

A Race to the Top?

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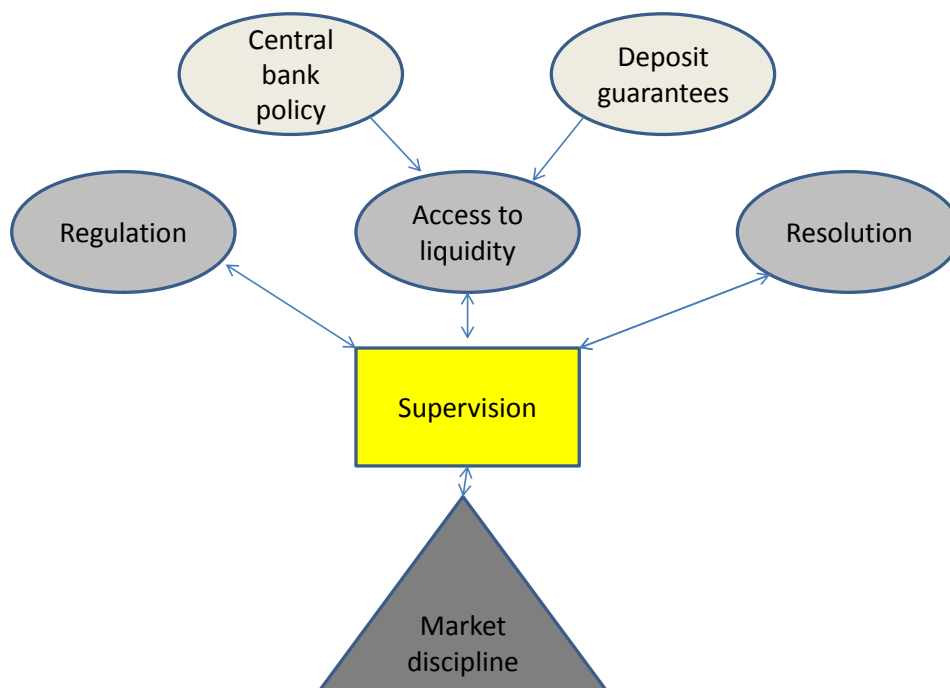
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A Race to the Top?

Thomas F. Huertas*

In the wake of the crisis, significant changes have been made to regulation, to deposit guarantee schemes, to central bank liquidity policy and to resolution. These will have a significant impact on supervision and on the interaction between supervision and market discipline. In particular, the reform of resolution could have significant implications for supervision, the way in which markets view supervision and the way in which banks regard supervision. Instead of a 'race to the bottom,' there could well emerge a 'race to the top'.

Supervision takes place in a broader context



This is so, since, prudential supervision takes places within a broader context set by regulation, resolution and policies governing the official provision of liquidity (either directly from the central bank or indirectly via guarantees such as deposit insurance). Changing one element of the mix can have a significant effect on the others. In

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particular, reforming resolution will enhance market discipline and may alter the way in which the market regards supervision. That will have knock-on effects on both supervisors and banks.

The role of prudential supervision

Essentially, prudential supervision consists of two tasks:

- (1) to monitor the institution, and
- (2) to 'mind' the institution.

The supervisor as monitor. The principal task of the supervisor as monitor is to determine – on a continuous basis -- whether or not the bank is meeting threshold conditions. This is a black or white, and largely factual, decision. As long as the supervisor considers that the bank meets threshold conditions, the bank is entitled to remain in operation according to the terms of its banking license. If the supervisor finds that the bank no longer meets threshold conditions, the bank is put into resolution. This should allow the resolution process to start at a point where the bank still has positive net worth. That in turn should reduce loss given resolution (increase recoveries given resolution).

Regulation sets threshold conditions. In the UK, for example, this requires that a bank maintain – currently and prospectively -- resources (especially capital and liquidity) adequate to support its business (FSA 2012, 2012). This implies that a bank can be put into resolution at a point where it still has significant positive net worth. That in turn increases the probability that creditors of the bank (particularly depositors) can realise a full and possibly timely recovery of their claims on any bank that is put into resolution.

Whether or not a bank meets threshold conditions is a matter of judgment – a judgment for the supervisor to make. Supervisory monitoring of liquidity can be as simple as observing whether or not the bank can fund itself in the market. Failure to maintain adequate liquidity is the reason most banks fail. Indeed, supervisors must put into resolution a bank that no longer has access to funding. Absent some official source of liquidity, the supervisor on its own cannot exercise forbearance. In practice, monitoring liquidity is a good deal more complex, especially where banks have access to guarantees (such as deposit insurance) or central bank funding (see discussion below).

