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Basel 4 – Emerging from the mist?

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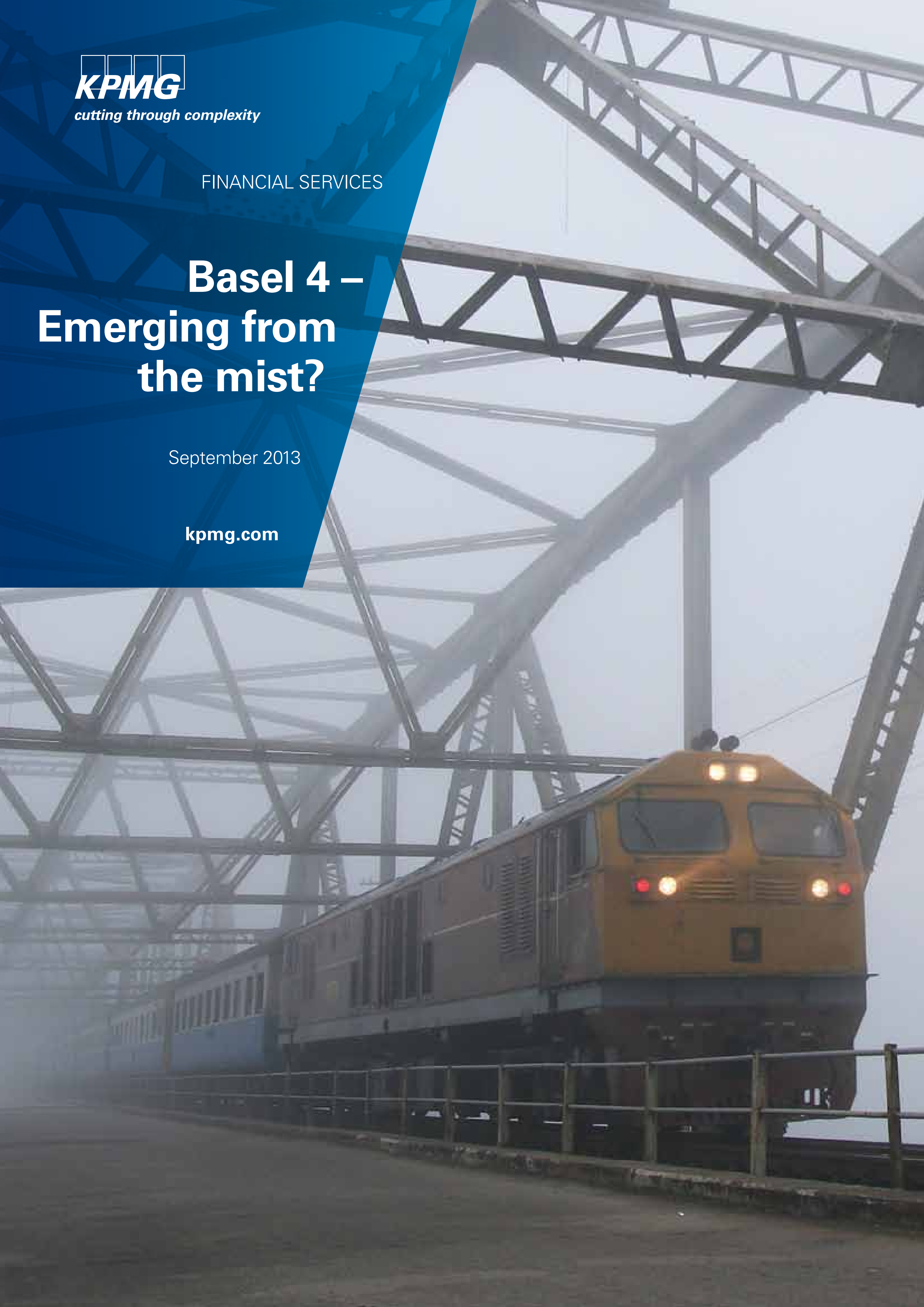


Executive Summary

Basel 4 – Emerging from the mist

Even before Basel 3 is fully implemented, 'Basel 4' may be emerging from the mist. Developments in recent months lay the groundwork:

- Some countries are already beginning to impose requirements that go beyond Basel 3. The US and Europe are requiring banks to meet minimum capital ratios even after the impact of severe stress; Switzerland, the US and UK have set a minimum leverage ratio at above 3 percent; others (Australia and UK) are insisting that 'Pillar 2' capital add-ons are met through highest quality capital; and finally, countries such as the US and UK are pushing for tougher liquidity standards;
- Widespread concerns among regulators and market analysts about banks' internal modelling and the accuracy of the resulting risk weighted assets;
- Resulting calls for greater simplicity in regulatory requirements from some leading regulators (including from Andrew Haldane in the UK and Thomas Hoenig in the US), supporting higher minimum leverage ratios and reduced reliance on models;
- A corresponding flurry of papers from the Basel Committee that look beyond Basel 3, including on the regulatory approach to banks' treatment of trading books, on the variability across banks of risk weights generated by banks' internal models, and on the balance between risk sensitivity, simplicity and comparability; and
- For euro area banks, the prospective actions of the European Central Bank (ECB) as supervisor, regulator and macro-prudential authority – the emergence of 'Frankfurt 1'.

