



# Azure Kingfisher

A sharp eye on structured finance



# REGULATORY REFORM





The 3 Rs, a lawyers' paradise!

## **A. RULES, REGULATION, REFORM**





# G20 Cannes – *Nouvelles Idées?*

- Key words:
  - Bank's resilience (*Basel II-5 and III*)
  - Standard *OTC derivatives* traded on exchanges
  - Reduce reliance on *credit ratings*
  - Loss absorbency for *G-SIFIs*
  - Direct regulation of *shadow banking*



# G20 - continued

- Markets:
  - High frequency trading
  - Dark liquidity (dark pools?)
  - CDS markets under scrutiny
  - Global legal entity identifier (LEI)





# How to Keep Up?



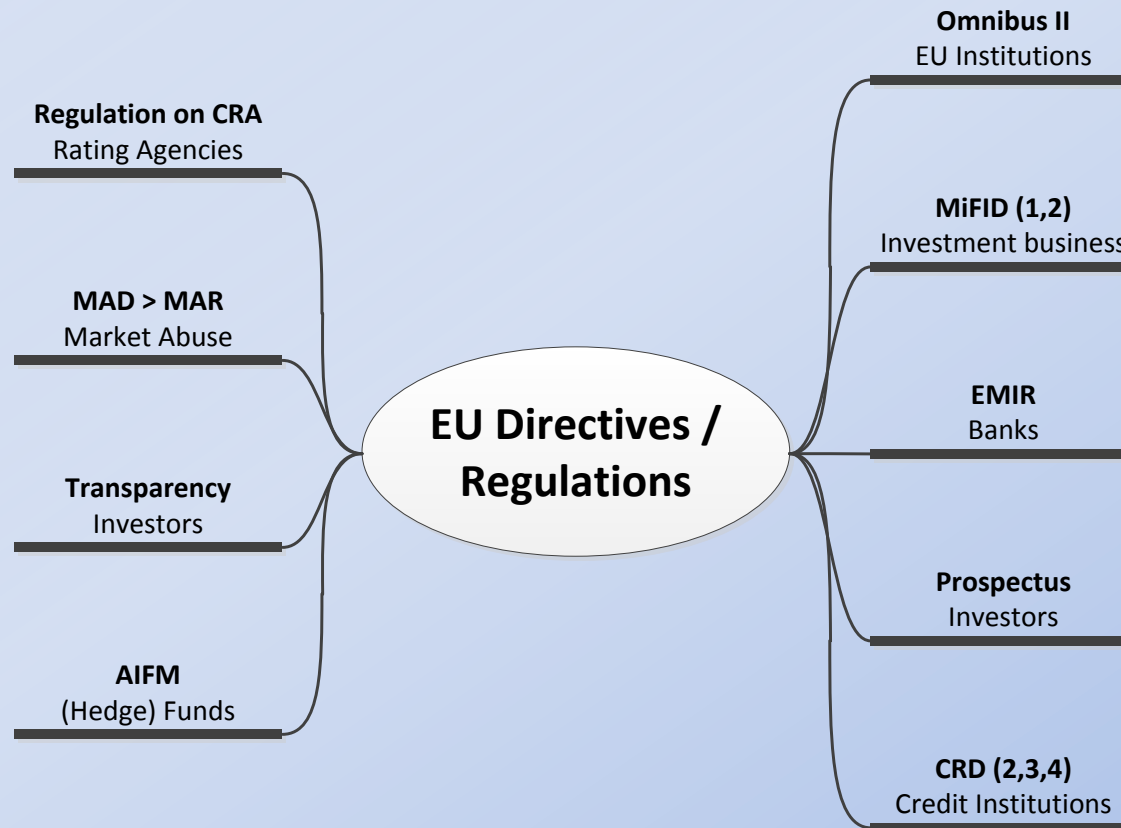


# Making Sense of It All

- Level 1: G20
- Level 2: BIS, IOSCO, FSB, FSF, FASB...
- Level 3: EU Directives, Regulations [US v EU]
- Level 4: Member States
  
- Who's driving, EU or local?
  - Divergence; shift towards harmonization



# (Partial) Overview EU Level



# And Plenty More...

- Transparency Directive, Solvency II, PRIIPs, Short Selling Reg, Securities Law Directive, Taxation of Financial Sector...



