Original Article

An overview on the inconsistencies of approach in regulating the capital position of banks: Will the United Kingdom step out of line with Europe?

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ABSTRACT After the collapse of a number of banking institutions and bailouts of banks by governments, regulators have taken a different attitude and now appear keen to take regulation seriously when it comes to ensuring that banks have adequate capital and sufficient liquidity. Not only that, but in the United Kingdom, the Independent Commission on Banking Reform has made proposals with regard to the capital position of banks. This article, which is an overview, will look at matters from a UK perspective and at the proposals for reform. This article, after its introduction and summary, will look at a number of areas: first, the reforms made by Basel III; second, the regulation of Systemically Important Financial Institutions (Sifis) and the proposals for dealing with these; third, some matters in relation to lending that relate to capital and liquidity generally; fourth, increased stress testing of banks; fifth, derivatives and risk taking and the new proposed structure of regulation in the United Kingdom; sixth, the war of spin between regulators and banks; seventh, Shadow Banking; and eighth, The Independent Commission on Banking Reform and its proposals for reform. It will also be a theme that the various proposals lack consistency and that this could lead to regulatory arbitrage. It is already clear that there are inconsistencies between the various regulatory organisations, with proposals in the United Kingdom indicating that banks will be required to keep much higher levels of capital than those proposed by Basel and the European Community. The views of those who have pointed out inconsistencies between the United Kingdom and Basel/Europe have been highlighted.
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INTRODUCTION

The recent financial crisis is not the first, nor indeed will it be the last.[1] The insolvency of some of the larger banks in both the United States and the United Kingdom was because of the collapse of the housing market and the entering into leveraged products in relation to this particular market. Despite the fact that banks and banking activity has been and is highly regulated, there were these collapses. Indeed, the stress testing that will be discussed subsequently has predicted that, if particular countries in the European Union such as the Republic of Ireland, Greece or Portugal default in relation to their sovereign debt, then there will also be a banking collapse in that country.[2]

Regulators have taken up the issue of the solvency and liquidity of banks throughout the world. However, despite this attention and increased regulation, the problem of banking collapses remains and it is suggested that it will continue to remain. Business and banking involves risk and there will be some banks that calculate the risk wrongly and in consequence suffer capital and/or liquidity problems. This is dealt with in the first section on Basel III and its development and background.

The issue of 'too big to fail' is one that has grabbed much attention. In the United Kingdom, the Independent Commission on Banking has not proposed the breaking up of banks or a Glass–Stegall rigid separation of the retail and investment parts of a bank. If they fail, such large banks might be more likely to cause other banks to fail and are an increased risk for the financial system. Hence, any regulatory rules relating to capital cannot just look at the capital of that bank and not the size of the bank in question. As larger banks pose greater risks to the financial system, the argument runs that they should have increased capital requirements imposed against them so as to ensure that they will not fail. The suggested figure of an increased tier one capital of 10 per cent measured against risk-weighted assets[3] for such institutions may of course not be sufficient. These institutions, in the United Kingdom, are not to be broken up – and therefore, although the banks in this category are relatively small in number, they could pose problems for the financial system in the future. This is dealt with in the next section, which deals with increased capital requirements for systemically important financial institutions.

The subsequent section looks at some micro-regulatory tools designed to promote responsible lending. The Bank Levy and mortgage lending will be looked at briefly. The role of the FPC is looked at briefly in this section, though it will be examined much more fully in the later section, the fifth section, on leveraged products. Stress testing is now all the rage, with more frequent tests.[4] These are designed to show whether a particular bank can withstand possible events of a negative nature such as economic downturn, increased unemployment, a fall in property prices or sovereign default. Banks may wish to use watered-down tests and there were tests used that did not take into account sovereign default.[5] This problem is now taken much more seriously, and recent tests have taken sovereign default into account. However, it has been alleged that some banks did not supply full or complete information using 'loopholes to hold data back'.[6] This indicates that some banks are not compliant with the rules set by the regulator. Stress testing is discussed in the fourth section.

The fifth section deals with highly leveraged products and their effect on the capital and liquidity of banks. Banks have become involved directly in derivative and highly leveraged transactions. These transactions necessarily involve high degrees of risk. The failure to impose additional capital requirements might be a significant weakness in regulation, particularly if such transactions pose a general systemic risk. There is support in the United Kingdom for leveraged controls, both by the House of Commons and by the Independent Commission on Banking.[7] The regulatory system in the United Kingdom, under the Bank of England, will, in the near future, regulate at a micro and a macro-level and there have been suggestions that the Bank of England will want to impose leveraged controls. In these days of spin and control by the media, there is much discussion about possible proposals for reform of the regulation of capital and liquidity of banks in the financial press. Some banks consider that increased capital requirements in the United Kingdom would make them less competitive and be damaging to economic growth. Not all banks agree with this and the regulators generally disagree with such conclusions on the basis that the banks' clients would wish for safer banks and that the economic disadvantages of having increased capital will be relatively small. The issue of spin is considered in the sixth section.

The fact that some activities can move into the shadow banking sector that are not regulated is a clear indication that some institutions have or could move where they cannot be seen or caught by the regulator. Some banks will of course carry on transactions in the same way that non-banks in this sector do. This creates a number of possible problems: first, those banks that carry on such activities will be subjected to greater risk or risks because of the inherent nature of the type of transactions carried out in this sector; second, banks will be competing with non-regulated institutions, which is undesirable in itself and puts such banks at greater risk; and third, if there are collapses of institutions in the shadow banking sector, this could spread and cause problems for the traditional banking sector. These are reasons why regulators are now taking greater interest in this sector. This is considered in the seventh section.

Governments are increasingly taking an active role in setting rules for the regulation of the capital of banks. This is shown through the rules now taking effect in Basel III. In the United Kingdom, the government have set up the Independent Commission on Banking. The Independent Commission on Banking has proposed that retail banks keep higher levels of capital. These proposed levels of increased capital are 3 per cent higher than under Basel III. These proposals and the discussion about them by members of the commission before the House of Commons Treasury Committee are described in the eighth section. In short, this article seeks to focus on those regulatory issues that relate to the capital of banks and to highlight inconsistencies in approach.[8] Both the interim report of the Independent Commission on Banking and its final report will be analysed.

BASEL III

There is, in general terms, an increased desire of regulators to look more seriously at the capital and liquidity of banks and issues relating to this.

Basel III and its tighter controls

Basel III provides for banks to increase the core tier one capital base from its current level of 2–7 per cent by 2019.[9] The increase in capital is regarded as a 'key element'.[10] The new rules have been called a 'stricter regime'.[11] The idea is to restrict banks' exposure to credit risk.[12] This capital base will then become the international standard as a form of soft law[13] and will be a 'benchmark'[14] and become incorporated into hard law, in the case of the United Kingdom through European Union directives.[15]

> … clearly the new Basel III standard will be embraced in a European Directive and will become binding on the UK as a minimum. Now, I have no concerns about that as a minimum standard, indeed my only concerns about the way the debate is going is that it is not tough enough,…[16]

The Basel Committee originally contained the regulatory institutions from the following countries that were its members and that provided individuals within those organisations, from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom and the United States.[17] These have been extended to Australia, Brazil, China, India, Korea, Mexico and Russia.[18] Over 100 countries have implemented Basel[19] and 'Basel III was also a major step forward in international co-operation'.[20] This gives a worldwide membership and tries to ensure a global base so that (i) countries will adopt the Basel rules and (ii) banks will adopt the Basel rules. In particular, there will be acceptance of Basel.[21] Basel III has been stated to be 'a fundamental strengthening of global capital standards'.[22] The result will be that regulators in any country can and will adopt this standard and formulate regulations consistent with it. In considering the strength of, or lack of, an economy, both the IMF and the World Bank look to see whether that country has adopted Basel standards.[23] Indeed, in the United Kingdom, the Independent Commission on Banking Reform is proposing rules for banks that are beyond Basel III.[24] The IMF has publicly supported the UK view to have capital standards above those of Basel III.[25]