These developments are likely to result in three changes that might form the basis of a future Basel 4.

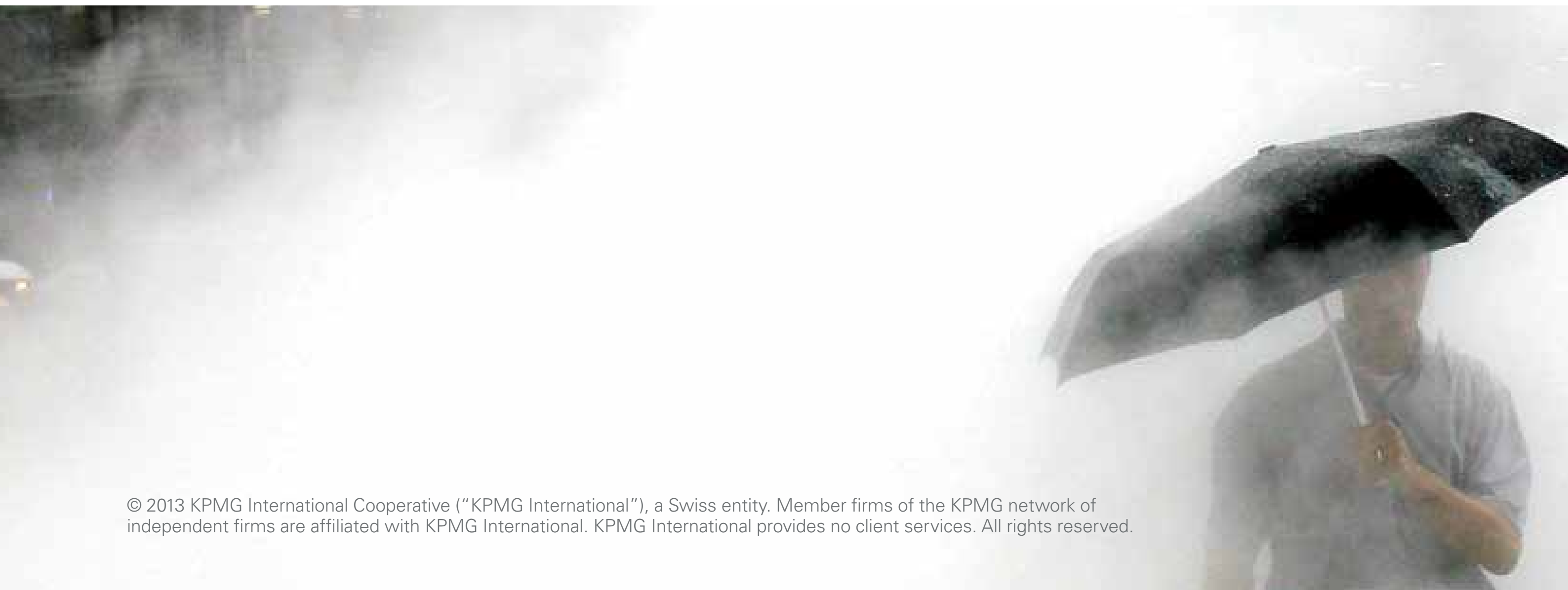
First, restricting the advantages to banks of using internal models to calculate their capital requirements. This could take the form of limits on the extent to which risk weights based on internal models could diverge from risk weights under the standardised approach; or of reducing the complexity of banks' internal models (perhaps with greater complexity allowed only in the assessment of Pillar 2 capital requirements).

Second, requiring banks to meet a higher minimum leverage ratio. A minimum leverage ratio of substantially above 3 percent would act more as a 'front stop' for Pillar 1 minimum capital requirements than the 'back stop' role it plays in Basel 3.

Third, greater disclosure by banks. To the extent that banks are allowed to use complex models, this would require banks to explain and justify why their risk weightings based on internal models differed from the standardised approach risk weightings. And to the extent that greater reliance was placed on a simple leverage ratio, banks would be able to explain how this differed from a more risk-sensitive approach.

What implications might this have for banks' capital requirements?

We understand the pressures for change here, but an over-zealous pursuit of simplicity and over-reliance on standardised risk weightings – or on a non-risk sensitive leverage ratio – could



have unintended consequences. It could encourage banks to hold riskier assets and could increase significantly the cost of funding a portfolio of low risk-weighted assets, including mortgage lending and high quality liquid assets. Moreover, the conditions that banks are required to meet before they can use internal models were always intended to encourage banks to improve their risk management capabilities: this link could usefully be reinforced, rather than weakened.