Whether the current level of capital exceeds the required minimum is essentially a valuation question. Here, the supervisor starts with the bank's balance sheet according to generally accepted accounting standards, and makes certain adjustments, such as the deduction of goodwill and deferred tax assets as required

by regulation. Additionally, the supervisor may require the bank to err on the side of prudence when valuing illiquid instruments (FSA 2011) . Finally, the supervisor may review the bank's impairment provisions as well as the models by which estimate probability of default and loss given default. These models effectively determine an asset's risk weighting and the amount of capital that a bank will be required to hold.¹

To assess whether or not a bank will continue to meet capital requirements in the future, the supervisor conducts what amounts to a going concern assessment. This can be far more stringent than the going concern assessment conducted by the bank's auditors under generally accepted accounting practice. For the auditor, the going concern assessment represents a determination at the time the audit is complete (i.e. after an interval following the balance sheet date) of whether or not the bank's accounts can be drawn up on a going concern basis (Sharman, 2011). In other words, the going concern assessment of the auditor effectively represents the auditor's judgment that nothing has occurred up to the date of the audit report that would suggest that the company should be put into liquidation. It does not constitute a forecast that the entity will remain a going concern for the period after the completion of the audit report.

In contrast, the supervisor as monitor can and does conduct much more forward looking assessments as to whether or not the bank can remain in operation over the foreseeable future. In particular, supervisors conduct stress tests on banks that examine whether or not banks will be able to maintain some level of capital and liquidity into the future even if the economic and/or financial environment turns out to be much worse than expected. Prominent examples of such an approach include the FSA stress tests in the UK (FSA 2009, 2009), the SREP exercises in the United States (FRB 2012a, 2012), Spain's current review of the caja sector (Roldan 2011) and the EBA stress test for major cross-border banks in the EU (EBA 2012, 2012). Banks that cannot demonstrate the required resiliency under stress are subject to supervisory sanctions, including the possibility that they will be placed into resolution.

The supervisor as minder. In addition to acting as monitor, the supervisor acts as 'minder'. As a minder, the supervisor effectively makes a judgment, not only on the bank's condition, but on the judgments that the bank itself makes regarding its strategy and the likelihood that that strategy will be successful (Sants, 2009). If the supervisor concludes that the bank is veering toward the point where resolution will be required, the supervisor has to induce management of the bank to take actions that reduce the probability that the bank will fail.

¹ Collectively these regulatory and supervisory adjustments amount effectively to a separate regulatory accounting standard for banks. It is therefore not clear that banks require a separate accounting standard, as proposed by Haldane (2011), especially if regulatory reports are disclosed.

There are four aspects to the role of supervisor as minder. First, the supervisor must rate the bank. In other words, the supervisor has to diagnose the state of the bank. How close is the bank to failing to meet threshold conditions? Second, the supervisor has to prescribe a regimen for the bank to follow, so that the bank will continue to meet threshold conditions. Third, the supervisor has to induce the bank to follow the prescribed regimen. Fourth, the supervisor may need to supplement measures with respect to individual banks (micro-prudential supervision) with measures applicable to the market as a whole (macro-prudential supervision).

Supervisory ratings. The first task of the supervisor as minder is to rate the bank. This is a “shades of grey” decision. How close is the bank to failing to meet threshold conditions, and how quickly might the bank reach the point of non-viability?

Supervisors have developed various ratings systems. In the United States banking supervisors employ a CAMELS rating system (FRB 2012b). In the UK the Prudential Regulation Authority (PRA 2011) intends to classify banks into five different stages according to the risk of the bank (likelihood that it would require resolution).

Supervisors base their ratings on publicly available information as well as confidential, non-public information provided by the bank to the supervisor. In this respect the supervisor will be in a similar position to a rating agency – a privileged recipient of confidential, price-sensitive, non-public information. As the supervisor will receive such information from all banks in the market, it will be particularly well placed to conduct peer reviews and analyses.

Prescription. Having diagnosed (rated) the condition of the bank, the supervisor as minder must develop a prescription that will potentially enable a sick (lowly rated) bank to avoid failure/return to health.

How should this be done? The supervisor is not the manager of the bank, and the supervisor should not be taking decisions for the bank. These need to be taken by the bank’s management and approved by the bank’s board.