Risk-weighted assets

The tier one capital, outlined above, is measured against risk-weighted assets. There is now a new focus on risk-weighted assets. These are now regarded as important for the reason that their calculation is a matter that does link to capital adequacy ratios and affects their accuracy.[26] Furthermore, different jurisdictions calculate risk-weighted assets differently with different jurisdictions having different approaches. Europe uses the more subjective approach contained in Basel II to the more prescriptive approach adopted in the United States, which adopts the approach in Basel I.[26] Lord Turner has stated:

> It would be sensible now to look in more detail at the denominator and examine whether risk- weighted calculations are comparable and consistent across banks and across countries.[26]

It has been argued that the risk weighting part of Basel actually discriminates against non-OECD countries.[27] In the United Kingdom, the Independent Banking Commission is considering whether to supplement risk weighting with 'an aggregate leverage ratio'.[28] Much was said by Sir John Vickers and his team in the House of Commons about the high level of leveraging by UK banks and the need for a leverage ratio. The introduction of such a leverage ratio, in the United Kingdom, would set standards beyond those of Basel III. 'Basel III, relative to Basel II, has revamped the risk weights to attempt to address some of the manifest flaws with the previous risk-weighting regime. There is also as a back-stop in Basel III an aggregate leverage ratio, and one of the points that we have under consideration is whether a capital constraint in relation to risk-weighted assets should be supplemented by an aggregate leverage ratio…'.[29] There are a number of regulators that are keen on this idea of imposing additional controls on the leverage of banks.[30]

Capital buffers: Capital buffer and countercyclical buffer

There are two capital buffers as part of Basel III. There is a capital conservation buffer of 2.5 per cent. Banks that fail to meet this buffer of 2.5 per cent will have restrictions on dividend and bonus payments.[31] This, in addition to the countercyclical buffer, is discussed below.[32] This capital countercyclical buffer can be raised by up to 2.5 per cent[32] in poor economic times and lowered in good economic times. The point is that it links the regulation of banks and economic policy.[33] It has been argued that additional buffers that are only imposed in some countries could produce distortion.[34] However, the government regard it as leading to a level playing field:[35]

> Basel III promotes a level playing field between domestic and foreign banks through the principle of reciprocity, under which the size of the countercyclical buffer is linked to geographical location of all exposures. Under Basel, reciprocity is obligatory for a buffer of up to 2.5 per cent. However, national authorities have the option of requiring their banks with exposures in a foreign jurisdiction to apply a buffer of beyond 2.5 per cent.[36]

Having a countercyclical buffer is regarded as 'very significant'.[37] There are reasons for having the countercyclical buffer: (i) to ensure that banks have additional capital to cope with the low end of the cycle and (ii) to actually help even out the high end of the cycle that might otherwise lead to substantial house price increases.[38] The financial crisis, the collapse of banks and bailouts of government have indicated the need for banks to create such buffers so as to deal with bad economic times.[39] It is also regarded as important to have this countercyclical buffer at times of credit growth.[40] However, if this buffer is not released when economic times improve, then 'it isn't really countercyclical but simply an incremental layer of capital'.[41] If a number of countries use the buffer when things are worsening, then it could lead to better coordination.[42] Such cooperation is important with regard to cyclical instruments such as the countercyclical buffer.[43] Any possible lack of cooperation and coordination with regard to such a buffer needs to be addressed.[43] The use of the Basel III countercyclical buffer:

> … represents an important step towards achieving a better coordination between home and host authorities in the deployment of macroprudential tools, and might serve as a model for international coordination of macroprudential policies more generally.[42]

Liquidity

There is increased desire by regulators to look at liquidity issues. This means that banks must keep greater liquidity and can demonstrate that they are able to withstand a lack of liquidity that may last up to 30 days.[44] Both Basel and the FSA have issued a number of policy papers on the importance and need to maintain liquidity.[45] The Committee on Banking Supervision responsible for Basel III have proposed a Liquidity Coverage Ratio so that banks are able to possess sufficient quality assets to withstand a situation of lack of funding over a period of time.[46] This is a matter that can be tested by regulators.[47] Currently, both Basel and Mervyn King favour the use of a liquidity buffer of up to 30 days to protect against possible market disruption or crisis.[48] The FSA has stress tested this 30-day situation for UK banks but also a less severe 90-day situation.[49] It has been reported that banks were not content in 2010 when they had to increase their liquidity and argued to the FSA that this should not be done until 2015 when there would be a uniform set of liquidity rules for all banks set by Basel in 2015.[51] Although the UK regulators appear to adopt a strict approach when it comes to liquidity, this approach is criticised by the chairperson of the Treasury Select Committee, and on its website it states: 'Liquidity squeeze could hit credit and hold back recovery – Tyrie warns Bank of England and FSA'.[50] In a letter dated 20 October 2011 to both Mervyn King and Hector Sants, he concludes in relation to this area: 'The squeeze on bank liquidity is running the risk of continued credit contraction, setting back the prospects of economic recovery … A number of ideas have been put forward as a means of relieving the liquidity squeeze. Whether any of these should be deployed is something the FPC may want to consider'.[51] Of course views differ, but this again shows an inconsistent approach at a high level. Recently, Paul Tucker has indicated that tough regulatory controls on liquidity could undermine the Quantitative Easing Programme.[52]

The criticism of Basel III rules

However, there are critics of Basel III. One commentator sees it as too rigid.[53] Criticisms have been made that Basel III is a 'one size fits all' solution.[54] Some critics regard Basel III as being weak and watered-down as a result of bank lobbying.[55] Mervyn King is of the view that the new Basel III rules 'will not prevent another crisis for a number of reasons'.[56] First, higher amounts of capital would be required, and such capital levels would be considered to be far too high in the opinion of the banking industry. Second, the risk weights are not necessarily accurate as they are based on previous experience that could become poor estimates for the future. Third, Basel III focuses too much on the assets side of a balance sheet rather than on liabilities, and hence may not effectively deal with the risks that follow from a lack of liquid assets.[57] Another commentator regards Basel III as creating a period of uncertainty as it is unclear as to the effect the rules will have.[58] Necessarily, Basel III is untested in a crisis situation.[59] In the opinion of Mervyn King,[60] the Basel ratios in relation to capital proved themselves to be 'a poor predictor of bank failures',[60] and that in the light of that, the Bank of England will place great weight upon leverage ratios.[60]

