaning they started to lose access to their main source of funding.

Then when Lehman Brothers failed, investors pulled their cash out of money market funds, fearful of their level of exposure to the stricken investment bank.

Now, with banks facing tougher capital rules and increased supervision, the fear is that more money will move out of the banking sector back into the shadow system.

WHAT CAN BE DONE TO CONTROL SHADOW BANKING?

Regulators have proposed a range of solutions, including requiring the institutions that most closely resemble banks, such as money market mutual funds, to be regulated as such.

There are also calls for more regulation to be done on asset classes rather than on institutions. This would mean that there would be minimum capital requirements such as haircuts and loan-to-value ratios on the lending of certain securities regardless of the parties are involved.

Regulators and central bankers have also said they want to have greater powers to help them shift the perimeter of regulation more quickly in future to impose rules on risky behaviour outside their main purview.

However, many experts in financial regulation argue that markets will always find a way round such rules, so the best regulators can do is to improve their monitoring of the sector so that systemic risks can be spotted sooner.

(Editing by Alex Richardson)

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