In effect, the position of the supervisor is akin to the position the bank itself would have as a lender to a corporate borrower in distress (but not default). In such circumstances borrowers make a proposal to the bank on how the borrower could conduct its affairs so as to avoid default and observe the covenants in the loan agreement. The bank then has a discussion with the borrower with respect to the likelihood that the proposed measures will be successful within the required time frame. In such discussions, the bank’s views carry great weight, for the borrower is well aware that the bank has the ability to take more formal remedies should the borrower breach its covenants or default. So the bank can induce the borrower to take action to improve its condition without becoming a shadow director of the borrower.

Similarly, the supervisor asks the bank to tell it what the bank will do to improve the bank's condition. The supervisor reviews the proposals made by the bank and gives the bank its views. The bank's management takes and the bank's board of directors approve the decision.

Recently, supervisors have started to ask banks to submit recovery plans to indicate what the bank would propose to do, if it came under severe stress (Huertas & Lastra, 2011). This makes sense. It creates a framework under which both the bank and the supervisor understand what the bank could and would do in such a dire situation. Effectively such a recovery plan amounts to a financial continuity plan. The plan is developed and owned by the bank, not the supervisor. The supervisor's role is to review the plan. The plan should allow the supervisor to determine how resilient the bank would be under extreme stress and to discuss with the bank the measures that the bank could take to improve its resiliency.

Inducing the bank to follow the prescription. As indicated above, the supervisor's ability to get banks to self-prescribe sensible measures depends critically on the formal powers that the supervisor may exercise (akin to the formal measures that the bank as creditor may take if the borrower breaches covenants or goes into default). Having a 'big stick' enables the supervisor to speak softly but still be heard loudly and clearly.

The ultimate stick is of course the power to put the bank into resolution (if the supervisor finds that the bank fails to meet threshold conditions). However, the law empowers supervisors to take various steps prior to such a finding in order to preserve the safety and soundness of a bank that is in danger of failing to meet threshold conditions. These powers generally include the authority to

- order the bank to undergo a special examination from a 'skilled person' to the specifications set by the supervisor and to implement the recommendations set out in such a report;
- issue cease and desist orders whereby the bank is required to stop certain activities; and
- make a finding that the bank's executives and/or directors are no longer 'fit and proper' and cause the bank to remove such persons and nominate replacements that the supervisor does find to be 'fit and proper'.

Together these powers enable the supervisor to exercise considerable influence over the bank. The possibility that the supervisor may have recourse to one or more of these tools greatly enhances the likelihood that the bank will be receptive to the supervisor's comments on how the bank might improve its condition and/or its resiliency. Generally speaking the bank will go to considerable lengths to avoid

formal supervisory sanctions, especially if such sanctions were to be made public (as the disqualification of executives inevitably would be).

Macro-prudential supervision. To supplement micro-prudential supervision, many jurisdictions supervisors have created or are creating macro-prudential supervisors. The United States has created the Financial Stability Oversight Council and the EU has created the European Systemic Risk Board. The UK proposes to create the Financial Policy Committee at the Bank of England (this is already meeting on an interim basis). At the G-20 level, there is the Financial Stability Board.

Each of these groups has the responsibility to consider the financial system as a whole. The task facing such groups is akin to finding and removing the needle in the haystack before the sunlight ignites a spark that will set the stack and the stable ablaze. The trouble is that the 'needles' that are easy to find are generally politically sensitive (e.g. use of Fannie Mae and Freddie Mac to promote sub-prime mortgages, excessive budget deficits in Euro-zone countries) whilst ones that can be removed may be difficult to find (Huertas, 2011).

Macro-prudential supervision has a different focus from micro-prudential supervision. Micro-prudential supervision focuses on the firm. For a global firm this will encompass the firm's activities in many different markets. The home country supervisor should provide consolidated official supervision in coordination and cooperation with host country supervisors. In contrast, macro-prudential supervision focuses on the financial system as a whole. But the primary focus of macro-prudential supervisors is financial stability within its own jurisdiction, not necessarily financial stability on a global scale.

Two aspects of macro-prudential supervision deserve emphasis. The first is that the legislation generally empowers the macro-prudential supervisor to give the micro-prudential supervisor a direction or recommendation with respect to micro-prudential supervision. For example, the systemic risk board (macro-prudential supervisor) may recommend or direct the micro-prudential supervisor to encourage banks to retain earnings or to increase capital or liquidity requirements. Such measures affect the banks headquartered in the jurisdiction of the micro-prudential supervisor. They are therefore both too broad (banks operate in many markets, not just the home market) and too narrow (branches of foreign banks operate in the home market and much of the financial market consists of non-bank and/or direct market activity).