Meanwhile, as we have commented elsewhere[(1)], the relentless introduction of more and more regulation may already have taken many economies, especially in Europe, beyond the 'tipping point' to a position where the costs of regulation exceed the benefits. The permanent downward drag on economic growth from greater regulation may now exceed the benefit of avoiding future periods of financial instability.

Regulators also need to pay more attention to developing more coherent and proportionate linkages between the Basel 3 minimum capital and liquidity requirements and the additional demands on capital and liquidity arising from the multiple regulatory reform initiatives running in parallel to Basel 3. These include stress testing, capital surcharges for systemically important banks, Pillar 2 add-ons, macro-prudential policy tools, and the loss absorbency provided in a resolution by the bailing-in of liabilities.

Indeed, there is a strong sense here of regulators building up layers and layers of uncoordinated conservatism to address multiple perceived causes of the financial crisis, rather than starting from scratch and building a more coherent approach.

We support greater disclosure by banks, who should have a strong self-interest in demonstrating why their internal models generate an accurate picture of their underlying risks.

What would it mean for capital?

Taking the major UK banks in aggregate as an example, at end 2012, their collective common equity risk-weighted capital ratio was 8.5 percent on a fully implemented Basel 3 basis and their leverage ratio based on common equity capital was 3.6 percent.[(2)]

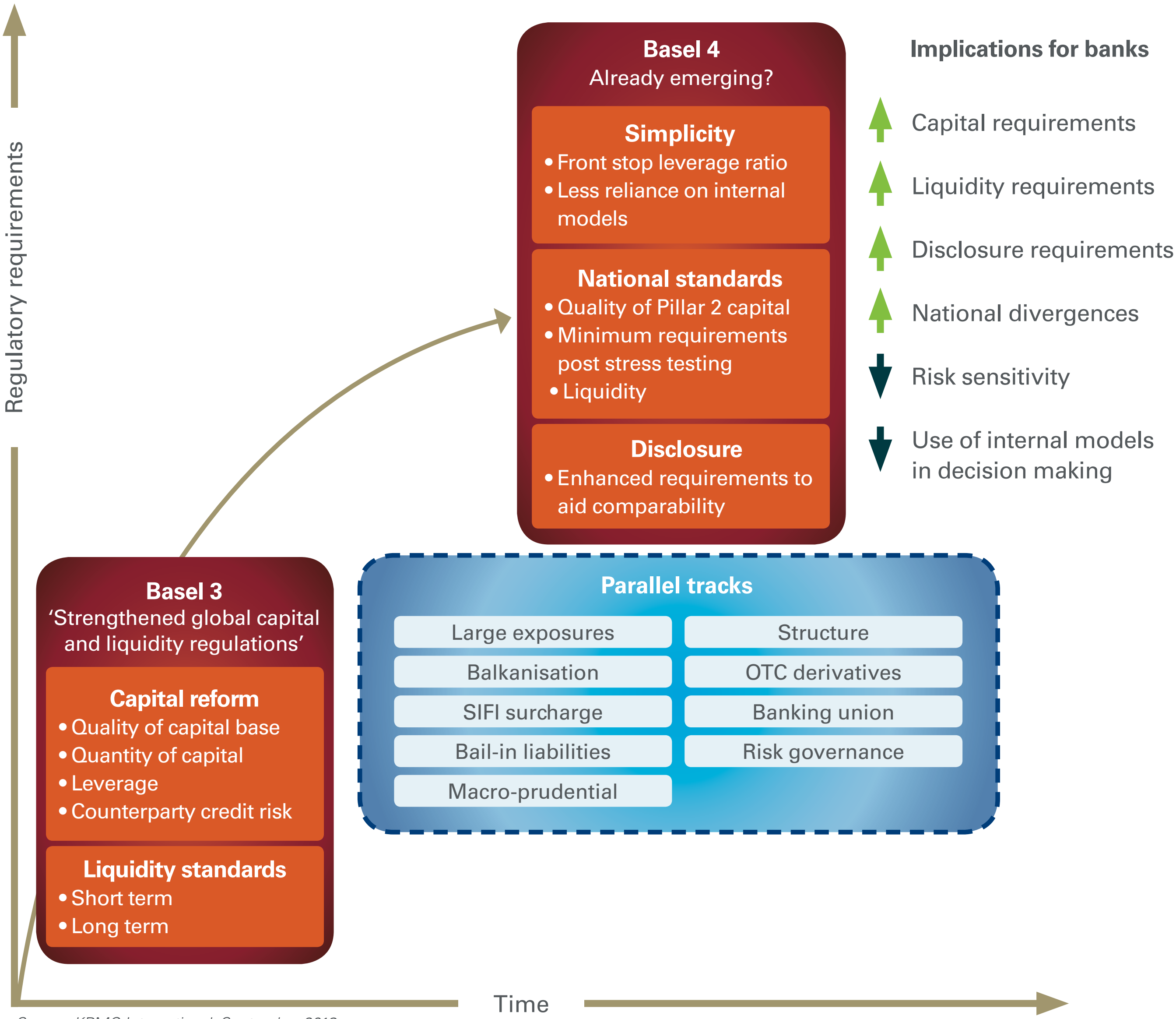
These banks are expected to be required to meet a 10 percent minimum common equity capital ratio (including a 3 percent systemic risk buffer) under the EU implementation of Basel 3, which will require these banks to increase their common equity capital by nearly £40 billion collectively, from £220 billion to £260 billion.