Some previous problems with Basel

There were also significant problems previously with Basel in that banks used securitised property as part of its tier one capital. Such assets were inadequate when property prices collapsed in the sub-prime mortgage market. Banks that wish to improve their financial position are selling their assets and this is taking place at the present time in order for the banks to be able to meet the requirements of the Basel III rules. Such assets include securities that contain mortgages and sub-prime loan assets that caused the problems with the collapse of the banking system.[61] This has also been done by raising of additional capital.[62] One bank has set up a fund to help other banks increase their capital.[63] Banks are now also entering into CoCo bonds that become equity instead of debt if and when the bank's capital is too low and if these are misused or overused as with securitised property, then this could cause widespread financial instability.[64] These CoCo bonds could be manipulated by the market and uncertainties about when they are triggered could lead to unpredictable results in times of systemic economic failure.[65] It would appear that both the FSA and the Independent Commission on Banking[66] approve of the idea of banks issuing bonds that would convert to equity in the event of that bank hitting financial problems.[67] Sir John Vickers has indicated that it is better for these to be issued in good economic times rather than in bad economic times, when it would be difficult to raise such funding.[69] However, the increasing complexity of the Basel framework will encourage the development of avoidance on the part of the banks.[68] The national regulator will then have to close the loopholes, which may take some time to do.[72] Ultimately, the UK regulatory system will have to be 'open minded'[69] about these contingent capital bonds. These bonds, which convert from debt to equity, should be capable of being triggered at an early stage.[73] A better solution, in the view of Paul Tucker, would be to have higher levels of equity in banks generally.[73]

> First best would be equity. Indeed, Adair has argued this evening that ideally Basel 3 would have set a higher equity requirement. But that did not happen.[70]

SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

What constitutes a 'systemically important financial institutions' ('Sifis') is a difficult question as the general economic context must be considered.[71] The FSA has suggested the following possible additional controls that could be imposed against Sifis: first, there should be additional capital requirements imposed; second, restrictions on their activities and limits on their riskier activities; and third, controls on the size of such institutions.[72] Lord Turner considers the idea of regulating Sifis to be a 'wise' one.[73] Lord Turner has indicated publicly that any losses that Sifis incur shall be spread and recovered from all institutions that lend. This would seek to ensure that the taxpayer is not subject to any exposure.[74] The importance of the quality of the capital that is possessed by Sifis has also been identified as a matter of importance.[75]

The IMF has suggested that there should be an increase in the fees paid by Sifis. The idea of these fees is that they would be put into a fund, which might be used to assist distressed banks. The exact amount of additional capital that such institutions might hold is between 1 and 9 per cent and might extend to up to 30 Sifis.[76] The subsequent development of Basel III to require systemically important banks to hold additional capital is clearly sensible. It is also a matter that is difficult, if not impossible, to ascertain because it depends on the particular facts that cannot be known in advance. Different institutions from those regarded as the important ones might be the ones that should have been regarded as systemically important.[77] It has been suggested by the Chairperson of HSBC, Douglas Flint, that the number of Sifis should be extended to beyond 80 such institutions, which would be an increase on the figure of 30 proposed by the IMF.[78] Furthermore, in his view, such institutions would be required to hold additional amounts of capital.[82] Such increase in capital could be left as a matter to be dealt with by the various national authorities.[79] It is understood that the European Union is considering proposing changes to the Capital Requirements Directive 'CRD' so that such institutions are brought within the CRD.[80] The Basel Committee have indicated that they wish to consider the introduction of additional loss absorbency for Sifis.[81] In the view of Douglas Flint, the number of such Sifis should be on the high side rather than the lower side, as the holding of increased capital has an anti-competitive effect and thus institutions should be placed within the list rather than outside it. To do otherwise would give those placed outside it a competitive advantage. However, as smaller banks have disproportionately higher costs in raising capital, the imposition of additional capital for Sifis evens out the position for smaller banks.[82] Sir John Vickers is aware of the issue of competitive disadvantage to Sifis in the United Kingdom; however, in his view, if a 10 per cent capital base was an international standard, then there would be no problem.[83]

> Our hope would be that for systemically important institutions, something of that level [at least 10 per cent] would be the international standard, in which case the question falls away. If you had a huge difference between the UK standard and the international standard, then the arbitrage possibilities that you allude to could start to come into play.[83]

These additional capital requirements proposed by Basel III are noted by the Independent Commission for Banking.[84] However, consistent with their approach for other matters relating to capital,[85] such additional amounts are seen by the Independent Commission on Banking 'as a minimum level above which national jurisdictions may wish, and are free to go'.[89]

Currently, there is a clear difference between the proposals in England and those of Basel and Europe. The difficulties that Sir John Vickers indicates would then materialise. Sir John Vickers had previously stated in a keynote speech:[86] 'one takes the view that the loss-absorbing capacity of banks needs to be massively enhanced – and beyond the prospective requirements of Basel III in the case of systemically-important institutions – there are dilemmas about how best to achieve that'.[91] The approach that Sifis should have higher capital standards has also been followed by the Financial Stability Board 'FSB'. The FSB has published a report[87] in which it states that global Sifis should have higher loss absorbency 'beyond the minimum agreed Basel III standards'.[88] Large banks included within the top tier are required to have capital of 2.5 per cent beyond the capital that they are already required to keep.[89] It is understood that the banks within this 2.5 per cent tier include Barclays, HSBC, Citigroup, JP Morgan, Deutsche Bank, Bank of America and the Royal Bank of Scotland.[94] A second group of banks will be required to have capital of 2.0 per cent beyond the capital that they are already required to keep. It is understood that the banks within this 2.0 per cent tier include Credit Suisse, UBS, Goldman Sachs and Morgan Stanley.[94] A third group of banks will be required to have additional capital of 0.5-2.0 per cent. It is estimated that there will be between 10 and 15 banks included within this third grouping.[94] A further estimate puts the number of banks as high as 20 banks.[90] Overall, around 30 banks will be required to have this additional capital.[94] This proposal has been criticised on three grounds: first, that it does not solve the too big to fail problem; second, because these larger banks will necessarily be bailed out, this creates a situation where customers will retain deposits with such banks and ignore any risks knowing that the particular government will ultimately protect their deposits; and third, these additional amounts of capital that must be kept by the larger banks further increases the amounts of capital that must be kept and will lead to additional costs for borrowers.[91] These new proposals for Sifis have been criticised as 'overkill'.[92] This proposed change has already led banks in the United States to campaign for these new rules not to be implemented.[93] In contrast, some regulators in the United States have indicated that rules requiring additional amounts of capital for the larger banks in the United States should be introduced.[94] Most recently, the Final Report of the Independent Commission on Banking[94] was of the view that there was a 'strong public interest'[95] that systemically important banks should hold more loss-absorbing debt and equity 'than they would choose themselves'.[95] In particular, the Independent Commission on Banking recommended that the large UK ring-fenced banks and the largest UK systemically important banks be required to hold primary loss-absorbing capacity of at least 17 per cent of risk-weighted assets.[96] This recommendation of the Independent Banking Commission is that this can be increased to up to 20 per cent of risk-weighted assets, should the regulator have concerns about the bank.[97] Where an individual bank, or the group of banks as a whole, falls below this figure, then the regulator could impose restrictions upon distributions or bonuses.[98] Again, the Independent Banking Commission is raising the standards ahead of Basel and those proposed to be used internationally.[99] At a European Union level, there will be changes in its Capital Directive so as to incorporate Basel III.[100] Such amendments will include new provisions relating to Sifis where such banks pose risks 'to the financial system taking into account the identification of systemic risk'.[101] Further, such institutions are to be stress tested so that systemic risk can be identified and measured.[102] It has been suggested[103] that, in addition to stress-testing individual banks, there should be a collective stress test for all Sifis as a complete group. Regardless of what regulators might attempt to do, and this includes enabling greater transparency and providing for resolution regimes, one view is that it is up to the market to discipline the banks and this includes the Sifis.