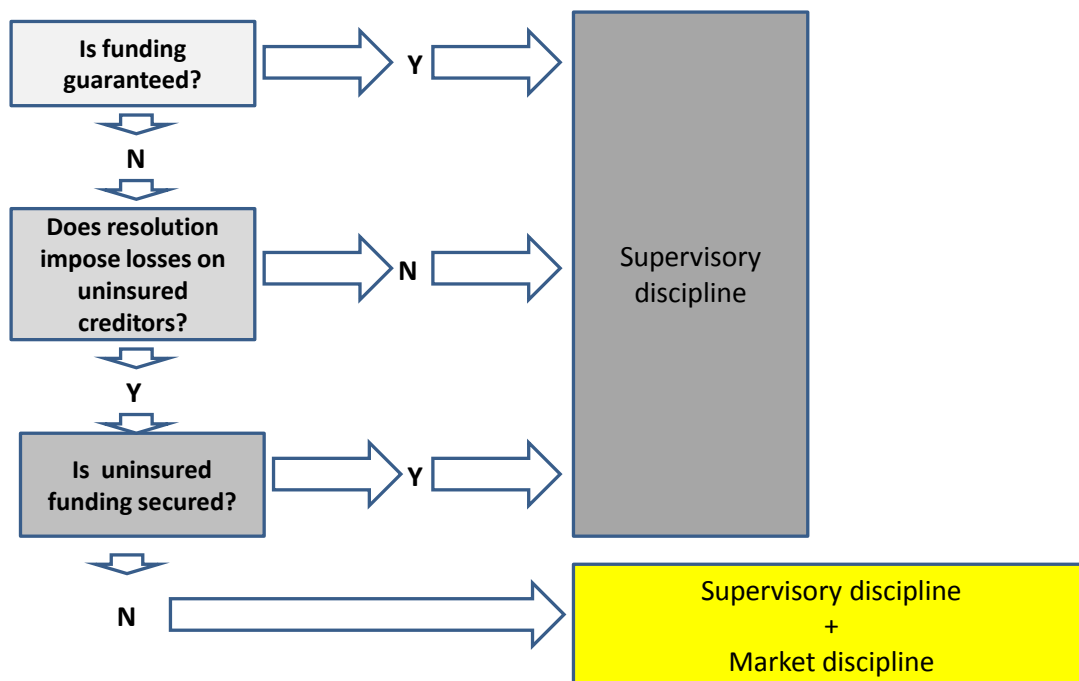
For this reason macro-prudential supervisors are empowered to make recommendations or give direction to the market as a whole. Under Basel III the home macro-prudential supervisor can set the counter-cyclical capital buffer as a supplement to the risk weight attached to exposures to home country borrowers (regardless of where the exposure is booked). Other measures are also under discussion, including the imposition of limits on borrowers (such as maximum loan to value ratios) in addition to limits on lenders.

In theory, macro-prudential supervision will promote financial stability. Better insight will promote better policy. In practice, however, will systemic risk boards have a blind spot where the stability implications of monetary and fiscal policy are concerned?

Supervision and Market Discipline

As outlined above, supervision is conducted within a broader framework given by access to liquidity (via explicit guarantees such as deposit insurance or to central bank funding), regulation and resolution. This broader framework dictates whether banks will be subject to discipline solely from the prudential supervisor or subject to discipline from the market as well as the prudential supervisor.

Can market discipline supplement supervisory discipline?



Supervision of banks with an explicit guarantee. In a world where banks fund themselves exclusively through insured deposits (and common equity), the supervisor is the only entity that disciplines banks. In such a world, banks can generally continue to raise funds by attracting new deposits (especially if the deposit guarantee scheme has earned the reputation that it can promptly pay out deposits at failed banks), since the depositor relies on the guarantee rather than reviews the condition of the bank. The market provides no discipline to the bank. The only disciplinarian is the supervisor.

If the supervisor fails to exercise discipline, severe costs can arise to the deposit guarantee scheme and to the taxpayer that ultimately must back the deposit guarantee scheme. Such was the case in the United States in the 1980s with respect to savings and loan associations (thrifts) that financed themselves exclusively through equity and federally insured deposits. The US thrift supervisor allowed a large number of thrifts to remain in operation, even though these institutions failed to meet minimum capital requirements (and in many cases had negative net worth). In other words, the supervisor exercised forbearance. It failed to act as a monitor of the bank's condition, and it failed to put banks into resolution at the point at which they no longer met threshold conditions (minimum capital requirements).