# Another way to look at reform

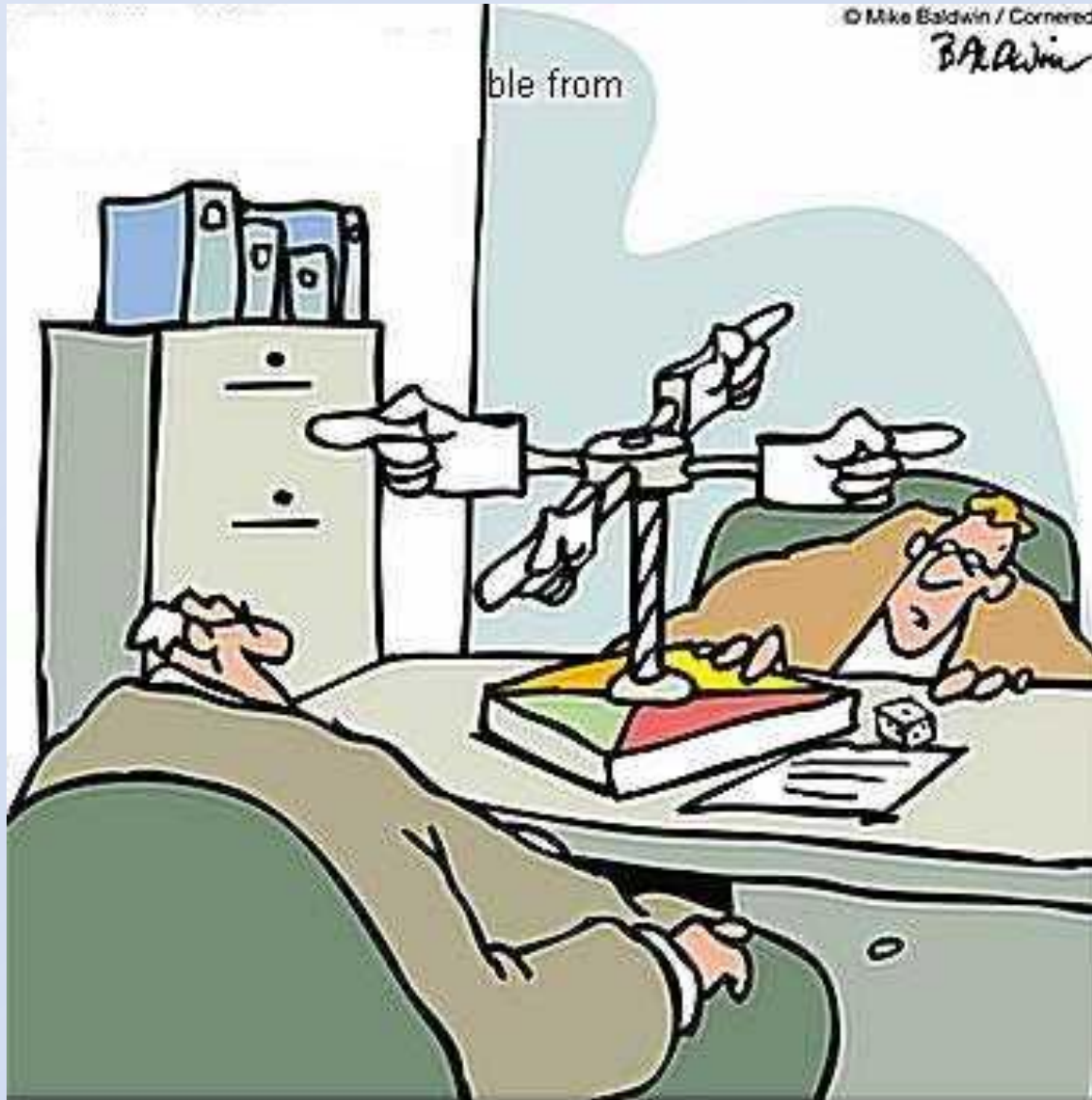


The blame game

## **B. CULPRITS**



ble from



“I call it The Blame Game.”



