

WHAT KIND OF REGULATION?

HANS TIETMEYER

MAIN CAUSES OF THE GLOBAL ECONOMIC AND FINANCIAL CRISIS

In previous contributions to this and last year's plenary sessions the causes of the global economic and financial crisis – which meanwhile is slowing, but still not fully overcome – were raised and analyzed several times. Last year I wrote an article called 'Globalization and the Present Crisis' in which I pointed to the following five facts as the main causes and amplifiers of the current crisis:

First, progressive opening and internationalization of financial markets as well as marked acceleration of this development through the increased use of new information and communication technologies since the 90s.

Second, erosion of previous national regulations and supervisory rules for financial institutions without the simultaneous development of an appropriate and adequate international regulatory system and efficient international cooperation in the application.

Third, increasing shift of banking activities from the more traditional buy-and-hold approach to an originate-and-distribute concept with certificates and increasing leverage effects. In particular, the escalating securitization and re-securitization often led to growing recklessness in terms of risk control and credit culture in the banks.

Fourth, in addition, amplified use of mark-to-market accounting and the growing practice of publishing results quarterly instead of annually led to increased short-termism and pro-cyclical effects in the financial sector.

Fifth, especially in the years before the outbreak of the crisis serious mistakes in monetary and exchange rate policies by some major industrialized and emerging countries not only led to large imbalances in the external balances, but also to excessive expansion of liquidity in many financial markets.

In addition to macro-policy mistakes, the encroachment of a behaviour skewed towards short-term results and bonuses as well as the insufficient development and application of new and internationally compati-

ble regulations for the supervision of financial institutions were important contributors to the crisis.

Despite recognition of these facts by various international bodies, there are still significant differences among, and even within, countries' approaches towards the actual content, scope, and particularly the necessary enhancement of regulation. This, however, is not surprising given the different traditions and the partially far-reaching consequences of debating new rules for the affected institutions and countries.

II. INTERNATIONAL INITIATIVES TO ADDRESS REGULATORY GAPS

Already at their first summit in Washington in November 2008, the leaders of the G20 jointly stated: 'Policy-makers, regulatory and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions'.

As early as 2007, the international financial crisis highlighted particular political and regulatory deficiencies in two ways:

First, the increasing openness of borders and the liberalization of international payments and capital raised the question of an international coordination of rules and early cooperation between national supervisors of financial institutions.

The Basel Committee on Banking Supervision, which was established by the central banks of G10 countries in 1974 and in which banking supervisory authorities are also represented, is essentially limited to the development of common guidelines and rules for the supervision of the participating national supervisory authorities of the G10 countries. Although the agreed frameworks, Basel I and Basel II, have also been partially accepted as a guideline by other countries, time frames and details of the application both inside and outside the G10 were often quite different. In particular, the application of Basel II has been delayed in the USA for a long time.

Second, in the past, the Basel framework as well as the monitoring practices of most countries focused primarily on rules monitoring activities of individual institutions only. Systemic problems affecting the stability of the financial system were not always timely and sufficiently taken into account.

In particular, significantly increased importance of systemically important financial institutions, a high degree of national and international integration of the banking industry, herd behaviour of financial intermediaries,

increasing product and marketing innovations in the national and international financial markets and traditional *micro-prudential* supervision of individual banks increasingly require an accompanying *macro-prudential* orientation in order to align to more systemic problems. This was recognised in as early as the spring of 1999, and on my personal recommendation, G7 finance ministers and central bank governors created the so-called Financial Stability Forum (FSF). It had the following triple mandate:

- to help identify incipient vulnerabilities in national and international financial systems. Concerted procedures are needed for a better understanding of systemic risk and to formulate effective financial, regulatory and supervisory policies to mitigate them;
- to improve arrangements necessary to ensure that international rules and standards of best practice are developed and implemented and that gaps in such standards are effectively identified and filled; and
- to ensure that consistent international rules and arrangements apply across all types of significant financial institutions.

The FSF, which includes both the representatives of central banks and supervisory authorities, representatives of governments and relevant international organizations, started its activities with a secretariat at the BIS in Basel before the new millennium. Unfortunately and contrary to my suggestion, under U.S. American pressure, initially it was confined to the G7 countries. Moreover, under Anglo-Saxon influence it was too limited to general discussions and opinions, and also lacked the possibility to promote adequately the development of specific solution concepts.

In light of the current crisis, the G20 summit in London strengthened the previous G7 Financial Stability Forum (FSF) in autumn 2008 and changed it into the G20 Financial Stability Board (FSB).

Thus both membership and task were considerably upgraded, a development which corresponds largely with the original idea for the FSF. It is already perceptible today that the FSB, chaired by Mario Draghi (Banca d'Italia), together with the International Monetary Fund (IMF) represent the principal international promoters and stimulators for the necessary evolution of national and international regulations for the financial sector.