To compound the problem, the US thrift supervisor failed to act as a minder for the banks under forbearance. Rather than imposing an orderly wind-down, the thrift supervisor allowed insolvent thrifts to continue operations normally. This induced the management of thrifts under forbearance to 'gamble for resurrection'. Most thrifts under forbearance lost that gamble for resurrection, greatly magnifying losses to the deposit guarantee fund and ultimately to the US taxpayer.

For this reason, the US FDICIA attempted to set a limit on the discretion that supervisors could exercise. The prompt corrective action provisions of the legislation required the supervisor to put the bank into resolution if its capital fell below 2% of its GAAP assets. In effect, FDICIA set a minimum standard that the supervisor as monitor had to observe.

Supervision of banks with an implicit guarantee. Similar issues arise where a bank enjoys an implicit guarantee, in particular where the market considers the bank 'too big to fail'. In such cases the market considers it to be very likely or even almost certain that the government will step in to protect the creditors of the bank. Either the government will intervene so that the bank never enters resolution (e.g. through the injection of new equity into the distressed institution) or the bank will be resolved in a manner that does not impose losses on creditors of the bank (e.g. through the provision of state guarantees to the bank's uninsured liabilities).

In such circumstances, loss given resolution is expected to be zero. This greatly diminishes the incentive of a market participant to review critically the condition of the bank in which it places its funds. Discipline comes primarily from the supervisor or the central bank, depending on whether the central bank regards borrowing as a right or a privilege (see below). The market provides little or no discipline to banks.

Regulatory reform. In response to the crisis the G-20 countries have reformed regulation. They have raised capital requirements, improved the quality of capital and introduced for the first time a global liquidity standard. In addition, they have introduced a cap on the leverage that a bank would be allowed to employ. Taken

together, these measures should reduce the probability that a bank will require resolution.

Whether they do or not depends on both the implementation and enforcement of the new standards. Jurisdictions must transpose the agreements reached in Basel into law and/or regulation. Supervisors must assure that banks actually adhere to the stricter regulation.

But regulatory reform alone does not change the nature of the race. There will still be a 'race to the bottom' as long as banks continue to operate with either an explicit or implicit guarantee. As long as resolution does not promise to impose losses on uninsured creditors, market participants will have little or no incentive to monitor and discipline banks. The only discipline will come from the supervisor. Banks will continue to have an incentive to seek jurisdictions where supervision may be lax and supervisors may have an incentive to soften their standards so as to attract more 'clients'. In other words there will still a race to the bottom. All regulatory reform does is to assure that such a race starts further away from the bottom.

Reforming resolution. Reforming resolution potentially changes the nature of the race. Ending too big to fail means that investors and uninsured creditors would potentially suffer losses if the bank went into resolution. This gives such investors and creditors the incentive to monitor not only the condition of the bank, but the actions of the supervisor, the central bank and the resolution authority. Together these determine the probability that the bank will be put into resolution and the probable loss given resolution. That allows the market participant to arrive at an estimate of its expected loss on exposure at default, and this expected loss should form the basis for the risk premium that the market participant will demand from the bank. Reforming resolution is therefore the first step toward assuring that the market, as well as the supervisor, will discipline banks.

Whether the market will in fact discipline banks depends on the answer to four inter-related questions:

1. Is the proposed resolution regime practical? Can it deliver the required results (resolution of the bank at no cost to the taxpayer and at minimal social cost) within the required time frame (a weekend)? This is a very tall order, but a view is emerging that a combination of tools may offer the best promise of success. Bail-in could be used immediately at the point of non-viability of to write-down or convert into common equity the bank's non-core Tier 1 capital, its Tier 2 capital and some portion of its senior debt. This would recapitalise the bank and, together with the provision of liquidity (against the bank's unencumbered assets), stabilise the bank. That would allow critical functions to continue and give the authorities time to execute an orderly

liquidation/wind-down of the bank by selling assets and/or businesses and/or establishing a bridge bank.

2. Does the bank have enough 'back-up' capital? Bail-in will only work, if there is enough 'back-up' capital available to be bailed in at the point of non-viability. What constitutes "enough"? Briefly put, this will be an amount sufficient to enable the bank to write off all the losses that the bank needs to recognise at the point of non-viability and restore capital to the point where the bank meets or exceeds capital requirements (4.5% minimum + 2.5% capital conservation buffer).