To meet the core elements of a prospective Basel 4 these banks would have to **increase their common equity capital by a further £50 billion or reduce their balance sheets by around 20 percent** – taking the core elements to be (i) a minimum common equity leverage ratio of 5 percent, and (ii) a 20 percent increase in risk weighted assets arising from restrictions on banks' internal models. A tougher approach to either element would increase further the additional capital required.

In addition to these quantitative impacts, banks need to ensure that they fully understand their capital and liquidity needs. This needs to be based on clear statements of strategy and risk appetite that drive both their internal assessment of capital and liquidity and how they manage their businesses.

(1) *Moving on: the scope for better regulation*, KPMG International, May 2013.
(2) Source: *Prudential Regulation Authority completes capital shortfall exercise with major UK banks and building societies*, Prudential Regulation Authority, June 2013.

The path to **Basel 4**



Source: KPMG International, September 2013

Beyond **Basel 3** to **Basel 4**

Differences are already emerging across countries in the design, interpretation and timing of the implementation of Basel 3. This is generating important inconsistencies across countries, and some unravelling of Basel 3 is already under way.

However, we focus here on the significant steps being taken by some countries – and by the Basel Committee – to move beyond Basel 3.

We view these steps as a move towards a Basel 4 characterised by:

- A higher minimum leverage ratio playing a more prominent role in Pillar 1 minimum capital requirements;
- Tighter limits on the advantages to banks of using internal models to calculate their capital requirements;
- A tougher approach to stress testing, Pillar 2 capital add-ons and liquidity requirements; and
- More disclosure by banks.

Leverage ratio

Some countries are moving ahead of the 3 percent minimum leverage ratio currently in the Basel 3 standards, in terms of the level of the minimum ratio, the definition of capital and timing.

In the US, the Federal Reserve Board is proposing a minimum leverage ratio of 5 percent for systemically important banks and 6 percent for retail banks owned by a systemically important bank, to be applied from 2018[3] (it is not yet clear whether these requirements would also apply to large foreign banks operating in the US); in Switzerland, the largest banks will be required to meet a minimum leverage ratio against total capital of around 4.3 percent by 2019[4]; and in the UK the Prudential Regulation Authority (PRA) is currently assessing the capital adequacy of large banks against a 3 percent leverage ratio based on Core Tier 1 (CET1) capital (rather than the Basel 3 use of the wider total tier 1 definition) and calculated after the imposition of a severe stress scenario[5].

By contrast, the Basel Committee has taken a less radical approach. In a recent consultative document on the leverage ratio[6] it stated that the 'parallel run' period (from 2013 to 2017) will 'test' the 3 percent minimum leverage ratio, and will be used to track the impact of using different capital measures (both total regulatory capital and CET1 capital). The consultative document also provided more detail on how exposures will be measured, and on the disclosures that banks will be required to make from 2015.

More generally, a number of regulators[7] and other commentators have argued for placing more emphasis on a higher minimum leverage ratio, on the basis that:

- In a world characterised not only by risk, but also by uncertainty (where it is not possible to attribute precise probabilities to outcomes), it may be better for policymakers to follow a simple rule rather than trying to match the complexities of the world. Indeed, trying to fight complexity by ever more complex rules can be disastrous if the complex rules are based on estimated relationships that break down;
- Simple rules (using leverage ratios and market capitalisations) would have predicted better which banks ran into difficulty during the financial crisis. Simple leverage ratios are better predictors of bank failure than risk-weighted alternatives; and
- The 3 percent minimum leverage ratio established in the Basel 3 standards may be too low. Some regulators, academics and other commentators have argued for a much higher minimum leverage ratio, often in the region of 6-8 percent.[8] And two US senators, Sherrod Brown and David Vitter, have proposed a 15 percent leverage ratio for the largest US banks.[9]

A higher minimum leverage ratio would immediately increase its importance within the set of regulatory capital ratios, because it would become the binding constraint for a larger number of banks. It would therefore increasingly become a 'front stop' rather than a 'back stop' requirement.