These international efforts for the development and coordination of the control systems are very important – and this is in particular true for common economic, financial and monetary areas, such as in Europe. However, in the world of today and probably also of tomorrow, the responsibility for the practical design and application lies foremost on the national level. In order to avoid dangerous erosion and circumvention through regulatory arbitrage, national regulations and controls should be sufficiently compatible.

III. CURRENT REFORM AGENDA FOR THE ENHANCEMENT OF THE SUPERVISORY FRAMEWORK

The reform agenda got going in the meantime currently focuses mainly on the further development and extension of the existing prudential rules. Hereby, the primary goal consists of the strengthening of the resilience as well as the limitation of high-risky activities of the regulated financial institutions.

However, it may not be overlooked that the so-called Basel II framework has already intended a row of improvements. Unfortunately, these improvements agreed a long time ago (such as the banning of the use of non-consolidated off-balance-sheet items like so-called special purpose vehicles), have been transferred into national law by several countries only after the outbreak of the crisis, or even not at all.

In addition, on behalf of the G20 summit, some additional enhancements of the regulatory framework are considered by supervisory authorities or are already being implemented. Below are some references about them.

Strengthening the capital base of financial institutions

Minimum capital requirements have been one of the key elements of the so-called Basel framework for banking supervision for a long time already. However, due to the experiences of the recent crisis, these requirements are intended to be recast and enhanced, at least partially. To enhance the resilience of the financial institutions, banks will be required to hold higher regulatory capital in the future, both in *quantitative* and *qualitative terms*. Hereby, the insertion of countercyclical capital buffers above the minimum requirements is also foreseen. Moreover, the introduction of a so-called systemic risk charge will be considered in order to internalize the positive externality of systemic relevance for the systemically important financial institutions in an appropriate manner (see also chapter V). Stricter capital requirements together with an enhanced coverage of risk exposures could counteract excessive leverage and risky business models of banks. However, to minimize the risk of a credit crunch, especially in the current economic recovery phase, the revision of these minimum requirements has to include an adequate transition period. The preparatory work for the revision of minimum capital requirements is progressing in the meantime. Therefore, a new version of the Basel II rules can be expected by the end of this year.

Improvement of the coverage of counterparty credit risks

Being part of the necessary risk control procedures, particularly the capture of so-called OTC derivatives exposure has proven inadequate in many cases. To improve this coverage, it is foreseen to standardize these derivatives as far as possible, to let them trade in the future via thoroughly supervised central counterparties exclusively and to create databases for these transactions (so-called trade repositories) with the aim to provide supervisors with an appropriate information base. Furthermore, the Basel Committee has suggested enhanced minimum capital requirements of trading book exposures (alignment with the banking book) and securitization exposures.

Restrictions regarding the leverage ratio

Currently, the mandated working groups are also discussing the question of whether the financial institutions should be obliged to maintain a certain leverage ratio in addition to strengthening their own capital base. Thus, such a rule seems to make sense taking into account the experience of the past. However, its explanatory power and effective leverage-limitation are still debated. In addition to this, rules limiting the leverage ratio have to refer to comparable accounting standards to ensure a level playing field. Therefore, besides the improved coverage of individual exposures, whether or not an overall ceiling on the allowable leverage will be introduced is not yet in sight.

Development of minimum liquidity requirements

The recent experiences during the crisis – especially in the context of extensive temporary dysfunction of the money markets – have also shown the urgent need for an adequate provision of liquidity of financial institutions. This will have as consequences, in particular, increased requirements regarding the internal control of the rollover risks, which also has to be checked by improved stress tests. At the same time, control of the so-called systemic liquidity risk that originates endogenously, if, for instance, even fundamentally solvent institutions are forced to liquidate their assets, is part of the consideration. Here, too, a larger liquidity buffer or a reduction in the maturity transformation risks is necessary. Currently, intensive preparatory work is being conducted to determine these minimum standards, which would ensure appropriate liquidity reserves.

Principles for sound compensation practices

In recent decades, the practice of an increasingly short-termist remuneration oriented only in profits and particular interests of some bankers and traders and applied in many financial institutions has led to the danger of a bias in risk assessment and short-termism in substantial parts of the business activities of the banks. Therefore, on behalf of the G20 summit, new principles for sound compensation practices have meanwhile been developed by the FSB. Their implementation and application in the G20 countries is currently under review by the FSB in a so-called peer review. On this occasion, the main issue consists of a limitation and longer-term focus of bonus payments to managers and traders.

Registration and transparency of the activities of credit rating agencies

In connection with the critical development of single financial institutions and financial products, the activities of credit rating agencies have come under criticism, too. The reproaches have focused mostly on the assessment practices which have been deemed often insufficiently transparent, as well as on the alleged conflicts of interest in the case of advisory activities of rating agencies. Now, after the agencies themselves have published codes of conduct for the future, most countries seem to be satisfied with an official registration of credit rating agency at least temporarily.