The requirement under Basel III that non-core Tier 1 and Tier 2 capital is subject to write down or conversion at the point of non-viability is a step in the right direction. But the full answer to this question will probably require banks to have a minimum amount of back-up capital outstanding.

3. Does the bank have enough unencumbered assets? Resolution will only be practical, if the portion of the bank that remains in operation remains liquid. That may require the central bank to provide liquidity for a period of time pending the implementation of other resolution tools. But the central bank can only do so, if the bank has unencumbered assets that it can pledge as security to the central bank.

If there are no limits on encumbrance, the first reaction of banks and their uninsured creditors will be to resort to liabilities, such as covered bonds and repurchase agreements, which are secured by the bank's good assets. In the event that the bank fails, the uninsured creditor has first claim on the assets pledged as collateral. In the case of repurchase agreements, the lending bank can sell such collateral immediately and use the proceeds of the sale to satisfy its claim. This effectively subordinates unsecured creditors (such as insured deposits) to secured creditors and increases the loss that they (or the deposit guarantee scheme) would suffer if the bank were put into resolution.

4. Is the authority empowered to resolve the bank in manner that imposes losses on uninsured and unsecured creditors as well as capital providers, and is it committed to doing so? Does the jurisdiction have a special resolution regime applicable to banks? Does this give the resolution authority the necessary tools to resolve the bank along the lines suggested above? Is the resolution authority committed to doing so?

The too big to fail problem arose in the first place because the authorities determined that the failure of a major bank would disrupt the financial system and impose severe costs on the economy at large. Providing open bank assistance and/or solvency support enabled the authorities to avoid those

immediate costs. The market recognised that the authorities would choose to rescue rather than resolve banks, and this reduced the incentive of the market to discipline banks.

How can the authorities change the market's calculus so that the markets authorities to resolve banks rather than rescue them? Making resolution practical is the first and most important step. That requires enactment of a special resolution regime with adequate tools for resolution. The second is some type of pre-commitment, either by limiting the ability of the authorities to rescue a bank or by stating in advance that protection would be limited to certain portions of the group rather than the enterprise as a whole.² The third is some assurance that resolution can work – that the bank itself will be restructured in a way that does not impose vast economic costs on society at large.³ That requires measures directed at the bank itself (such as bail in and bridge bank) as well as measures to assure that the resolution of the failed bank does not destabilise financial infrastructures (such as payment, clearing and settlement systems) or the economy at large. This is particularly difficult for large, complex, cross-border institutions. It will require close coordination between the resolution authority and the systemic risk authority and close cooperation among major countries. This is precisely the problem on which the Financial Stability Board has focused its attention.

As a practical matter, much will depend on the path that financial failures take. Will resolution measures be in place before the next failure of a major financial institution, and will the authorities in office at the time actually implement the measures? If they do, and if they are successful, the market will gain confidence that the authorities will act in a similar manner in subsequent failures.

Supervision in a world with effective resolution. Assume for the moment that the market expects the authorities to resolve banks in a manner that exposes all capital providers plus uninsured creditors to loss and assume further that the bank has significant amounts of such 'at risk' liabilities in issue. In such a case market discipline will supplement supervisory discipline. But market discipline will also take the quality of prudential supervision into account, and this has implications for the

² For example, the Dodd-Frank Bill prohibits taxpayer assistance to failing institutions. Under the Independent Banking Commission (Vickers) proposals in the UK support for portions of the group outside the ring-fence should be materially less than support for the bank inside the ring-fence.

³ Without some assurance that resolution can work, the authorities may be reluctant to employ the resolution tools that legislation may offer. After all, governments have – when faced with imminent economic disaster - time and again found ways to support major banks that are about to fail. For example, Gramm-Leach Bliley was supposed to limit protection of US financial groups to insured banks. It did not. Nor will Vickers alone necessarily restrict protection in the UK to the bank inside the ring fence.

manner in which the prudential supervisor should conduct its activities as monitor and minder.

To the extent that supervision reduces the loss given resolution and/or decreases the probability that the bank will be put into resolution, supervision will reduce risk to private creditors. A simple example illustrates the point. If the prudential supervisor performs poorly as monitor, it will fail to put the bank into resolution promptly. This increases loss given resolution. In the example shown in Table 1, loss given resolution under 'poor' supervision is 40%; loss given resolution under 'good' supervision is 20%. If the prudential supervisor performs poorly as minder, there is a greater probability that the bank will have to be put into resolution. In the example shown in Table 1, the probability that the bank will require resolution is 10% if the prudential supervisor performs its tasks as minder poorly, but only 5% if the prudential supervisor performs those tasks well. Taken together, the effect of prudential supervision on expected loss can be significant. In the example given in Table 1, the expected loss would be 4% where the supervisor performs poorly both as monitor and minder, but only 1% where the supervisor performs both functions well. Such a difference in expected loss should be reflected in the risk premiums that banks would be expected to pay. All other things equal, the better supervised bank should have a lower funding cost.