(3) *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions*, Federal Reserve Board, July 2013.
(4) *Financial Stability Report 2013*, Swiss National Bank, June 2013.
(5) *Prudential Regulation Authority completes capital shortfall exercise with major UK banks and building societies*, Prudential Regulation Authority, June 2013.
(6) *Revised Basel III leverage ratio framework and disclosure requirements*, Basel Committee on Banking Supervision, June 2013.
(7) *The dog and the Frisbee*, Andrew Haldane, Bank of England, August 2012; *Back to basics: a better alternative to Basel capital rules*, speech by Thomas Hoenig, Federal Deposit Insurance Corporation, September 2012.
(8) *The bankers' new clothes: what's wrong with banking and what to do about it*, Anat Admati and Martin Hellwig, Princeton University Press, 2013.
(9) *Terminating Bailouts for Taxpayer Fairness Act*, US Senate, April 2013.

However, an over-reliance on the leverage ratio could have perverse consequences. It could encourage banks to hold riskier assets; increase significantly the cost of funding a portfolio of low risk-weighted assets, including mortgage lending and sovereign debt; and remove an incentive (regulatory permission for a bank to use internal models to calculate risk weights) that can be used to drive improved risk management by banks.

Simplicity

The Basel Committee has recently published a discussion paper on balancing risk sensitivity, simplicity and comparability.(10) The paper explains how and why we have reached the current high level of complexity and non-comparability, primarily through the pursuit of risk-sensitive capital requirements; the advantages of greater simplicity and comparability; and the potential disadvantages of overly simplistic capital requirements.

The paper sets out some ideas to improve simplicity and comparability, including:

- Recognising simplicity as an additional objective against which new Basel Committee proposals should be judged;
- Mitigating the consequences of complexity – adding floors to constrain the results of modelled capital requirements; introducing a more refined 'use test'; and limiting national discretions in the area of internal models;
- Strengthening the leverage ratio by replicating elements of the risk-based capital requirements – adding 'buffers' to the leverage ratio and imposing tougher leverage requirements on systemically important banks;
- Enhancing disclosure – by encouraging banks to implement the Enhanced Disclosure Task Force (EDTF) recommendations; requiring banks to disclose the results of applying their models to hypothetical portfolios or disclosing both modelled and standardised calculations; and requiring banks to publish (on a consistent basis) additional metrics that might be useful to investors – capital ratios using market values of equity, risk measures based on equity volatility, revenue-based leverage ratios, historical profit volatility, and the ratio of non-performing assets to total assets; and
- More fundamental longer-term reforms – using a tangible equity leverage ratio (as the UK and some other countries are already doing); abandoning the use of internal models; imposing capital requirements against income volatility; or reducing risk and complexity by limiting the use of complex and innovative financial instruments and restricting non-traditional banking business.

Reflecting these themes, the paper also discusses a re-balancing of the three pillars to place more emphasis on Pillar 2 and Pillar 3, not least as a way of simplifying Pillar 1 minimum requirements by shifting some of the complexity – including risk-sensitive weightings and internal modelling approaches – into Pillar 2; and as a way of enabling shareholders, bondholders and market analysts to exercise a more informed view based on the disclosure by banks of a wider range of information.

Internal modelling

The Basel Committee and other regulatory authorities have been focusing increasingly on the risk weightings generated by banks using their own internal models. The complexity and opacity of the risk weightings generated by internal models leaves banks vulnerable to moves by regulators to restrict the extent to which internal modelling can drive down risk weightings.

The first move in this direction was the Basel Committee's proposals for a fundamental review of the trading book.(11) This responded to a number of failures in the trading book regime highlighted by the financial crisis, including inadequate capital held against market risk and excessive latitude in determining which assets could be placed in the trading book. The proposals included:

- Changing the basis of definition for trading book assets to limit the assets that a bank could include in its trading book;
- Changing the underlying model methodology from 'value at risk' to 'expected shortfall' – a fundamental change that would add modelling complexity, and increase capital requirements for many assets;
- A more detailed assessment of illiquidity risk – with additional capital add-ons for instruments at greater risk of illiquidity under stress; and
- Narrowing the differences between internal models and the standardised approach.

More recently, the Basel Committee and the European Banking Authority (EBA) have released the preliminary findings of their analyses of differences in risk weightings across banks.(12)

(10) *The regulatory framework: balancing risk sensitivity, simplicity and comparability*, Basel Committee on Banking Supervision, July 2013.
(11) *Fundamental review of the trading book*, Basel Committee on Banking Supervision, May 2012.
(12) *Regulatory consistency assessment programme – analysis of risk weighted assets for market risk*, Basel Committee on Banking Supervision, January 2013; *Regulatory consistency assessment programme – analysis of risk weighted assets for credit risk in the banking book*, Basel Committee on Banking Supervision, July 2013; *Interim results update of the EBA review of the consistency of risk weighted assets*, European banking Authority, August 2013.

The Basel Committee reports on the risk weightings of banks' banking book and trading book assets showed wide divergences in risk weights. It is difficult to determine how much of this variation reflects different levels of actual risk, although for banking book assets the Basel Committee found that underlying differences in the risk composition of banks' assets explains up to three-quarters of the variation in risk weightings across banks.