> The Basel accords provide an internationally standardised set of rudimentary best practices in bank regulation, but they can only perform well in synergy with the market.[104]

However, if there are differences in approach to Sifis, then those countries with low additional surcharges for Sifis will be 'at an advantage'.[105]

RESPONSIBLE LENDING

Lending responsibly

One of the problems with the collapse of the banking system is that the banks lent too much money to individuals who were not able to repay. The consequence of this is that the regulatory system needs to take steps to ensure that it does not lend too much and cause problems for itself. The problem is worse in the commercial property area where commercial property prices have fallen by an estimated 20 per cent.[106] The FSA proposed mortgage affordability tests from October 2009 to attempt to ensure that lenders would lend to individual borrowers in a way that was within their means to repay and one that was responsible.[107] The FSA wants lenders to properly assess the income of borrowers and to reduce the amount lent to those with a poor credit history.[108] There have been accusations by the FSA that banks have moved customers to more lenient terms to minimise bad debts.[109] A firm was fined a substantial amount by the FSA for lending irresponsibly and this demonstrates that actions are being taken by the regulatory authorities.[110] There are proposals for further reforms including income verification and limits upon interest – only loans.[111] The FSA has introduced stricter mortgage rules.[112] There are also new principles in lending that include: stress testing; the possibility of interest rate rises; and that the lender is to ignore the possibility of increased property prices.[112]

Bank levy

A number of European governments have proposed a levy upon their banks to meet the cost of any future crisis involving banks.[113] Further, the contribution paid by the bank should reflect the systemic risk posed by that bank.[114] The levy that has been introduced into the United Kingdom, from January 2011 on banks with £20 billion of liabilities, is modelled on the IMF Report[120] and aims to encourage banks not to use risky funding models that could threaten the financial stability of the United Kingdom.[115] It is thought that it will raise two and a half billion pounds from the banks.[116]

The Financial Policy Committee and mortgage lending

Having stricter rules so that banks do not over-lend is one way of tackling the problem of overheating of the financial system. In relation to domestic lending, a rule requiring a 20 per cent deposit has been proposed in the United States.[117] In the United Kingdom, the reforms to regulation include the setting up of the Financial Policy Committee 'FPC' within the Bank of England, which will have powers to stop any over-lending on the part of individual banks or the banking system generally. This would include financial limits on individual mortgages and powers in relation to the capital bases of banks.[118] The Independent Commission on Banking Reform is aware of the use of such tools and agrees that it would be correct for the proposed FPC to have controls in relation to mortgage lending. 'An example of such a tool could be a loan-to-value cap on mortgage lending – already in use in Hong Kong and Singapore, among others – which may be used to lean against a house price boom by shifting the balance of capital provision away from banks and towards individuals'.[119]

STRESS TESTING AND ITS FAILURES AND CONSEQUENCES

These necessarily complement other types of regulation regarding the capital of banks and are regarded as an additional 'valuable'[120] tool.

Stress testing in Europe

The stress testing that has taken place in Ireland has proved unreliable as stress tests that gave the banks there a clean bill of health then collapsed only a short time later.[121] In the opinion of Lord Turner, these tests were still 'useful exercises'[122] but it was important to distinguish liquidity from solvency problems. Further, in the view of Lord Turner, such tests were not 'sufficiently extreme'.[123] In the view of one commentator, the failure of some stress testing to take on board sovereign debt effectively rendered them invalid and was irresponsible on the part of the regulators.[124] In the view of that commentator, such tests should test at the extreme, and it was wrong not to include the risk of sovereign debt when stress testing Greek banks.[125] Subsequently, the regulators in Greece were concerned about the exposure of Greek banks to sovereign debt, and the stress testing carried out by the European Banking Authority (EBA) in June 2011 did include exposure to Greek Sovereign Debt.[126]

The United Kingdom

Hector Sants, Chief Executive of the FSA, has indicated that the Prudential Regulatory Authority will take stress testing seriously with teams that will have particular knowledge of the bank that is being stress tested.[127] The FSA, which will be the predecessor of the Prudential Regulatory Authority, has run stricter tests than those undertaken by the EBA.[128] This indicates an inconsistency in approach, which could cause uncertainties for the banks who will be unclear as to what amounts of capital they should hold. In the UK stress tests carried out by the FSA, the regulator required banks to have a tier one ratio of 8 per cent.[129] Lord Turner is quoted as saying that the tests carried out by the EBA are a 'useful exercise' even though the UK tests are 'tougher and tighter'.[134] In the view of Lord Turner, 'a stress test is designed to imagine things that don't occur', and should be tough.[130] This has not always been the approach of the EBA.[131] It appears to be the position that the FSA requires banks to have a liquidity buffer sufficient for 3 months of stress, which was greater than the 1 month provided for under Basel.[132] The FSA, which will become the Prudential Regulation Authority, are currently about to introduce business model assessments, which will look at the revenues of the banks it assesses and also any funding from the Bank of England's special liquidity scheme. As part of the assessment, there will be stress tests.[133] It has also been suggested that the results of stress testing should be translated into the planning about banks' liquidity and capital.[134]

EBA

Paradoxically, the EBA instead of increasing the strictness of its testing has actually reduced it. Previously, a 20 per cent fall in share price was built into the model, whereas in the later test in 2011 only built in a 15 per cent fall in share price.[135] There were criticisms that these results, in July 2011, were 'skewed'[136] and calculated in different ways in different countries.[142] The stress testing in July 2011 by the EBA did take on sovereign lending and how likely default will be in relation to such lending.[137] These tests in July 2011 resulted in failure by eight banks[138] with a shortfall of capital of over two billion pounds.[139] In contrast to the tests in 2010, the large Spanish and Italian banks fared well in these tests in 2011.[145] The EBA were concerned that some countries adopted their own standards rather than those proposed by the EBA.[140] However, sovereign debt default was included and those banks that had not taken it into account were asked to retest.[141] Those banks that failed the stress testing would have to enter into distressed debt deals.[140] Andrea Enria, chairperson of the EBA, is reported as saying that taking on board sovereign risk when stress testing is a matter that is 'highly relevant'.[142] Further, Andrea Enria, talking about the tests in 2010, was of the view that those banks that passed the stress testing narrowly should be subject to regulatory intervention, such as the capping of their dividends.[143] It has also been suggested that stress testing should be used to provide information to the market about the financial position of particular banks, such information not currently being available to the market.[144] It has been accepted and noted by the EBA that some countries have set higher standards than in the European Union.

> The EBA notes that national authorities in countries currently in IMF-EU programmes are strengthening the capital of banks in their countries and in many cases have, or will be, setting capital standards to a higher level than that in the EU wide tress test in order to address uncertainties.[145]

The United States

In the United States where 19 banks were stress tested in 2009, 10 failed to successfully pass the test and two American banks were asked to raise around 75 billion dollars within a few months.[146] In order to be allowed by the regulatory authorities to repurchase shares or declare dividends, the various American banks being stress tested would have to pass the test.[147] As a consequence of stress testing in the United States, the regulatory authorities asked the top 10 banks in America to raise 74.6 billion dollars.[148] Stress testing has been used in the United States to determine whether particular banks were able to repay the USA government funds that were lent to them during the crisis.[149] Stress testing in the United States has been used for different reasons than that in Europe. In Europe, the regulators have had genuine concerns about the banks in which they regulate and the stress testing was seeking to minimise the possible problems of liquidity and capital adequacy that banks might have. In contrast, in the United States, the stress testing appeared to be directed for the regulators' benefit.[150] It is interesting that the tier one capital figure that was used in the stress testing in November 2011 was 5 per cent, which is lower than those proposed by Basel, Europe and the United Kingdom.[151] Where US banks have been able to demonstrate that they have capital reserves of above 5 per cent of their risk-weighted assets, they are to be allowed by the Federal Reserve to use their annual earnings to pay substantial dividends to their shareholders.[152] This approach has been criticised [153] on the basis that such repayments of dividends should only be allowed when banks have put in place the increased capital requirements of Basel III. This represents not just a difference of timing but a substantial difference of approach.

