



July 14, 2010

HIGHLIGHTS

- In the wake of the financial crisis, the global community agrees that improved financial reform is needed, but consensus has yet to be reached on the details that will shape it.
- Increased capital and lower leverage will reduce global systemic risks. However, the benefits of greater financial stability need to be balanced against its economic costs.
- The balance between benefits and costs will be dictated by the countless details shaping the new regulation.
- Ultimately, we need to be pragmatic about new regulation and understand that addressing yesterday's mistakes and vulnerabilities doesn't guarantee that another financial crisis will be avoided in the future.
- Financial regulatory reform will be an ongoing challenge for years to come.

Craig Alexander
SVP and Chief Economist
416-982-8064
mailto:craig.alexander@td.com

Beata Caranci
AVP and Deputy Chief Economist,
416-982-8067
mailto:beata.caranci@td.com

Martin Schwerdtfeger
Economist
416-982-2559
mailto:martin.schwerdtfeger@td.com

FINANCIAL REGULATION REFORM: A MYRIAD OF DOUBLE-EDGED SWORDS

In the wake of the financial crisis, the global community agrees that improved financial reform is needed, but consensus has yet to be reached on the details that will shape it. A challenge in achieving this end is that there are economic transition costs (or trade-offs) to moving to a tighter regulatory environment and countries participating in the reform drive are arriving at this juncture with very different domestic macroeconomic backgrounds. The potential near-term dampening effect on economic growth from tighter financial regulation could compound the challenges towards fiscal consolidation. The November G-20 Summit in Seoul will represent a critical juncture to this end. At that meeting, G-20 members will review proposals by the Basel Committee on Banking Supervision (BCBS), who were tasked with finding a set of international rules that will improve both the quantity and quality of bank capital and discourage excessive leverage and risk taking. The pressure is on for the international community to reach an agreement, as the G-20 has publicly stated that Basel III should be finalized before 2011 and implemented by the end of 2012. However, as you are about to read, it will be no small feat to find common ground, and we can't help but wonder whether G-20 members have bit off more than they will be able to chew at the upcoming meeting. So far, the path of least resistance has been for countries to pursue tailor-made national policies in a number of areas of financial reform, as evidenced by a bank levy in the U.K., and the Dodd-Frank bill that passed the House of Representatives in the United States. If this trend continues, there is a risk that financial institutions will seek regulatory arbitrage opportunities between countries. And this can run contrary to reducing global systemic risks.

Basel III Banking Regulation Proposals

Discussions on financial reform have been taking place for some time. During the recent financial crisis, regulators and central banks were rudely awakened to inappropriate settings of capital and leverage among financial institutions. As a result, discussions on regulatory reform have largely centered on these two aspects.

Basel III has been one of the primary vehicles for financial regulatory change; however, while it has put forward a number of recommendations, an enormous task remains in hashing out the details. To provide some background, we will introduce a brief description of the salient aspects of the current BCBS proposals, which were released in the form of two consultative documents¹ in December 2009. Among the key areas under discussion, we outline six where final details and/or a middle ground still need to be found among participating nations. These areas certainly serve to illustrate the degree of complexity involved in changes to regulatory requirements.

1. Tier 1 and Tier 2 Capital

There is no question that banks need to hold adequate capital against the risk

they take while conducting their operations. But, determining precisely what that capital requirement should be across an entire global system is a balancing act. If capital requirements are too stringent, there is a downside risk that credit availability and economic growth could be stifled.

Here is a snapshot of some of the issues that Basel III is grappling with in this area. Under the Basel proposal, Tier 1 capital is formed by common equity and retained earnings (core Tier 1 capital), as well as “additional going concern capital”. The BCBS suggested raising Tier 1 capital from the current 4% of risk-weighted assets, and possibly also sharply increasing the share of core capital within Tier 1. However, the actual capital ratio and the limits for each sub-component have not been specified yet. It is also expected that the range of debt instruments eligible to integrate “additional going concern capital” will be significantly reduced. And finally, limitations such as minimum maturities and amortization periods would be imposed on subordinated debt issued as Tier 2 capital. If implemented, these changes will reduce bank funding options, thus raising their capital costs. However, this would be dramatically influenced by the details governing calibration of the ratios and specific restrictions on the types of instruments eligible within each capital tier.