The remaining variation is driven by two main factors – diversity in models across banks and diversity in supervisory guidelines and practices. One way to isolate these factors is to test how banks would calculate risk weights for a common hypothetical portfolio. The Basel Committee found that for banking book credit risk, these factors generated differences across banks of up to 20 percent either side of the average, with the main differences being in probability of default estimates (especially for corporate exposures) and in loss given default estimates (especially for retail exposures). Although the report plays down regional differences, it is nevertheless striking that the three banks applying the most aggressive (lowest) risk weightings under the hypothetical portfolio are all from Europe.

For market risk positions, the highest and lowest risk weighted exposures reported by banks differed by a multiple of almost three.

In addition to the data findings in the Basel Committee reports, regulators are known to be concerned by:

- The extent to which banks are engaged in 'risk weighted assets optimisation' as a means of reducing their capital requirements, even if a large part of this reflects no more than cleaning up data and the planned rolling out of risk modelling to a broader set of exposures;
- The extent to which a prolonged period of low interest rates is enabling borrowers to avoid default, and thereby generating misleadingly low probability of default estimates;
- Low risk weights on exposures to other financial institutions that take no account of the systemic risks inherent in such interconnectedness; and

- The difficulty of establishing transparency – and therefore the limited scope for relying on market discipline – in this area.

The Basel Committee highlighted three potential policy options in response to its data findings:

- Enhanced Pillar 3 public disclosures by banks and regulatory data collection to improve understanding of how banks calculate risk weighted exposures using internal models. This would be consistent with the recommendations in the Enhanced Disclosure Task Force report;
- Additional policy guidance to constrain differences in bank and supervisory practices; and
- Limiting the flexibility of the advanced approaches, for example by setting 'benchmarks' (which supervisors could use as a reference point for assessing firms' internal model estimates) for risk parameters, or setting more explicit constraints such as floors (or even fixed values) for certain parameters.

These options seem likely to characterise a 'Basel 3.5' amendment in due course. They would limit the extent to which a bank could benefit from using its own internal calculations of risk weightings. And they would increase the pressure on banks to explain and to justify – to regulators and other stakeholders – the gap between standardised risk weightings and the weightings generated by internal models.

Stress Testing

Many authorities – including the US, the EBA, Ireland and the UK – are using the results of regular stress test exercises to require banks to be in a position to meet minimum capital ratios even after severe stress events. This requires banks to hold significant capital buffers to enable them to meet the minimum requirements not just on a backward-looking basis (using standard calculations of capital ratios), but also after applying stress scenarios.

These authorities are also beginning to use the Basel 3 minimum capital ratios as the basis for such exercises, thus turning Basel 3 into a minimum post-shock requirement, with the additional required capital acting as the primary shock absorber. This creates 'buffers on buffers' and negates the intention in Basel 3 that the capital conservation buffer and any counter-cyclical capital buffer would be the cushion to absorb a shock.

National authorities can also use stress testing to introduce considerable national discretion into how much capital their banks are required to hold, irrespective of attempts to introduce greater international consistency in the setting of minimum capital standards of internal models.

In addition, the EBA has recently issued a recommendation(13) that national regulators should ensure that major European banks should maintain a capital floor expressed as a monetary amount (not as a ratio to assets) that continues to meet the requirements set in the December 2011 EBA Recommendation (following the EBA's earlier stress tests).

However, it is not clear how this will prevent further deleveraging by European banks. National regulators will be allowed to waive this requirement, where banks hold sufficient capital to meet minimum CET1 capital requirements, under fully implemented EU Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) rules.

Pillar 2 capital add-ons

In principle, the tougher Basel 3 requirements on the quality and quantity of minimum Pillar 1 capital requirements should mean that banks are subject to smaller Pillar 2 capital add-ons – since there are fewer risks that are not adequately captured by the Pillar 1 minimum requirements. However, it remains far from clear to what extent regulators will follow this route.

There are some indications that the capital conservation and counter-cyclical capital buffers will be regarded by some regulators as a partial substitute for Pillar 2 capital. But at the same time Australia(14) and the UK(15) are moving to requiring Pillar 2 capital to be held primarily or solely through CET1 capital, rather than through a combination of tier 1 and tier 2 capital.

Liquidity

Although the Basel Committee signed off on a revised approach to the Liquidity Coverage Ratio (LCR) in January 2013, in the EU the EBA is still working on the definition of high quality liquid assets and on the appropriate run-off assumptions for different types of deposit. Meanwhile, the UK is clearly unwilling to replace its current tough regime with the LCR, and the Financial Policy Committee has asked the PRA to consider whether additional liquidity requirements are needed on systemic grounds to supplement the LCR.