Summary

What might be concluded is that stress testing is now part of what regulators do worldwide. This marks a significant change from the position before the banking collapse. In the United Kingdom, the approach is that the regulator must form its own view of the financial position of the bank it supervises. If the regulator feels that it has genuine concerns about the soundness or safety of the bank it supervises, then action must be taken by the regulator.[154] Nevertheless, inconsistencies in approach have been seen with different regulators in different countries taking different approaches to such stress testing. Further different regulators regard such testing with varying degrees of importance. One commentator, Kamal Mustafa, has made the point that the fact that there was a need for this stress testing has indicated that the levels of capital held by banks was far too low.[155] Furthermore, one of his conclusions is that there is inconsistency of approach by regulators in relation to stress testing:

> Global and regulatory authorities have yet to define a standard approach and methodology towards stress testing. Banks are being pressured to perform stress tests without any direction and specific criteria. Different regulatory bodies are requesting different stress tests with varying levels of detail and substantially different focuses.[156]

To deal with this criticism, the EBA is required to provide national authorities with 'common methodologies'[157] in relation to stress testing and 'common approaches to communication on the outcome of these assessments'.[164] As regulatory authorities develop and use stress testing, it could lead to a standardised approach and 'common language'.[158]

DERIVATIVE TRANSACTIONS AND RISK

Prudential supervision in the United Kingdom

At a general regulatory level, there is the disclosure that the Treasury and the Bank of England allegedly gave ['water[ed] down'] figures to the IMF about the state of UK public finances before the collapse.[159] This disclosure is contained in a report made by the IMF's independent watchdog.[166] This watchdog has also criticised the IMF itself for failing to identify and appreciate the banking collapse that occurred and to take measures in relation to it. There have been criticisms of the system of regulation in the United Kingdom during the banking crisis.[160] The reforms that are taking place with regard to the regulation of banks are not a central part of this article; however, it has been indicated by Mervyn King that the Prudential Regulatory Authority will look at the big picture and the financially important areas, which will include capital and liquidity issues.[161] The concept of a more wide ranging regulatory supervision covering the general supervision over capital and liquidity of banks is supported on the basis that it will link regulation and general monetary and economic policy.[162] Despite the proposed reforms that would have one institution involved in micro and macro prudential regulation, there could still be problems in that systemic risk might still not be fully considered. It remains to be seen whether this structure would stop a financial crisis of a different nature happening in the future. Much might depend upon how well each part communicates with each other; however, micro-prudential regulators might still have a narrow focused approach and still not draw relevant matters to the attention of those involved in macro-prudential regulation. In the view of one academic: '… looking at systemic risk is a sound idea, but because although supervisors were looking at individual trees-not necessarily always very well-they didn't have a view of the forest…'.[163] However, the Governor of the Bank of England takes the view that the combined regulatory system in the United Kingdom is likely to be much more effective: 'Prudential supervision is rather different. This is about saying that most banks are all taking the same kind of risk, that leverage ratios have reached a point when we ought to be deeply concerned about the fragility of the system, and that is something that I hope the new arrangement of a combination of the PRA focusing on the big questions for individual banks and the new FPC focusing on system-wide developments will be able to give us a better chance of dealing with these problems than happened last time'.[164] Both micro and macro views are necessary in order 'to reach forward-looking judgments'.[165]

However, it has been made clear by Mervyn King that the FPC will be independent of the Chancellor and will make its own independent decisions. The FPC will also be able to make its decisions in relation to capital adequacy and capital buffers, which will be binding upon the PRA.[166] 'When it comes to the decisions on the regulation of individual institutions or the decisions about the instruments that you will give to the FPC about, for example, counter-cyclical capital requirements, those are the responsibility of the FPC and shouldn't be second guessed by the Chancellor. They have to be decided by those bodies'.[167] The new regulator, the Bank of England, will therefore have combined functions. This combined with increased powers could lead to a new super-regulator.[168] Differences in approach could be ironed out, if there is a will to do this. However, as will be seen, the approach of regulation in the United Kingdom will require banks to have higher levels of capital than their European counterparts and not to iron out potential differences of approach. There could be inconsistencies at the start and these will continue in the future if and when the United Kingdom introduces higher capital ratios over UK banks.[169]

> The details of the new Basel accord in this area aren't pinned down yet. As they become pinned down then the FSA will need to think about how it wants to converge its regime into the Basel regime, but it's quite hard for them to do that when the Basel regime hasn't got all the i's dotted and t's crossed.[170]

Indeed, there is acceptance that different countries are likely to have different rules initially as convergence is now only an 'aim'[171] and there will be 'different starting points'[178] in relation to capital buffers. If the UK regulators do not converge with Basel rules, then they run the risk that they also do not converge with European rules, as the European Commission is to introduce the Basel rules into its new capital regulations. Indeed, it has been pointed out that the UK's approach will be entirely different, with higher standards, than the rest of Europe. This difference will be increased further when the ring-fencing proposals take place.[172] This divergence of approach and structure has been summarised by one lawyer:

> This is a cack-handed request by the UK to Europe to say: we understand you are trying to put together a single European framework, but would you mind if we set up an entirely separate one for our national banks?[173]

Central counterparty clearing

It has been confirmed that there are no plans for those banks entering into derivative transactions but not involved in central counterparty clearing 'CCP' to be subject to an additional capital levy or charge: 'Another international standard setter the Basel Committee is looking at what the appropriate capital charges should be for financial institutions which are not using a CCP. They may also conclude that there should be a capital charge for using a CCP as well, so there may be that international standard. It is possible that, as a result of consultation and the due process of impact assessment, the FSA would decide that there should be some additional capital charge, but I am not aware that there are any plans to do that at this stage'.[174] However, There has been the express approval of the suggestion of having leveraged controls in addition to controls over capital.[175] 'Given that capital and liquidity reform will not be sufficient, and that leverage appears to be an indicator of potentially increasing risk, we support the introduction of a leverage ratio. Such a ratio does not adjust for risk, and thus is not satisfactory on its own, but is a useful addition to (inevitably imperfect) risk-weighted measures'.[176] Stefan Ingves, current chair of the Basel Committee on Banking Supervision, regards a 33 per cent leverage ratio as the 'ultimate break'[177] if 'we don't do the models right'.[184] The Independent Commission on Banking strongly disagreed with this suggested 33 per cent leverage ratio on the basis that it was far too lenient. Such a view makes considerable sense for the reasons given by the Independent Commission, but it again shows differences in approaches at high level.

> … a leverage cap of thirty-three is too lax for systemically important banks, since it means that a loss of only 3 per cent of such banks' assets would wipe out their capital….[178]

The FPC is to increase transparency by requiring banks to publish their leverage ratio by 2013, whereas this will not be required by Basel III until 2015.[179] Further, the Capital Requirements Directive is to be updated to include the 'risk of excessive leverage'[180] and its leverage ratio will come into force from 1 January 2015.[181] It may well be correct to introduce such controls. However, the point is that again there is inconsistency in approach with the United Kingdom appearing to want regulations that are earlier and possibly higher than in other countries. Further, Mervyn King has sought and obtained additional powers for the PRA so that it will have the right to demand that a particular bank modifies its financial position so as to reduce its leverage ratio.[182] The FPC, in exercising its functions to assist the Bank of England in achieving its Financial Policy Objective[183] will be responsible for 'the identification of, monitoring of, and taking action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system'.[184] These systemic risks include, in particular 'unsustainable levels of leverage, debt or credit growth'.[184] The FPC 'must have regard to …the international obligations of the United Kingdom'[184] and particularly so where the FPC actions relate to powers to be exercised by the PRA or FCA.[184] Further, the FPC will be able to direct the FCA or the PRA to exercise its functions 'so as to ensure the implementation, by or in relation to a specified class of regulated persons, of a macro-prudential measure…'.[184] The Treasury by order will prescribe what is a 'macro-prudential measure'.[184]

In the context of setting higher capital standards, the argument of the FPC would be that the CRD Directive is merely a minimum standard, and setting higher standards will comply with the CRD Directive and the international obligations of the United Kingdom. Further, by putting macro-prudential instruments into secondary legislation, the government considers that greater flexibility will be achieved.