2. Contingent Capital

Contingent capital is debt that converts into capital when certain triggers are hit, thereby increasing the capital level and enhancing the solvency of that institution in a moment of financial distress. This means that after conversion, the debt instrument is demoted in the payment priority ranking under a bankruptcy procedure. As such, contingent capital arises as a potential tool to reduce the need for government intervention and the associated cost to taxpayers. The G-20 declaration after the Toronto Summit states that G-20 leaders “support the BCBS’ work to consider the role of contingent capital in strengthening market discipline and helping to bring about a financial system where the private sector fully bears the losses on their investments.” It is still not clear from the BCBS proposals whether contingent capital would be mandated or simply allowed. Other important questions also remain on the drawing board, such as whether conversion would be into Tier 1 or Tier 2 capital, what would be the triggers for conversion, how precisely a conversion would operate and what would be the conversion price.

For example, one of the conversion methods being proposed establishes that each contingent security could convert into any number of common shares determined by dividing the par value of the contingent security by the average mid-

day market value of common shares during the last several – yet to be defined – trading days². However, this method would likely be particularly contentious among pre-existing common shareholders. If a bank is under market stress, both its debt and equities would be trading at severely discounted values. Therefore, converting debt at par value (presumably well above market value) will dilute existing shareholders’ equity by a disproportionate factor. This would create a huge incentive for common shareholders to liquidate their positions whenever there is suspicion the bank is about to trip a trigger, generating a self-fulfilling prophecy. By the same token, the ability of a bank to recapitalize itself will be drastically diminished; in anticipation of the trigger event investors would fear the common equity they are about to purchase will soon be diluted. The latter could even have a systemic impact, if the trigger event in one institution generates expectations of imminent triggers in other financial firms. Therefore, despite its theoretical appeal and the support of policymakers, implementation of contingent capital poses some risks which warrants serious consideration.

3. Countercyclical Capital Buffers

The BCBS proposal contemplates a “fixed” buffer to be set by national regulators over Tier 1 capital which could be drawn down during periods of stress. This buffer would work in conjunction with limitations on dividend and employee bonuses payments, as well as share repurchases, to preserve capital. However, there is a question as to whether the buffers should be fixed or vary with the cycle to provide a counter-cyclical dimension to a business cycle.

4. Leverage Ratio

This BCBS proposal aimed at reducing banking leverage is much stricter than the status quo during the financial crisis, but it is uncertain whether it will, after calibration, strike the right balance or become unnecessarily too restrictive. BCBS suggests to value bank liabilities on a gross exposure basis, which means it would no longer be permitted to net liabilities from assets that have similar characteristics. This would result in inflated ratios, which would require significant balance sheet adjustments. As a point of reference, for systemically important institutions – i.e. those that fall under the “too big to fail” label – the US House bill establishes a 15:1 ratio (Canadian banks operate in the neighbourhood of 18:1 and the Canadian regulatory standard is 20:1, though both countries apply different definitions in this measurement). The level at which this ratio is set is critical, because it could become even more restrictive than

the risk-adjusted capital ratio. In other words, the leverage ratio could become the de-facto capital constraint for lower risk banks, when in principle, it should be a supplementary measure to the Basel II risk-based framework.

Here's where the delicate balancing act comes in to make sure the leverage ratio is set low enough to prevent excessive risk-taking and guard against potential bank failures during periods of financial stress. However, an overbearing ratio would negatively impacting credit availability and the cost of credit, and act as a headwind to economic growth.

5. Liquidity Considerations

In this area, two criteria have been proposed by BCBS: a Liquidity Coverage Ratio (LCR) which focuses on short-term liquidity needs, and a Net Stable Funding Ratio (NSFR) which focuses on potential longer term funding mismatches. Here too, there is a great deal of uncertainty regarding the calibration of these standards. However, the initial perception is that these ratios would prompt banks to hold less risky, low-yield instruments, as well as to seek longer term funding, which is more expensive.

6. Forward-looking provisions

Under this measure, banks should make provisions for loan losses on the basis of "expected" rather than "incurred" losses. The design of these provisions, as well as the above-mentioned capital, liquidity, and leverage ratios, are influenced by accounting standards, which ultimately determine how to evaluate assets and liabilities. This is another area in which it may be difficult to find agreement between the International Accounting Standards Board and the U.S.-based Financial Accounting Standards Board – the two main global accounting standard setters.

There are a number of other possible regulatory changes that are currently under discussion, either formally within Basel III or by particular countries, including capital surcharges for systemically important firms, limits on the scope of bank activities (e.g. the "Volker rule" banning institutions covered by deposit insurance corporations to conduct proprietary trading or participating in hedge funds), and recovery and resolution plans. Indeed, some countries (like the U.S.) are already pursuing independent national strategies in these areas.