Restriction of proprietary trading by banks

In particular in the USA, another long-lasting debate has flared up again about the consequences of the repeal of the so-called Glass-Steagall Act which requires the separation of commercial banks and investment banks. In January 2010, President Obama, with reference to Paul Volcker, did not propose a complete return to the former principle of separating banking business, but rather a ban on proprietary trading and own investments in hedge funds or private equity funds for those banks profiting from national deposit guarantee schemes. In this manner, a potential conflict with customer interests should be avoided. Whether and to what extent this so-called 'Volcker-rule' will be binding in future in the USA or even worldwide, is not yet clear. Both in the USA and internationally, intensive controversy is currently in progress.

Change of provisioning practices

The aimed correction of a number of individual accounting standards is part of the lessons of the financial crisis. It has appeared that, in particular, the strict market value orientation has considered crisis aggravating. With the objective to give accounting rules a more stabilizing role, the use of, for instance, expected, instead of previously only allowed, incurred losses will be made possible. This transition is likely to have positive forward-looking, earning-smoothing effects and could contribute to stabilize the individual institution and the entire financial system as well.

IV. MACRO-PRUDENTIAL TASKS OF BANKING SUPERVISION AND REGULATORY POLICIES

One of the main lessons of the crisis is to focus on the systemic dimension of financial stability by means of macro-prudential supervision. Although the discussion about the dimension, nature and measures of the macro-prudential supervision is only in preliminary stage, it must also be continued and brought to some possible concrete common conclusions.

The traditional supervisory approach needs, in particular, a stronger emphasis on systemic views. This also includes the recognition of the fact that maintaining the stability on the individual financial institution level only – which is in the focus of traditional micro-prudential supervision – is insufficient to ensure the sustainable stability of the overall system as well.

Even rational behaviour of individual financial intermediaries may lead – particularly if they act in a similar manner – to contagion and second-round effects at the system level, causing high overall costs. As important as solidity and responsibility (liability) of the single financial institution for the sustainable preservation of a sound financial markets functioning are, the systemic risks are thus not yet sufficiently under control.

Micro- and macro-prudential supervision follow different approaches. Banking supervision looks at the risk factors as widely exogenous risk. It aims to limit the risk exposures of individual financial institutions by single rules (level playing field) to make them as resilient as possible. Linkages with other parts of the financial system are only considered primarily provided that they show immediate risks (in terms of market, credit or counterparty risk) based on contractual relationships. In contrast to this, the macro-prudential supervision gives priority to systemic risks. These are above all those risks which arise from the dynamic interactions within the financial system

itself as well as from feedback effects between financial and real economy. In addition, these risks encompass the varied contagion risks and vicious circles, such as increase of leverage or limited access to liquidity.

Compared to the micro-prudential supervision, in particular to solvency oversight, it is difficult to outline the remit of the macro-prudential regulation precisely *ex ante*. A single financial institution may collapse in the liability-based market economy, whereas a breakdown of the entire financial system by escalating contagion effects must be prevented in the public interest. While micro-prudential regulation shall secure primarily the permanent functioning of individual institutions, the macro-prudential objective of regulation consists, above all, in the permanent preservation of the stability of the financial system. Moreover, for this task, not only are supervisory authorities in charge, but central banks, governments and legislators competent for macroeconomic policy are as well. Sustained financial stability can be achieved only by a consistent combination of a regulatory framework and policy-making, both stability-oriented, whereas the influence of technological and international changes has to be taken into account.

V. TREATMENT OF SYSTEMICALLY IMPORTANT BANKS

Beside the appropriate exit or reversal strategy of the very expansionary monetary and fiscal policy designed to overcome the financial crisis, the focus of macro-prudential discussion currently lies on one question: How can the moral hazard problem, which has become obvious after the public bail-out of so called systemically important banks (too-big-to-fail or too-connected-to-fail), be solved in a way that influences the future behaviours of these TBTF institutions?

The public bail-outs of so many systemically important financial institutions during the recent crisis have damaged considerably the personal liability in the financial world as one of the fundamental principles of the market economy. Moreover, the incentive for market participants has been reduced to exercise their disciplinary monitoring-functions over their counterparties.

The so-called Volcker-rule to limit proprietary trading for commercial banks, proposed by President Obama in January 2010, is still highly controversial in public debates and would certainly alleviate this problem, but may solve it insufficient. Obama has therefore also proposed an additional limitation of risk accumulation as well as an additional tax for the largest financial institutions.