> Establishing the toolkit in secondary legislation will allow the Government to better reflect any international developments in macro-prudential policy…[185]

Such an approach, which would mean that great discretion is vested in the FPC, has been criticised by Simon Gleeson on the basis that the European approach is rule based, whereas the United Kingdom, in contrast, is about to introduce a discretionary-based system

> It really does not matter whether it would be a good idea for the UK to have a fully discretionary regulatory system – the EU is in the process of building a fully rules-based system with policy making reserved to the European Banking Authority….[182]

THE WAR OF SPIN

It is clear that the banks lobbied the Basel Committee for changes to Basel III and that the banks were able to discuss their specific concerns with the Basel Committee.[186] As a consequence, some of the Basel III rules were softened as banks indicated that otherwise their lending would be restricted,[187] in particular, the softening of the rules in Basel III through less rigid definitions of liquidity and a phasing in of the rules over a longer period of time.[188] In addition, the definition of capital was relaxed so as to include government and corporate bonds, which would count as part of the bank's relevant capital.[189] One of the concerns of the banks regarding Basel III is that requirements for banks to keep increased capital will make them less efficient. In particular, the Banks have stated that Basel III will result in increased costs for them resulting in increased charges for those using payment systems.[190] The suggestions made by banks that they would move to other jurisdictions as a consequence of capital adequacy reforms is a matter regarded as of 'questionable credibility',[191] 'very depressing'[192] and a 'fantasy'.[193] Others regard this as a real possibility that if banks were required to hold additional capital in the United Kingdom, then they would be placed at a competitive disadvantage compared with their European counterparts, and would move to European destinations.[194]

Douglas Flint, chairperson of HSBC, regards increased capital requirements as putting UK banks in a position that makes them less competitive and damaging to the whole of the City of London.[195] It has been suggested that Basel III will mean that banks will not lend for long periods and their customers will have to borrow on the bond market instead.[196] Douglas Flint, chairperson of the FSA, has given his view that Basel III rules will significantly affect the willingness of banks to lend.[197] The OECD have indicated that the capital requirements of 7 per cent tier one capital would increase the cost of lending by 50 base points and would lower growth by 0.05 to 0.15 percentage points.[198] The French Banking Federation is of the view that Basel III could reduce the GDP in the euro-zone by more than 6 per cent.[199] One estimate suggests that German Banks will need over £50 billion in order to recapitalise.[200] In relation to the report of the Vickers Commission, the banks lobbied extensively so as to seek to tone down the report.[201] Banks have also suggested that increasing the capital requirements will increase the cost of lending.[202] In addition, it could lead to fewer loans being made.[203] Moreover, as banks have extra costs as a result of Basel III, it will lead to increased interest rates so that banks recoup some of these costs.[204] Not only could it lead to increased costs of lending, it could also lead to less lending, as the need and requirement of increased capital buffers have 'unsettled bank lending'.[205] The Basel Committee have played down such concerns and any reduction in lending would be small and much less than suggested by the banks.[206] It has also been suggested that, if a particular country imposes additional capital requirements beyond those of other comparable countries, that this, instead of being anticompetitive, will improve the standing of such banks as their clients will regard them as safer entities.[207]

There have also been dialogues at government level between senior regulatory officials where one country feels that another country is not compliant or fully compliant with Basel III.[208] One of the possible reasons for having capital controls is to ensure a level playing field so that banks in one country do not have an unfair advantage over banks in other countries.[209] The banks in the 1980s believed that there was not a level-playing field. In particular, bankers in London and New York were of the view that lack of international controls over the capital of banks gave Japanese banks advantages, as they were subject to less rigorous financial controls.[210] However, this view is challenged by one member of the Basel secretariat who indicates that, although observers often took this view, this was not in fact the position. In his view, the objective of Basel was to simply strengthen the capital position of banks so as to provide safe and sound banking systems and to protect depositors.[211] The extent to which Basel has and will lead to a level playing field is a matter that 'is still uncertain'.[212] If the UK banks are required to hold more capital than their European counterparts, then there will be an unlevel field. If UK banks are to have higher capital ratios and hold more lower yielding assets than their rivals, their profitability will be further reduced.[213]

> A crucial question is whether the decline in GDP will be higher in some countries than others and whether some countries' banks will be more affected than others. This depends in part on whether the Basel rules will be implemented uniformly in each country. It is far from clear that they will be. Last month it was revealed that the E.U. may delay a decision on whether to adopt Basel III's leverage and liquidity rules, although Michael Barnier … has since denied that the E.U. will do so. The truth remains to be seen.[214]

SHADOW BANKING

Critics have indicated that the 'shadow banking' sector could pose problems in that its institutions are not regulated in the same way as banks are and do not have to keep the same capital as banks.[215] Further, the Basel rules apply to banks and not other institutions.[216] This gives the shadow banking sector advantages over the banking sector and results in an unlevel playing field.[217] It also encourages institutions to put their assets into the unregulated shadow banking sector.[218] Therefore, riskier transactions move into the shadow banking sector,[219] and furthermore, collapse of institutions within the shadow banking sector could lead to a risk of damage to the whole financial sector.[220] One commentator correctly identifies this as a 'major overall problem'.[216] 'Just as the old capital rules begat the current shadow sector, the latest round known as Basel III could throw up obscure new participants.'[220]

The Independent Commission on Banking Reform have taken a similar view about 'shadow banking' and consider that riskier activities could move outside the banking sector. 'The crisis demonstrated that financial instability can be caused by activities outside the regulated banking sector. While additional regulatory requirements are being imposed on banks, there is the prospect that riskier activities will shift to the shadow banking sector, which to date has received relatively little regulatory attention'.[221] Whereas in the past, the regulators in the United Kingdom focused upon banks, in the future more attention will be placed upon the shadow banking sector.[222] This will require considerable will, attention and resources as it may be difficult to regulate this sector. The FSB has produced a report,[223] which is of the view that the shadow banking sector can create a number of potential problems: it can create systemic risks; it can create bank runs similar to those in the banking system; by creating additional leverage, it can increase pro-cyclicality; it can cause systemic problems for the banking sector because of the close connection of shadow banking with the mainstream banking sector; and it can reduce the effectiveness of bank regulation.[224] The FSB was also of the view that lack of information about the shadow banking sector and the fact that parts of the shadow banking sector were located offshore were matters that needed to be combated if regulation was to be effective.[225] Another view is that being able to control the shadow banking sector is always likely to prove difficult. One commentator is of the opinion that, '…If the reality, however, is that the mice are smarter and more agile than the cats – and in some respects more powerful – all that can be hoped for is some form of compromise…'.[218] This difficulty was recognised in a general way by the Independent Commission on Banking where it was stated that the numbers seeking to evade any restrictions is greater than the numbers of regulators seeking to enforce any regulations. Further, those seeking to evade any regulations had the necessary incentive to do so and possessed the necessary ingenuity.[226] A further reason why non-regulated banks might be used is that it is cheaper to use institutions from the shadow banking sector.[227] Further, because such institutions will not be subject to regulatory controls, they are able to take greater risks and do so more easily.[228]