Derivatives

Beyond banking regulation, however, the 2008-09 financial crisis also highlighted the need for more transparent, safer and sounder derivative markets. According

to data from the Bank for International Settlements (BIS), this market ballooned to \$614 trillion globally in 2009 (up nearly 700% from a decade ago), and was deemed to have promoted inappropriate risk taking behaviour under relatively little transparency and supervision. As such, G-20 leaders in Toronto reaffirmed their "commitment to trade all standardized over-the-counter (OTC) derivatives contracts on exchanges or electronic trading platforms, where appropriate, and clear through central counterparties (CCPs) by end-2012 at the latest." A CCP is an entity which steps in between the buyer and the seller of a derivative contract, and assumes the responsibility of honouring the contract in case one of the counterparties defaults. This allows the CCP to net contracts with standard characteristics among several counterparties, thus reducing counterparty risk.

On the other hand, the establishment of a CCP can actually increase systemic risk, given the fact that the CCP itself can default. In order to mitigate this risk, the CCP should be subject to strong operational controls, well defined governance practices, appropriate collateral requirements, and safe capital ratios. Furthermore, there are a myriad of critical issues to be addressed when designing the regulatory framework in which a CCP should operate. First and foremost, establishing the regulatory jurisdiction for CCP to clear contracts with global counterparties could be particularly cumbersome. Other important aspects include how many CCPs should there be for each asset class, ownership structure, risk mitigation and management procedure, asset valuation model and standard, collateral posting procedure, membership standard, etc. In all, even though CCPs have the potential to make derivative markets safer, the establishment and proper functioning of such institutions requires significant infrastructure and regulatory frameworks, and a great deal of international coordination. All of them are far from trivial exercises.

Where to from here?

Coming out of the most severe recession in 70 years triggered by a financial crisis, there is broad consensus in support of stricter financial regulation. However, actual implementation of a one-size-fits-all regulation at a global scale poses significant challenges. The same changes in regulation would affect each country's financial system differently, given their varying structural characteristics, such as the relative size of banks with respect to the economy, and how reliant non-financial firms are on debt versus equity financing. For instance, business groups among key non-financial corporations in both France and Germany recently warned their governments of the negative repercussions for credit



availability that would stem from some of the changes in regulation that are currently under consideration, given the higher reliance on banks rather than equity financing across Europe.

What are the macroeconomic consequences of stricter financial regulation?

The ultimate goal for more stringent financial regulation is to achieve greater macroeconomic and financial stability by reducing the occurrence and severity of recessions induced by a financial crisis. However, there will likely be a near-term trade-off for enhanced long-term stability. The transition cost from going to a tighter regulatory environment would have knock-on effects to credit costs and availability, likely resulting in lower economic growth than otherwise would have been the case. The transmission mechanism works along the following lines: to achieve a higher capital ratio, a bank can reduce its loan portfolio, which would increase the ratio for a given amount of capital. Or, it could issue more capital, which – for a given amount of funding supply – would elevate its cost. That higher cost of capital would translate into higher interest rates offered to customers or less availability of credit. Less aggregate credit means less consumption and investment, thus lower production and employment. In turn, higher liquidity requirements compress bank profits in two ways: higher liquidity implies a lower return, and more stable long-term funding is more expensive than short-term funding. Lower profits require more capital issuance (because retained earnings are lower), which is more challenging precisely because earning prospects are weaker. Ultimately, higher funding costs for banks hinder their capacity to extend credit to households and businesses, which dampens the rate of economic growth. Less credit availability and higher costs will also impact negatively on secondary debt markets, which depend on bank credit to function properly. This is an indirect channel through which tighter banking regulation will curb future economic expansions.

However, if the capital and leverage ratios are set at the optimal level, the growth that would be lost would be that portion of the expansion that was driven by inappropriate access to credit or a lower-than-appropriate cost of capital. Hence, this would be a desired outcome, because it would enhance long-term global economic and financial stability. The obvious challenge is in determining the optimal ratios and regulation, which would likely be a trial-and-error

process that could take years to achieve. Consequently, it would be extremely difficult for countries to come to a consensus as to what the new rules should be and how they should be applied. The economic costs would be higher for countries which have weaker banking systems, given that they have more ground to cover in order to meet new regulations. Ultimately, this would create incentives for both banks and governments to try to tailor the changes in regulation to their own jurisdictions in order to reduce the economic costs of the adjustment.