Table 1
Supervision Matters

	Quality of Supervision	
	Poor	Good
Loss given resolution	40%	20%
Probability of Resolution	10%	5%
Expected loss	4%	1%

Accordingly, in a world where resolution imposes losses on uninsured creditors, banks with 'good' supervision should be able to fund themselves on better terms than banks with 'poor' supervision. This creates the possibility that in a reformed resolution world, the race will be not to the bottom, but to the top.

Assuring good supervision: the role of disclosure. Mandating disclosure of regulatory returns is a powerful way for supervisors to induce the market to reinforce the role of supervisor as monitor. As outlined above, this is largely a decision to be made on the basis of facts, and such decisions are easier to make when the facts are out in the open. Essentially disclosure allows the market to access much if not all of the information that the supervisor would use to determine whether or not the bank continues to meet threshold conditions. Based on such information the market

will decide whether or not to fund the bank. If the market decides not to fund, the supervisor has no choice (unless the central bank decides to provide liquidity – see below), but to close the bank. Unless the bank has access to liquidity, the supervisor alone cannot exercise forbearance.

In the UK consideration is being given to publishing some or all of a bank's regulatory returns. In particular, the authorities⁴ are working together to promote greater consistency of disclosures as well as to mandate additional disclosures of credit risk (including impairments and loans subject to forbearance agreements), deferred tax assets, risk-weighted assets, and liquidity risk (Bank of England, 2011, p. 43). Additionally, the FPC has recommended that the FSA encourage banks to disclose their leverage ratios as defined in the Basel III agreement and the FPC has drawn attention to the importance of making investors aware of the degree to which a bank's assets may be encumbered (Bank of England, 2011, pp. 51-52). Finally, the FSA has proposed that banks file a prudent valuation return (FSA 2011) to assure that banks provide information on the degree of uncertainty in the valuation of financial instruments such as derivatives. Similar efforts are being made at European level and in other jurisdictions. The EBA is proposing a binding technical standard that will harmonise regulatory reporting across the EU.

In contrast, it would be counterproductive to disclose the details of what the supervisor does as minder. Here the supervisor's effectiveness primarily depends on the timeliness and quality of its judgment and the ability of the supervisor to induce management to take corrective measures. Such judgments and such discussions are best conducted in private. Accordingly, the supervisor's interaction as minder with the bank should be treated in the same confidential manner as a bank's dealing with a corporate client that may be having difficulty meeting the covenants in its loan agreement.

In particular, it makes little sense to disclose the supervisor's rating of the bank. This is certainly material, price-sensitive information. As the supervisor has the power to put the bank into resolution, the supervisor's assessment of how close the bank is to the point of non-viability is certainly relevant for investors. If such information were disclosed, some market participants might simply rely on the supervisory rating and cease their own analysis of the bank's condition. If so, changes in the supervisor's rating of a bank could cause investors to revise their own rating of the bank and alter the willingness of investors to provide funds to the bank. In particular, a downgrade of the bank by the supervisor might induce market participants to withdraw funding from the bank, seek collateralisation and/or shorten maturities. This could increase liquidity pressure on the bank and accelerate its decline.

⁴ The Financial Reporting Council, HM Treasury, the Bank of England and the FSA.

The prospect of such an adverse market reaction may also diminish the willingness of the bank to disclose adverse information to the supervisor and/or adversely affect the timeliness or accuracy of the information that the bank discloses to the supervisor? Even though banks may have a duty to disclose to the supervisor relevant information, there is certainly a wide range of behaviour consistent with fulfilling such an obligation. If the supervisor as minder wishes the bank to be open with it so that it can induce the bank to take actions to avoid failure, supervisory ratings should be kept confidential.