> Although Basel III closes a number of identified shortcomings, both the incentives for, and the risks associated with, regulatory arbitrage will likely increase as Basel III raises the rigour of bank regulation.[229]

THE INDEPENDENT COMMISSION ON BANKING REFORM

Interim Report

The interim report of the Independent Commission on Banking Reform has proposed a 10 per cent of 'core tier one' (best quality capital) against 'risk- weighted assets' as opposed to the 7 per cent proposed by the Basel Committee.[230] That it is against risk-weighted assets was confirmed by Sir John Vickers.[231]

> 'The Commission's view is that the 10 per cent equity baseline should become the international standard for systemically important banks, and that it should apply to large UK retail banking operations in any event.'[232] Further, 'We believe this should be agreed internationally. But whether or not it is, we believe that it should apply to UK retail banking'.[233]

The European Union is in the process of introducing Capital Requirements Directive 4, which will provide rules for the capital of banks. It is understood that the Vickers proposal for retail banks to hold 10 per cent capital will be allowed under this directive.[234] This demonstrates a desire to strengthen the position even though the Basel Committee's proposals where only proposed shortly before the interim Vickers report. David Miles of the Monetary Policy of the Bank of England has suggested in discussion paper 31[235] a much higher ratio of 15-20 per cent of tier one capital to risk-weighted assets, and confirms an inconsistency of approach to that of Basel and Europe who wish for a much lower ratio. This discussion paper 31, which wanted a much higher ratio, concluded[236]: 'We conclude that even proportionally large increases in bank capital are likely to result in a small long-run impact on the borrowing costs faced by bank customers. Even if the amount of bank capital doubles our estimates suggest that the average cost of bank funding will increase by only around 10-40bps. (A doubling in capital would still mean that banks were financing more than 90 per cent of their assets with debt). But substantially higher capital requirements could create very large benefits by reducing the probability of systemic banking crises'.[237] Towards the end of the report, the discussion paper stated the need for banks to use their equity rather than their debt: 'Were banks, over time, to come to use substantially more equity and correspondingly less debt, they would not have to dramatically alter their stock of assets or cut their lending. The change that is needed is on the funding side of banks' balance sheets – on their liabilities – and not their assets'.[238] Such an approach in banks having greater equity and not reducing their assets is supported by Robert Jenkins.[239]

Sir John Vickers, chairperson of the ICB, Martin Taylor, ICB member, and Bill Winters, ICB member, recently gave evidence before the Treasury Committee[240] to deal with the interim proposals made by the Independent Commission on Banking. Sir John Vickers indicated that there were inherent risks in retail banking and this was a good reason for having greater capital cushions for such banks.[241] In relation to the risk side, Sir John Vickers confirmed that retail banks would not need to hold back as much capital on a risk-weighted basis as investment banks.[242] Further, reforms on capital and liquidity would be part of a package of reforms including a complete culture change in the attitude of banks to risk taking on the part of banks themselves[243]: '…what we are recommending is a package of tools that involves a structural, capital, liquidity, incentive, governance and culture dimension. It is the package that is critically important'.[244]

Final Report

In relation to the equity to risk weights ratio, the recommendation of the Independent Commission is that large ring-fenced banks should hold an equity ring-fenced buffer of at least 3 per cent above the Basel III 7 per cent of risk-weighted assets.[245] This confirms and continues the recommendation made in the interim report.[246] 'In sum, the Commission believes that the Basel baseline is by some margin too low'.[247] In order to minimise the possible anticompetitive effects of this additional 3 per cent,[248] the Independent Commission recommends the use of a sliding scale from 0 to 3 per cent, 3 per cent being used for the largest rink-fenced banks.[249] Some evidence that was given to the Independent Commission was to the effect that ring-fenced banks should be subject to an even higher ratio than 10 per cent.[250] This again shows an inability to agree to one figure and that there are a range of views as to what it should be. However, the Independent Commission strongly rejected the European Commission's approach for harmonisation.

> In the context of capital standards for banks, maximum harmonisation lacks economic logic…. There are perfectly good reasons why some EU member states wish to go beyond International minimum capital standards. Their banking systems, including exposures to global financial markets, are by no means the same…. For all these reasons, maximum harmonisation is not the right approach to capital standards for banks….[251]

Some commentators are of the view that in any event that the differences between the United Kingdom on the one hand and those of Basel III and Europe on the other hand are relatively small. Lord Myners considers that the Vickers proposals are 'actually not significantly higher than those in Basel III'.[252] Further, the differences between Europe and the United Kingdom for the core one tier capital ratio will be small particularly if Europe decides to raise this to 9 per cent.[253] At a world level, Basel is aware of problems of inconsistency by sending out teams around the world to seek to ensure a uniform approach.[254] Nevertheless, problems remain with differing approaches of the European Commission to that of the Independent Commission on Banking in the United Kingdom. These differences have been highlighted with France and Germany seeking special treatment for banks that own insurance companies so that Basel III rules will not fully apply to such institutions.[255]

> One flashpoint is Mr Barnier's bank capital reforms, which respond to the Basel III international standards. To the delight of European banks – and the consternation of Whitehall – the Commission in July proposed a limit on how much capital national regulators could force banks to hold. British ministers think this was deliberately aimed at undermining the flagship recommendation of the Vickers commission, which advocated ring fencing UK retail operations behind a higher capital buffer.[256]

CONCLUSION

The proposals of the independent banking commission would set higher standards for capital than in many other places for the regulation of banks. This inconsistency is problematic and could cause uncertainty among UK banks. If the Governor of the Bank of England has his way and is given increased powers to regulate, then suggestions of higher capital standards could become a reality. UK banks would then be subject to two regulators with European and Basel regulatory regimes being of a lesser standard. Not only would there be an unlevel playing field, but it might become unclear as to the standards that groups of banks and their subsidiaries should seek to comply with.

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References and Notes

1 See generally: Arora, A. (2010) The global financial crisis: A new global regulatory order?. *JBL* 8: 670–699, In contrast to that article, this article will look at regulation from a UK perspective and how it has been affected by Basel III.
2 Jenkins, P. (2011) Quality of stress testing disclosures a mixed bag. *Financial Times*, 18 July.
3 These concepts are discussed subsequently in part 1: Basel III.
4 See the large number of informative pieces in the *Financial Times* about these.
5 See the subsequent discussion of these in Section 'Responsible Lending'.
6 Jenkins, P. (2011) Quality of stress testing disclosures a mixed bag. *Financial Times*, 18 July 2011. See also page 1 of the *Financial Times*, 19 July 2011; in a section with a heading 'UK banks hit hardest' it is alleged that one bank had used a loophole to avoid disclosure about its exposure in Ireland.

7 The proposals of the Independent Commission on Banking are discussed primarily in section 8, but it is clear that the commission also support leveraged ratios: see the end of section 1.

8 This article is not looking at issues relating to the lender of last resort nor the special resolution regime contained in the Banking Act 2009 for failing banks: See generally Singh, D. (2011) The UK banking act 2009, pre-insolvency and early intervention: Policy and practice. *Journal of Business Law* 2011(1): 20–42.