Indeed, the unilateral or regional actions that we have seen in recent months reinforce this view. The U.S. has moved ahead with a financial reform bill that has already been passed in the House of Representatives and will soon come to vote in the Senate³; the United Kingdom announced in mid-June, as part of its government budget, a tax on banks, which has been favoured by other European leaders – France and Germany, in particular. During the turmoil of the Greek sovereign debt situation, both French and German authorities spoke strongly in favour of mandating hedge funds that trade eurozone sovereign debt derivatives to register with and be subject to eurozone regulations. This did not resonate very well with some high ranking U.K. government officials, because such a decision would be detrimental to the stronger presence of the hedge fund industry in that country.

The challenge in finding consensus

The incentive for countries to defect from a coordinated international strategy is made stronger by the fact that financial regulation is taking place in the midst of a global recovery that is already fraught with risks, especially as many governments put in place severe fiscal austerity measures that restrain economic activity. The adoption of new banking rules could restrain banks from channelling the expansionary monetary stance to firms and households that would be needed to offset some of the economic drag created from fiscal austerity. The Institute of International Finance (IIF) has recently released a report estimating the economic impact of the Basel proposals – if adopted as they presently stand – for the U.S., the eurozone, and the Japanese economies. According to this study, the proposed tighter regulation would cause the rate of economic growth for these three economies as a whole to be 0.6 percentage points lower on an annual average basis during 2011-15, for a cumulative cost of 3% of GDP. Likewise, job losses would amount to approximately 1 million a year, on aver-



age⁴. Naturally, this economic impact would be compounded if the drag from fiscal austerity was also taken into account. However, the overall economic impact is extremely difficult to measure. For instance, the IIF estimate could be an understatement given that they could not model off-balance sheet activities. On the flip side, the IIF estimate does not take into account the benefits that would accrue to the global economy from greater financial stability.

The BCBS is analyzing the results of the quantitative impact studies (QIS) carried-out by each country to assess the impact of the proposed changes in regulation. It is likely that the macroeconomic cost estimated by BCBS based on the QIS results will show a significantly smaller output loss than that estimated by the IIF. At the end of the day, estimating the economic costs from tighter regulation is a bit of a moving target because many have argued that the full basket of Basel proposals are simply too restrictive and will likely be watered down. So, while changes in the financial status quo are necessary to promote long term stability, the timing and path to achieve this end remains uncertain.

Concluding Remarks

All these financial regulation issues will be under consideration in the months ahead in the lead-up to November's G-20 meeting in Seoul, which is the deadline for the BCBS to present the final capital and liquidity requirements to be phased in for definitive implementation by end-2012. There is little doubt that greater global scrutiny in the area of bank regulation is necessary to avoid a repeat of the latest painful financial crisis. However, in our view, it is unlikely that there will be agreement on some of the key issues, because it would

be natural for countries to pursue alternative schemes tailored to their unique circumstances. Moreover, with a key player such as the U.S. well into the process of passing its own financial reform legislation, other countries might also opt to deal with the important details that will shape new regulation within their national regulatory agencies, rather than set them at the global level. The flexibility to adjust the proposals at their own discretion would come at the price of risking a lack of global coordination, which creates incentives for financial institutions to seek regulatory arbitrage opportunities. And this usually runs contrary to reducing global systemic risks.

As we have just illustrated, there are so many moving parts to this financial regulation puzzle that striking the perfect balance on a global scale will likely require a lengthy trial-and-error approach. Increased capital and lower leverage will reduce global systemic risks, recognizing that there will be economic costs associated in doing so. However, the economic costs need to be balanced against the benefit of greater financial stability. Ultimately, we need to be pragmatic about new regulation and understand that addressing yesterday's mistakes and vulnerabilities doesn't guarantee that another financial crisis will be avoided in the future. As Bank of Canada Governor, Mark Carney, noted in a June 10th 2010 speech, "in reducing some aspects of systemic risk, policy-makers will undoubtedly increase others." In this context, the balance between benefits and costs will be dictated by the countless details shaping new regulation. One thing we can be certain of is that financial regulatory reform and oversight will be an ongoing challenge for years to come.

Endnotes

- 1 See "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring", BIS December 2009
- 2 See "Too-big-to-fail and Embedded Contingent Capital, OSFI"
- 3 For details on U.S. Financial Regulatory Reform, see the TD Economics publication at http://www.td.com/economics/special/jm0710_df.pdf
- 4 See "Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework, IIF June 2010"

This report is provided by TD Economics for customers of TD Bank Financial Group. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Financial Group and the members of TD Economics are not spokespersons for TD Bank Financial Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Financial Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.