In the US, Federal Reserve Governor Tarullo has proposed that banks that are substantially dependent on wholesale funding should hold additional capital(16), which might become the basis for a revision to (or even the replacement of) the Basel Committee proposals for a Net Stable Funding Ratio.

Possible implications for banks

These moves towards Basel 4 have three major implications.

First, banks are likely to face significantly higher capital requirements, arising from a combination of a higher minimum leverage ratio, restrictions on the extent to which exposure calculations can be based on internal models, and a generally tougher regulatory approach to imposing stress test and Pillar 2 buffers above minimum capital requirements. This will require banks either to hold more capital or to reduce their on- and off-balance sheet activities. This in turn will raise the cost and reduce the availability of bank finance for individuals, corporates and other bank customers.

Second, banks will likely need to improve their capital management, not least in terms of understanding fully the capital required to support their various businesses and linking this clearly to their strategy, risk appetite and business models.

Third, a less risk-sensitive approach to both capital ratios and internal modelling is likely to force banks to re-evaluate the balance between lower and higher risk businesses. Once liquidity needs have been met, there will be a strong incentive for banks to reduce their holding of less risky assets, including sovereign debt, other highly rated securities, prime mortgage lending, high quality corporate lending and fully secured exposures. This may lead to a significant shift in some banks business models, and in the price and availability of these types of bank intermediation.

(13) *Recommendation on the preservation of core tier 1 capital*, European Banking Authority, July 2013
(14) *Implementing Basel III capital reforms in Australia*, Australian Prudential Regulation Authority, September 2011.
(15) *Strengthening capital standards: implementing CRDIV*, Prudential Regulation Authority, August 2013.
(16) *Federal Reserve Board approves final rule to help ensure banks maintain strong capital positions*, Opening statement by Governor Tarullo, July 2013.

Parallel tracks

In addition to the Basel 3 standards, banks face many other regulatory reform initiatives relating to capital and liquidity.

Basel 3 is but one element of the multiplicity of regulatory reforms under way – the 'more and more of everything' approach to regulation[17]. The parallel tracks discussed here can be seen primarily as supplementing Basel 3, although in some cases they may also provide a means for regulators to bypass and marginalise Basel 3. Either way, they add significantly to the regulatory burden.

Banks need to consider the combined impact of all these initiatives, in addition to the impact of Basel 3 and of moves towards Basel 4, on their strategies and business models. [18]

Policymakers also need to take proper account of the collective impact of all these initiatives on both banks and the wider economy. Adding layers and layers of conservatism may reduce the risk of future financial crises, but this comes at a high cost in terms of a permanent reduction on annual growth rates.

Banking Union

Although many of the details remain to be finalised, banking union within a sub-set of EU countries is likely to have a major impact on the supervision and regulation of banks in Europe. One key rationale for moving bank supervision to the ECB was that it would take a more consistent and challenging approach to supervision, as is already emerging through its intended asset quality review of the major banks for which it is to become the primary supervisor.

The ECB will also be a key player in developing and operating the resolution regime within the banking union; a key member of the EBA in developing binding technical standards and encouraging cooperation and coordination; and will be given powers – alongside the relevant national authorities – to use macro-prudential tools across the banking union area. This range of ECB roles and responsibilities may lead in due course to an identifiable 'Frankfurt 1' approach to bank supervision and regulation.

Capital surcharges for SIFIs

Prospective capital surcharges of between 0.5 and 2.5 percent have been announced for 28 global systemically important banks (G-SIBs), and attention is now turning to the designation of – and imposition of tougher capital, supervision and resolution requirements on – banks of national systemic importance (D-SIBs) [19].

Macro-prudential oversight

Macro-prudential regimes are still evolving. They are taking shape around the Basel 3 counter-cyclical capital buffer, other macro-prudential tools, and stress and scenario testing to assess resilience against systemic risks.

In Europe, the CRR/CRD package provides for:

- The counter-cyclical capital buffer;
- An additional systemic risk buffer (SRB) that member states can apply to all, or a subset, of firms to cover medium-term structural or systemic risks. The UK is expected to apply a SRB of 3 percent, bringing the minimum CET1 capital ratio up to 10 percent. It is not yet clear how far the SRB will substitute for capital surcharges on global and domestic systemically important banks – the EU legislation allows for both the SRB and the capital surcharge to be applied to a bank where the SRB relates only to exposures located in the member state that sets the buffer, not to exposures outside the member state; and
- The introduction by member states or the Commission of more stringent large exposure limits, sector-specific risk weightings, liquidity and disclosure requirements on all, or a subset of, firms.

Large exposures

The Basel Committee has consulted on the measurement and limits on banks' large exposures.[20] The main proposed changes are to:

- Tighten the reporting (by moving to a 5 percent of CET1 threshold) and 'hard' limits on large exposures (leaving the upper limit at 25 percent of capital, but again narrowing the definition of capital to CET1 capital);
- Define more precisely how exposures should be measured, so the requirements can be applied more consistently across countries; and
- Impose tougher limits on the large exposures of systemically important banks.

