Financial regulation of banks – accounting, stress testing, securitisation, credit rating

Although financial regulation of banks is frequently associated with rules on liquidity and capital, current legislative reform also encompasses a number of other areas which are directly relevant to the financial operations of banks. The rules which are being developed in the areas of accounting, stress testing, securitisation and credit rating are due to have a significant impact on the way banks value their business and measure their risks.

1) More realistic accounts

The issue: Bank accounting rules and audits did not provide any advance warning of the crisis for investors or the market. Regulators did not understand the implications of the narrow basis on which bank accounts are prepared (or how this undermined the effectiveness of the regulatory capital regime under Basel rules) and they did not appreciate (or concern themselves with) the implications of accounting decisions by firms or their auditors.

Key areas of concern are the restrictive basis for recognising impairment of loans and the “fair value” (i.e. mark-to-market) principle for valuation on the trading book. These provided auditors with clear rules to follow but produced a narrow and potentially misleading picture of a bank’s position; they may also have hindered the traditional practice of banks putting away reserves in the good times to see them through the bad.

The policy: Many areas of the accounting rules and related reporting are being reviewed and extensive debate between regulators, accounting bodies and the industry has already started. Reform of accounting standards is an area of international, rather than domestic reform. BCBS has issued a set of high-level guiding principles to assist international accounting bodies in addressing issues surrounding provisioning, fair value measurement and related disclosures.

Key areas of debate so far have been the short-term nature of the picture given under accounting rules, particularly impairment on the loan book (which may well be foreseen but is not recognised in the accounts because a loss event has not occurred at that stage) or the trading book (where a market downturn may be anticipated but not reflected in mark-to-market valuation). BCBS issued guiding principles for the revision of accounting standards for financial instruments in September 2009 to assist IASB in relation to provisioning and fair value, and the Financial Crisis Advisory Group also issued a report in late August 2009. The Toronto G20 Leaders’ Statement (June 2010) advocates convergence towards a single set of high-quality, global, independent accounting standards on financial instruments, loan-loss provisioning, off-balance sheet exposures and the impairment and valuation of financial assets. It urges the IASB to improve the involvement of prudential regulators.

The FSA is currently inviting discussion on its recommendations to introduce guidelines to ensure prudent valuations as well as a system of regulatory valuation adjustments to ensure greater consistency in balance sheet valuation approaches.

The impact: As international accounting standards are fleshed out, the FSA will become much more involved and intrusive on accounting issues, including benchmarking and challenging firms and their auditors over accounting decisions.

The timetable: International accounting bodies were initially scheduled to complete their convergence project for a single set of global accounting standards by June 2011, but the FASB and IASB have indicated that this is more likely to be end-2011. Initial IASB proposals for the classification and measurement of financial assets and impairment standards have been published; consultation and redeliberation is underway. The implementation of programmes for convergence with and adoption of new standards of the IASB is to be achieved by 2012.

The IASB plans to issue an IFRS on disclosures about unconsolidated entities by the end of 2010, and an IFRS improving disclosures under the derecognition standard by the third quarter of 2010 to prevent entities ceasing accounting for assets they still control. The effective date of IFRS 9 (Financial Instruments) on classification and measurement of financial assets is 1 January 2013.

The FSA has invited the industry to discuss its recommendations regarding approaches to valuation, the deadline for comments being 26 November 2010.

2) FSA stress testing – the "what if" game

The issue: Why is it that, despite apparently complying with detailed financial regulations such as the Basel II rules, financial institutions were not adequately prepared for the financial downturn? Recent events have illustrated that financial regulation cannot work in the abstract, but must be calibrated in accordance with factual assessments that pre-empt adverse economic developments.

The policy: The FSA has stated that it expects firms to engage in regular stress and scenario testing that assesses their ability to meet capital and liquidity requirements in stressed conditions. As such, stress testing is an inherent part of risk assessment and management, and the FSA expects boards and senior management to take an active role in establishing and overseeing stress-testing programmes. Stress testing is also an important element of capital adequacy assessments under Pillar 2 as set out in the FSA's GENPRU sourcebook, which firms are expected to calibrate in accordance with the FSA's supervisory recommended scenarios.

FSA's new reverse stress-testing requirements will require firms to consider the scenarios that are most likely to make their business model become unviable and then to take steps to mitigate these risks. This is part of the broader trend towards firms having to plan for their own demise (for example through preparation of living wills) and FSA scrutiny of business models. FSA has announced that it will further strengthen its framework to allow it to carry out stress tests of specific firms, and to conduct simultaneous system-wide stress tests of multiple firms using a common scenario. Additionally, CEBS carries out an annual EU-wide stress-testing exercise relating to selected banks.

The impact: FSA's new reverse stress-testing requirements apply to banks and building societies as well as insurers and CRD investment firms. Pillar 1 ICAAP/ICAS stress-testing requirements apply to some BIPRU firms in relation to certain exposures, Pillar 2 ICAAP/ICA requirements apply to banks, building societies, insurers and investment firms, and stress tests for Individual Liquidity Adequacy Assessments must be carried out by all BIPRU firms subject to BIPRU 12.

Although the FSA has not generally followed the approach of the US Federal Reserve and published the results of its stress tests, this may change following its recent publication of the results of stress tests carried out by UK banks in 2010 under the supervision of CEBS.

The timetable: FSA published a policy statement on 'Stress and scenario testing' in December 2009, confirming that firms must ensure compliance with new reverse stress-testing requirements by 14 December 2010.

3) Tougher rules for securitisation

The issue: Securitisation and the originate-to-distribute model are seen as a major weakness in the banking system following the collapse of securitised markets such as mortgage-backed securities.