Supervisor’s activity as minder is similar to bank’s own activity vis-a-vis a distressed corporate client – and should have same confidentiality treatment

	Bank	Supervisor	Market
Supervisor’s rating of the bank	Bank to keep confidential	Supervisor to keep confidential	Market to form own judgment of bank’s condition/prospects based on available information
Deliberations concerning remedy	Bank to keep deliberations confidential	Supervisor to review/comment upon bank’s proposed remedy	Situation is similar to situation facing non-bank investor when distressed borrower is dealing with a bank syndicate
Implementing remedy	Bank to implement measures as agreed with supervisor. Disclose if required to do so.	Supervisor to monitor implementation; resort to formal powers, if needed.	Market to assess decisions taken, timing and effect of implementation.

If supervisory ratings are to be kept confidential, three things must occur. The supervisor must be prohibited from publishing such ratings and this prohibition should extend to other public authorities and to supervisors in other countries to whom the supervisor might disclose its ratings. Second, the bank itself must be prohibited from publishing its ratings.⁵ This is to prevent banks with good ratings from trumpeting that fact and leaving the market to infer that banks which have not published have something to hide. Third, such a prohibition should be made consistent with the securities laws, either via an explicit carve out or via recognition that the supervisory rating is information generated by and belonging to the supervisor, not the bank.

Central bank lending. Finally, reference should be made to the central bank. This is a potential source of liquidity to banks. Indeed, one of the central bank’s core

⁵ This is in fact routinely done. See for example (OCC et al. 2005).

functions is the provision of liquidity to the banking system. How the central bank elects to meet these responsibilities shapes the context in which both supervision and market discipline will occur.

The key consideration for both the market and the supervisor is whether the central bank regards borrowing as a right that banks have or a privilege that the central bank extends. If borrowing is a right, the central bank makes its lending decision solely on the basis of the collateral offered by the bank to support the loan. The central bank sets eligibility requirements for such collateral and haircuts against the value of such collateral. It does not make a determination of the viability of the bank prior to extending the loan. It accepts the determination of the supervisor that the bank continues to meet threshold conditions.

In such cases, stigma does not necessarily attach to borrowing from the central bank. Indeed, extending credit to banks is part of normal central bank activity (indeed in the case of the ECB, extending credit to banks is the principal means by which the central bank implements monetary policy).⁶

In cases where the central bank regards borrowing as a privilege, the central bank will conduct its own assessment of the bank's viability prior to making a loan to the bank. Stigma can attach to the bank making such a loan request, for the request poses the possibility that the central bank could deny to provide the funds requested (Goodhart, 2002, p. 232). Such a denial could signal that the central bank regards the bank requesting the loan to be unviable. That would undermine the bank's ability to attract funds from the market and almost certainly lead to the bank's failure. Indeed, the mere request for credit from the central bank is generally taken by the market to be a signal that the bank is in trouble.

If the central bank does provide significant amounts of funding to a bank, providers of unsecured market funding may find it advantageous to run from the bank, particularly if there is some doubt as to the viability of the bank and/or the central bank's lending is short-term and/or non-renewable. Running from the bank allows the market participant to get out whole. Indeed, the longer an uninsured, unsecured market participant waits to take out its funds, the greater the potential loss such a market participant will suffer if the bank is put into resolution. As the bank increases borrowing from the central bank, its good assets will become increasingly

⁶ If the central bank lends solely on the basis of collateral and the supervisor regards the central bank's provision of funding as 'proof' that the bank meets threshold conditions, a bank can remain in operation as long as it retains unencumbered assets eligible for rediscounting at the central bank. This can be long past the point at which the bank falls below minimum capital requirements or the point at which the bank ceases to have positive net worth, particularly if the central bank progressively relaxes eligibility requirements. In other words, forbearance will occur, for the supervisor (perhaps at the behest of the political authorities) has confused liquidity with capital.

encumbered. This will leave less value available to provide recoveries to unsecured, uninsured creditors should the bank ultimately be put into resolution. So market participants need to make their own assessment of a bank's viability. To the extent that they continue to provide funds to the bank, they may wish to shorten maturities, demand collateral and/or raise rates to reflect the increase in risk.

Conclusion

In sum, reforming resolution will change the nature of prudential supervision as well. In particular, the market will take a heightened interest in how well supervisors perform their roles as monitor and minder. If resolution really does expose uninsured creditors to loss, providers of unsecured and uninsured funds will have an interest in assuring that

- supervision monitors banks accurately (for that will prompt timely intervention/resolution and lower loss given resolution); and
- supervision minds firms well (for that will lower the probability that resolution will be required).

So in a world of reformed resolution and increased market discipline, better supervision will lead to lower expected loss (and hence to lower funding costs). And that in turn may well lead firms to race, not to the bottom, but to the top.

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