# 1. Supervisors





# Supervisors

- Faulted for being too lax (Iceland)
- Supervisory big picture:
  - *Living wills*, more powers to deal with banks going under, based upon English example
  - Powers to stop a crash in its tracks (*flash-crash*), short selling bans, systemic risk recognition, too big to fail
  - New supervisory framework to improve coordination



# Omnibus I

- ESRB (systemic risk)
- European Supervisory Authorities (ESAs), replacing previous advisory bodies, enhanced powers (investigate breaches of EU law, ban financial activities etc.):
  - EIOPA (Insurance and Pensions, replacing CEIOPS)
  - Banking (EBA, replacing CESR)
  - Securities and Markets (ESMA, replacing the CEBS – banking supervisors)



## 2. Banks



## 2. Banks

- No easy way out:
  - Higher capital requirements and various additional ratios (Basel III), including leverage ratio (but please go on lending...)
  - Reducing the arbitrage incentives for structured products (move away from risky products)
  - Remuneration, more supervision
  - Bank levy, OTC derivatives increased cost
  - Borrowers' demands in documentation (yank-a-bank, snooze-you-loose)



# CRD 2

- Implementation 31.12.10
  - Concentration: restriction on large exposures on a single group (25%)
  - Hybrid capital rules tightened > permanence, loss absorbency (farewell innovative tier 1)
  - (Much) higher risk weighting for re-securitisations (out)
  - Liquidity policies (Northern Rock)
  - (Cross-border supervision)



# CRD 2: 122a

- Skin-in-the-game rules for securitisation (122a)
  - Vertical, horizontal, first loss or randomly selected.
  - US: Dodd-Frank 941
  - Retention Statement in prospectus ('The Seller will retain a material net economic interest of at least 5%.')
  - Additional risk factor statement ('Regulatory initiatives may result in increased regulatory capital requirements.')



# CRD 4 (Basel III)

- Basel Committee Dec 2010
  - No more ‘gold-plating’
  - Quality of capital (no more Tier 3)
  - Increased capital (equity / tier 1 up)
  - Leverage ratio, anti-cyclical buffer
  - Liquidity coverage ratio / Net Stable Funding Ratio
  - Derivatives clearing > extra capital charge
  - Buffer for G-SIFIs
  - Large exposures: 35% increase risk weight (interbank concentration)
- Directive into force 1.1.13, full implementation 1.1.19





# Basel IV

- EBA 26.10.11
  - Banks required to build up temporary buffer against sovereign debt exposures reflecting *current* market prices
  - Core Tier 1: 9%
  - But *no* excessive deleveraging (*how?*)
- Deadline of 30.6.12



### 3. Rating Agencies



# CRA in the Crunch

- Faulted for the downgrades
  - Conflict of interest (issuer pays model / Stockholm syndrome)
  - Playing catch up with the market?
  - Ratings arbitrage
- ‘Between a rock and a hard place’



# Problems

- Over-reliance on ratings (quasi-regulators)
  - Investor mandates
  - Forced by legislation (e.g. Basel risk weights)
  - Proxy for investor due diligence
  - Trustee reliance (!)
- Cliff-effect
- Limited competition (high barrier to entry / WBS?)
- Lack of transparency (SF)
- Lack of accountability



# Rating Agencies

- Regulation:
  - Licensing
  - Conflicts of Interest
  - Liability
  - US: CRA Reform Act (2006 and 2009, including SEC rule 240 17g-5(a)(3)), Frank-Dodd (2010, driven by Abacus 2007 AC-1)
  - EU: Regulation on CRA (2009), amended 2011 (ESMA supervisor)



# CRA Regulation

- Examples:
  - 3<sup>rd</sup> party ratings (equivalence)
  - Disclosure of 5% revenue