The policy: Regulators aim to tackle weaknesses in the originate-to-distribute model. These will require those originating transactions to keep 'skin in the game' (a 5% retention – reduced from the original proposal of 10%) to give them a direct interest in assessing the product risk. There are proposed or agreed changes at international level (BCBS in relation to Basel II and IOSCO) and at EU level (CRD2, CRD3 and other legislation); these have been commented on by the domestic tripartite authorities (and Turner also reported on the development of structured/securitised credit markets in his report). The G20 progress report published in July 2010 advocates quantitative retention requirements.

The CRD2 provisions will prevent banks from taking on an exposure to the credit risk of a securitisation position unless the originator, sponsor or original lender has expressly disclosed that it will retain on an ongoing basis a material 'net economic interest' of not less than 5%. They will also be required to perform stress tests "appropriate to their own securitisation positions" and monitor the performance of exposures underlying their securitisation positions. This would require firms to analyse externally rated securitisations to address the weaknesses exposed in recent market turmoil in CRAs. There will be capital penalties if the new requirements are not complied with. Originating banks must apply the same criteria to origination as they would if they were holding the entire exposure and must give investors access to the data/information required for effective stress-testing and due diligence. Failure to meet the new obligations will mean the originator has to hold capital as if it retained the entire securitised exposure. Higher capital charges for certain securitisation positions have been proposed – these relate to liquidity facilities and "re-securitisation" positions.

The impact: The originate-to-distribute model will survive as the authorities recognise that it is currently an irreplaceable source of finance. Firms need tighter risk and due diligence controls over origination, distribution and investment in securitisations. There is more flexibility in the final rules on the new mandatory retention; retention means that it will no longer be possible to remove securitised assets from the balance sheet.

The timetable: CEBS has published a consultation paper on draft CRD2 implementation guidelines relating to securitisation practices. The deadline for comments is 1 October 2010.

Following the European Parliament's approval of CRD2, the 5% retention will apply to new securitisations from 1 January 2011 and to new exposures under existing ones from 1 January 2014.

4) Credit ratings – reforming the system

The issue: The credit-rating system is seen as a significant contributor to the crisis; the financial rules (and the risk controls within firms) placed great reliance on the use of ratings by external CRAs. Those ratings, as they were developed for structured or securitised products, were seriously defective (as a SEC investigation graphically demonstrated) as a result of inadequate due diligence and monitoring, and pressure to negotiate ratings with originators (a pressure which does not arise when rating a listed company). The current reforms are based on reducing the dependency on external CRA ratings and on regulation of the CRAs.

The policy: The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies sets out criteria which CRAs are recommended to adhere to, including independence from governments, banks, brokers and other institutions that may have an interest in credit ratings; objectivity (meaning CRAs must not issue recommendations regarding investment, acquisitions or disposals); and analytic integrity and openness (based on transparent and detailed methodologies).

Under the European regulation on credit rating agencies, credit institutions and investment firms (including banks, insurers/life insurers/reinsurers, UCITS and occupational retirement institutions) may now only use credit ratings for regulatory purposes if they are issued by CRAs established and registered in the Community. All CRAs whose credit ratings are to be used in the EU need to apply to CESR for registration. Decisions on registration are made by relevant securities regulators acting as a college. Registered CRAs have to comply with rules to ensure that ratings are not affected by conflicts of interest, that they remain vigilant on the quality of the rating methodology and the ratings themselves, and that they act in a transparent manner. The new rules do not allow CRAs to provide advisory services and stop them from rating financial instruments if they do not have information of a sufficient quality to base their ratings on. Transparency is improved by requiring that CRAs (a) disclose the models, methodologies and key assumptions on which they base their ratings, (b) publish an annual transparency report and (c) differentiate the ratings of more complex products by adding a specific symbol. CRAs also have to internally review the quality of their ratings and ensure they have at least two independent directors on their boards who are appointed for no more than five years, can only be dismissed for professional misconduct and whose remuneration cannot depend on business performance. At least one of these directors should be an expert in securitisation and structured products. The UK Credit Ratings Agencies Regulations designate the FSA as the competent UK authority for the purpose of regulating CRAs.

When rating banks, CRAs also consider the stand-alone strength of a bank and the likelihood of government support. These overall ratings are used for capital requirement purposes. Where a bank is likely to be supported, use of the overall rating instead of the stand-alone rating is likely to reduce the amount of capital they hold. FSA therefore thinks that firms should be required to use stand-alone bank ratings for capital requirement purposes to ensure that capital reflects risk. The Toronto G20 Leaders' Statement (June 2010) calls for authorities and financial institutions to reduce their reliance on CRAs, and refers to the implementation of international standards (including Basel III) for the oversight of CRAs.

The impact: CRAs have lost their longstanding campaign and now face direct regulation and some potentially onerous requirements. The legislation also impacts their legal structure. Firms face the challenge of developing their in-house rating expertise. Originators will face a more rigorous and compliance-driven process to obtain ratings (in addition to the new rules on retention and their own due diligence).

The timetable: National supervisors of CRAs whose ratings are used for regulatory purposes were recommended to achieve global consistency with the IOSCO Code of Conduct by early 2010. The BCBS is due to report to the G20 on general principles for CRAs in October 2010.

The Regulation of the European Parliament and of the Council on CRAs came into force on 7 December 2009, and has applied since 7 June 2010.

5) Further reforms

Further reforms affecting financial regulation of the banking sector are those relating to **liquidity and capital**. For an overview of these reforms, please click here.

Banks are also likely to be affected by a number of **structural reforms**, outlined here.

For an overview of the regulation of **remuneration** and the potential impact on bank capital, please click here.

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