In addition to these US-American tax proposals, there are also a number of other proposals and suggestions. They encompass the obligation for large and systemically relevant banks to build up larger capital buffers and/or to establish and finance a joint stabilisation fund (with or without public participation or guarantees) as well as the obligation of these banks to elaborate a so-called 'living will' for an orderly liquidation and the introduction of specific and earmarked taxes. They are already being discussed in some European countries, whereas their concepts range from a transaction tax (Tobin approach) to a functional tax (Pigouvian approach).

The FSB's mandate is to present these and other outstanding issues in October 2010 as joint proposals to the G20 leaders. The current discussions in the expert groups of the FSB deal with a long list of subjects that concern the following issues:

- targeted capital;
- leverage and liquidity requirements;
- improved supervisory approaches;
- simplification of firm structures; and
- strengthened nationwide and cross-border resolution frameworks and changes to financial infrastructure that reduce contagion risks.

This long list of issues makes it clear that there will hardly be simple and generalized solutions for coping with systemic problems that have become obvious during the crisis. On the one hand, the functioning of financial markets may not be jeopardized. On the other hand, privileges for certain financial areas have to be excluded and at the same time negative undesirable trends and dangerous escalations have to be prevented.

VI. FURTHER DEVELOPMENT OF RULES AND REGULATIONS AS A PERMANENT TASK

At present, the regulatory framework of financial markets is in a dynamic development, both at national levels as well as in international forums. However, we are still far away from a common and internationally viable and future-oriented regulation. In addition to the already elaborated and agreed further developments, which now only have to be implemented, there will no doubt be additional innovations in the coming years. That is the reason for the agreement and implementation of the new regulation to be realized only in a longer process.

Nonetheless, the experiences of the recent crisis have highlighted the importance of national standards as well as their international comparabil-

ity and internal consistency. It is vital above all, that the fundamental orientation must be right. Neither should the principle of liability of capital and management be undermined nor the necessary transparency be compromised. At the same time, an 'over-regulation' endangering the economic efficiency of the financial industry has to be avoided.

Given the international nature of financial markets, beside the substantive orientation of the framework, another key and difficult problem remains to be solved: Although today a large part of the financial activities already takes place internationally, the authority for determining the regulatory framework and its application lies primarily at the national level, and will also do so in the future. Nevertheless, a large part of the supervision today already takes place in so-called supervisory colleges consisting of national authorities responsible for the activities of the respective financial institutions. This cross-border cooperation, which is already well established especially in the EU, is valid for developing it further in the near future and for using it increasingly beyond the EU. Only then can the agreed frameworks be effectively monitored and dangerous contagion effects be prevented.

Only the future will show whether there will also be a move towards joint supervisory authorities, at least in single currency unions, such as in the euro-area. Indeed, a European Systemic Risk Board (ESRB) will be established in the near future in the EU, with a secretariat located at the ECB. Moreover, three European supervisory authorities for banks, insurance and securities markets will be created. Nevertheless, at least so far, also in the EU, the readiness to set up a supranational, last-responsible supervisory authority for financial institutions has not been given yet.

This applies a fortiori to the global level, where there is now hardly a readiness to joint supranational regulations and controls despite the greater willingness of major nations and regions to cooperate in the development of consistent frameworks. This is expected to remain the same for the foreseeable future. In any case, we are certainly still far away from a global financial supervisory authority, and the desire to have one is at least questionable.

Nevertheless, in my opinion, the transformation of the G7 Financial Stability Forum in the G20 Financial Stability Board for the development of common rules is an important achievement. The IMF, consisting of virtually all countries with, however, very different quota shares, would probably be overwhelmed because of the formal decision rules applicable in this task. That is mainly true because the USA almost strictly have a sole veto on account of their high quota share.

Monitoring the implementation of the rules agreed among the G20 could be effectuated probably only by an extensive and neutral transparency of the application practice. In addition to the currently developing practice of so-called peer review by the FSB, in my opinion, the IMF could and should contribute to the monitoring of the implementation of the agreed frameworks. In my view, the IMF could also use its so-called annual 'Article IV – consultations' to check the practical application of the framework agreed by the G20 and to publish its findings in its reports, with no need to change the Articles of Agreement.

Such periodic review and publication would release, in my opinion, useful pressure on effective implementation and enforcement of the agreed frameworks. The latest IMF's internal debate on current and future publication practices of the Fund has shown, however, a certain reluctance to further transparency of the IMF's activities precisely on the part of some representatives of major emerging economies. Obviously, they fear the excessive influence and pressure from the developed countries. Nevertheless, I think the inclusion of the regulations governing financial institutions and a periodic extensive publication of the results would be sensible and useful.

Both the international agreement on an adequate framework as well as the control of its national implementation and application by an appropriate transparency are necessary.

However, there will not be simple nostrums also on this occasion. The process of international cooperation for the rule-making itself as well as for the implementation of the rules is still on a learning curve which must remain open to new and better solutions.