Balkanisation

Localisation is not a new phenomenon, but its extent is increasing, even as the G20 is promoting greater international cooperation and coordination. Examples range from the US rules to require foreign banking organisations with a significant US presence to create an intermediate holding company and to hold stronger capital and liquidity positions locally in the US; to the moves by many Asian supervisors to require or encourage foreign banks to operate in their countries through subsidiaries rather than branches, at least for retail business.

Host country authorities are increasingly requiring foreign banks to operate within the host country as subsidiaries

(17) *Moving on: the scope for better regulation*, KPMG International, May 2013.
(18) *Evolving Banking Regulation,* KPMG International, Feb 2013.
(19) *A framework for dealing with domestic systemically important banks*, Basel Committee on Banking Supervision, October 2012.
(20) *Supervisory framework for measuring and controlling large exposures*, Basel Committee on Banking Supervision, March 2013.

rather than branches, and to meet local standards – on capital, liquidity, stress-testing, bail-in liabilities, intra-group exposures and intra-group shared services. This reflects three main drivers:

- Financial stability concerns – host country authorities are focusing more on preventing the failure of the local operations of foreign banks where they are of systemic importance for the local system, and on maintaining critical local economic functions in the event of failure;
- Home country resolution planning and structural separation – home country recovery and resolution planning, and moves to introduce greater structural separation, may reduce the confidence of host country authorities that the local operations of foreign banks will receive support from their home country authorities; and
- Home country deposit protection arrangements to protect overseas depositors – home country deposit guarantee arrangements may be inadequate to protect depositors in overseas branches.

Resolution

The main focus on resolution in recent months has been on the bail-in tool, including the latest version of EU Bank Recovery and Resolution Directive (BRRD), FSB guidance on resolution[21], including the multiple and single point of entry approaches, and proposals for the single resolution mechanism in the banking union in Europe.

The BRRD and similar proposals in the US and Switzerland require banks to meet minimum overall levels of loss absorbency through a combination of capital and long-term bail-in debt instruments. Under the BRRD national authorities will have the discretion to set minimum requirements for loss absorbency for each bank based on its size, risk, resolvability, systemic impact and business model. A more harmonised approach could be introduced by the Commission in 2016, based on recommendations from the EBA.

Structural separation

Some countries – including the US, UK, France and Germany – are already introducing various requirements for structural separation between differing types of retail and investment banking activities. The EU Commission has issued a 'road map' on the possible implementation of the Liikanen report recommendations, most likely through the ring-fencing of a set (still to be specified) of investment banking activities rather than through the UK-style ring-fencing of the retail bank.

OTC derivatives

Most of the rules are now in place in the major markets for the standardisation, exchange trading, central clearing and reporting of derivative transactions. Attention is now focused on efforts to achieve greater convergence of approach across the US and the EU.

Meanwhile, the Basel Committee, the International Organisation of Securities Commissions and the Committee on Payment and Settlement Systems are developing capital adequacy standards for exposures to central clearing counterparties (CCPs)[22], counterparty credit risk[23] (where the Basel Committee is consulting on consolidating the two existing non-modelled approaches, namely the current exposure method and standardised method), and the capital and other support required by CCPs, including for their recovery and orderly resolution.

Disclosure

The G20 and the FSB welcomed and endorsed the October 2012 recommendations of the EDTF (a private sector group comprising banks, investors and audit firms) to enhance the risk disclosures of banks[24]. These recommendations included enhanced disclosure by banks of how risk weighted assets are calculated; the impact of the use of internal models on a bank's regulatory capital requirements; how banks' internal ratings grades map across to external credit ratings; and how internal models are back-tested and validated.

Risk governance

International standard-setters are placing increased emphasis on the importance of good risk governance, including:

- Sound risk governance practices, covering the Board, Chief Risk Officer and risk management function[25];
- Risk appetite framework, covering the risk appetite statement, risk limits, and clear roles and responsibilities for risk management[26]; and
- The aggregation and reporting of risk data, covering the generation of risk data, its reporting to the Board and senior management, and governance arrangements.[27]

(21) *Guidance papers on recovery and resolution planning*, Financial Stability Board, July 2013.
(22) *Capital treatment of bank exposures to central counterparties*, Basel Committee on Banking Supervision, June 2013.
(23) *The non-internal model method for capitalising counterparty credit risk exposures*, Basel Committee on Banking Supervision, June 2013.
(24) *Enhancing the Risk Disclosures of Banks: Report of the Enhanced Disclosure Task Force*, Financial Stability Board, October 2012.
(25) *Thematic review on risk governance*, Financial Stability Board, February 2013.
(26) *Principles for an effective risk appetite framework*, Financial Stability Board, July 2013.
(27) *Principles for effective risk data aggregation and reporting*, Basel Committee on Banking Supervision, January 2013.

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