# Licensing

- US: NSRO, disclosure
  - Frank-Dodd strengthened supervision by the SEC
    - Internal control and transparency
    - Special damages rules for CRAs, and much more
- EU: registration, operational standards
  - SF symbol added
  - IOSCO report on implementation (Feb 2011)





# Conflict of Interests

- US: SEC Rule 17g-5
  - Applies to issuer pays ratings for SF deals (covered bonds excluded)
  - All information provided to the hired rating agency by arranger / originator must be posted on a secured website, with access for non-hired rating agencies
    - NSROs turn table on originator to provide the same information to all hired NSROs
    - Killing dialogue
- EU: not followed; detailed governance and organisational rules



# Benchmarking

- SEC Rule 17g-7
  - Global application
  - ABS ratings report: description of the reps, warranties and enforcement mechanisms available to investors in respect of the relevant transaction *and* how such items compare with provisions included in issuances of similar securities
  - Interpretation: look at asset pool, security and remedies



# Liability (US)

- Before the crunch: plead the first amendment
- Post: Frank-Dodd:
  - Repeal of 436(g) Securities Act 1933, which exempted rating agencies from expert liability in respect of their ratings for a public offer. CRAs now face potential liability for material misstatements or omissions in any information (ratings) prepared
  - CRAs response has been to withdraw consent of the ratings for public uses



LONDON (Standard & Poor's) Nov. 10, 2011—As a result of a technical error, a message was automatically disseminated today to some subscribers of S&P's Global Credit Portal suggesting that France's credit rating had been changed. This is not the case: the ratings on Republic of France remain 'AAA/A-1+' with a stable outlook, and this incident is not related to any ratings surveillance activity. We are investigating the cause of the error.



# EU shake-up

- FT October 20, 2011, proposals on the table:
  - ESMA empowered to restrict or suspend credit ratings of countries undergoing bail-outs
  - Force issuers to regularly change its rating agency, in a bid to open competition and avoid conflicts of interest (3 years)
  - ESMA to develop *technical* standards in order harmonize rating scales and presentation of reports
  - Shareholders not to invest in more than one agency at a time



# Yesterday: drafts

- Draft amendment to CRA Reg (plus AIFM D)
  - Promote internal ratings for reg purposes
    - All banks (and many others, e.g. fund managers) required to make their own credit risk assessment
  - More information underlying the ratings
  - ESAs to avoid external ratings in guidelines (finally...)
  - Rotation: no CRA more than 3 years, and SF require 2 CRAs
  - More regular, transparent and reliable sovereign ratings.



# And More

- Network of smaller CRAs
- EURIX index
- Harmonize rating scales
- Civil liability: gross negligence or intent





# 4. Securities Markets

- Prospectus Directive (PD),
- Amendments:
  - Liability extended for summaries
  - (Professional investor barrier raised (E 100k))
  - 100 (instead of 150) (legal) person exemption
  - Publish prospectus on website



# Final Terms v Base Prospectus

- ESMA advice 4.10.11
  - Strict guidance (A,B or C)
  - No new algebra
  - Issue specific *summary* to be annexed to final terms
- Next: draft Regulation, and implementation  
1.7.2012?



# 4. Hedge Funds



# Hedge Funds

- Faulted for aggravating the crisis by short selling
- Regulation (EU: AIFM Directive)
  - Authorisation
  - Capital requirements (€300K if self-managed)
  - Minimum level of services and information
  - Business conduct requirements, organization
  - Leverage constraints
  - Conditions for control in companies
- (US: Dodd-Frank)



# Two Others: MiFID II

- Liquid derivatives to regulated market (and cleared), to bring 'dark pools into the light'
- ESMA & national regulators empowered to ban investment products
- Regulation of automatic trading firms
- Risk controls for *high-frequency trading* firms
- National regulators to demand information on derivative positions, reduce a position and limit ability to enter into commodity derivative position



# MAR (MAD II)

- Corporate liability accrues to legal persons for insider trading or market manipulation (including for failure to supervise a 'leading person' which has made the offense possible)



“We’ll get there when we get there!”

## **C. CONCLUSION**





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