9 www.bis.org/publ/bcbs193a.pdfSee, in particular, Scott, H. (2010) Reducing systemic risk through the reform of capital regulation. 1 September 2010 *JIEL* 13(3): 763–768. Some of the articles below, in particular those by Marianne Ojo are of a very detailed analysis beyond the scope of this article. See generally: J.J. Norton, *Bank Regulation and Supervision in the1990s*, Lloyds of London Press Ltd, 1991; J.J. Norton, *Devising International Bank Supervisory Standards*, Graham & Trotman/Martinus Nijhoff, 1995; S. Gleeson, *International Regulation of Banking Basel II Capital and Risk Requirements*, OUP, 2009; D.K. Tarulo, *Banking on Basel*, Pearson Institute for International Economics, 2008; G.M. Mangion, How regulation works in an uncertain financial world. *E.F.P.L & P* 2010 4(5): 10–11. A McLean Bank capital and liquidity measures: The implications for borrowers. *F.R.I.* 2010 July/ 7-9 August. *Hamish Risk*, Banks digest the meaning of Basel III, *Euromoney* 2010, February 2010. Louise Bowman, Damned if you do, dammed if you don't. *Euromoney* 2010 June, 92–95. In relation to Basel II: A McKnight Basel 2: The implementation in the UK of its capital requirements for banks: *Law and Financial Markets Review* (July 2007): 327–340. D. Coskun, Credit-rating agencies in the Basel II framework: Why the standardised approach is inadequate for regulatory capital purposes (2010) *Journal of International Banking Law and Regulation* 25(4): 157–169. See generally: A. Arora: The global financial crisis: A new global regulatory order? (2010) *J B L* 8: 670–699. The Basel Committee on Banking Supervision is described at pages 676 and 677 of Anu Arora's article. See also: C. Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997*, Cambridge University Press Online Publication, September 2011.

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12 Alexander, K. (2003) Editorial: Reforming the Basel accord. *Journal of Banking Regulation* 4(4): 298–300.

13 Novembre, V. (March 2010) The bargaining process as a variable to explain implementation choices of soft-law agreements: The Basel case study (March 2009). *Journal of Banking Regulation* 10: 128–152, The author regards Basel I as a 'successful soft-law international agreement because of its worldwide implementation'. See also L.L.C. Lee, The Basel Accords as soft law: Strengthening international banking supervision (1998) Vol 39 (1): 2–39, *Virginia Journal of International Law* where the author talks about soft law and hard law. In a European context the Basel rules are implemented through the capital adequacy directive and through rules and regulations of the UK regulatory authorities. Christos Hadjiemmanuil, Banking Regulation and The Bank of England LLP 1996, talks about the implementation of Basel I and in footnote 88 at page 203 he writes: 'Remarkably, nobody questioned the validity of the Bank's quasi-formal implementation of the formally non-existent international document'. See in addition: D.E. Ho, 'Compliance and international soft law: Why do countries implement the Basle Accord?' 1 August 2002 *JIEL* 5(3): 647–688.

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15 Professor Norton, J.J. confirms the point that the Basle Committee's proposals in the European Union 'will be enacted through formal legal means. In: J.J. Norton (ed.) *Bank Regulation and Supervision In The 1990's*. Lloyd's of London Press Ltd, Appendix (to Chapter 5) *Background note on the Basle Committee* Joseph J Norton.

16 Mervyn King in response to question 8 of Stewart Hosie: The Uncorrected Transcript of Oral Evidence to be published as HC 430 –i: House of Commons Minutes of Evidence Taken Before Treasury Committee Financial Regulation Wednesday 28 July 2010. This is an oral transcript and witnesses and Members of Parliament have not had an opportunity to correct the record. As will be seen below, the Independent Banking Commission is seeking to introduce higher levels of capital reserves than those proposed by Basel III. Simon Gleeson makes the point that for European Union Law and the Basel rules to be different would be highly damaging for the banking industry. Gleeson, S. (1999) A journey from Basle to Brussels. *Journal of International Banking Law* 14(9): 275–276, See also S. W. K-S Reforming regulatory capital: The European response to the financial crisis (2009) 10 *JIFBL* 603.

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226 HC 1069-i: House of Commons Oral Evidence: Taken before The Treasury Committee: Independent Commission on Banking: 24 May 2011, Sir John Vickers, Martin Taylor and Bill Winters: Response of Martin Taylor to Q99 of Stewart Hosie. Neither witnesses nor Members have had the opportunity to correct the record.

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230 The other proposals, in particular in relation to ring fencing, are outside the scope of this article. See generally Walker, G. (2011) The independent commission on banking: Interim findings and comment. *Law and Financial Markets Review* 5(3): 213–223.

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232 Independent Commission on Banking: Interim Report: Consultation Reform Options: Executive Summary, April 2011.

233 Independent Commission on Banking: Interim Report Publication 11th April 2011 Opening Remarks Sir John Vickers. This approach is confirmed by Paragraph 2.28 of the Independent Commission on Banking Final Report Recommendations September 2011: 'large ring-fenced banks should maintain equity of at least 10% of RWAs'.

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235 External MPC Unit: *Discussion Paper 31* revised and expanded version: Optimal bank capital: David Miles, Jing Yang and Giberto Marcheggiano April 2011 expanded version from an earlier version published in January 2011.

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238 At page 41: External MPC Unit: Discussion Paper 31 cited above. A view echoed by Admati, A. (2011) Force banks to put America's needs first. *Financial Times*, 20 January 2011.'Significantly increasing banks' equity funding would provide many benefits to the economy, at little social cost'. David Miles, Banks fail to convince crying foul over Basel reforms, *Financial Times* 24 November 2010. 'But it does not follow that if banks are forced to hold significantly more equity their overall costs of funds is bound to be higher'. Lord Turner has made clear that he is an advocate of higher capital ratios also: A. Turner, Leverage, Maturity Transformation and Financial Stability: Challenges Beyond Basel III, Cass Business School, 16 March 2011 and hence the system will 'remain more vulnerable to instability than is ideal' at page 6. See also M. King, Banking –From Bagehot to Basel, and back again at the Second Bagehot Lecture, Buttonwood Gathering, New York, 25 October 2010, 'the bank of England would have preferred an agreement to set capital ratios at higher levels', at page 7 and at page 8 where Mervyn King mentions the 'simple solution' of having higher capital levels as proposed by David Miles. Mervyn King also agrees that banks should be financed more heavily by equity rather than short term debt and is a solution that is 'remarkably simple'. The work of David Miles is acknowledged by Sir John Vickers in response to Q88 Andrew Tyrie: Chairperson: HC 1069-i House of Commons Oral Evidence Taken before the Treasury Committee: Independent Commission on Banking 24 May 2011: Sir John Vickers, Martin Taylor, Bill Winters: Neither witnesses nor Members have had the opportunity to correct the record.

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241 Sir John Vickers: In response to Question 41 of Mr Mudie: House of Commons Oral Evidence Taken Before The Treasury Committee: Independent Commission on Banking 24 May 2011: Sir John Vickers, Martin Taylor and Bill Winters. Neither witnesses nor Members have had the opportunity to correct the record. The transcript is not yet an approved formal record of these proceedings.

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244 Bill Winters in response to question 71 from Jesse Norman: House of Commons Oral Evidence Taken before the Treasury Committee: Independent Commission on Banking, 24 May 2011: Sir John Vickers, Martin Taylor and Bill Winters: neither witnesses nor Members have had the opportunity to correct the record. The transcript is not yet an approved formal record of these proceedings. This article has focused on the capital and liquidity matters.

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250 Paragraph 4.32 of the Independent Commission on Banking Final Report Recommendations September 2011. The Independent Commission referred to the evidence of Admati and Hellwig.

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