

crisisresponse

PUBLIC POLICY FOR THE PRIVATE SECTOR

The Reform Agenda

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This is the second in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

Charting the Future of Financial Regulation

The crisis has prompted a shift toward a tighter and more macro-prudential approach to financial regulation. But the reform agenda still needs to address the role of supervisory (rather than regulatory) failures, while the institutional arrangements needed to implement the new framework remain to be worked out. For most emerging economies, the existing reform agenda—developing institutional and legal underpinnings for the financial system and promoting financial access—remains valid. But for those characterized by weak financial oversight structures and more volatile economic cycles, adopting capital buffers as part of a macro-prudential regime may be a useful complement.

The ongoing crisis has reaffirmed some fundamental tenets of financial sector policy making, but it has prompted a rethinking of others. While radical reforms should not be rushed in the middle of a crisis, countries and the international community have already proposed a broad range of new measures (box 1). Reforms that have been announced or are under debate can be grouped into three thematic areas: financial regulation, market infrastructure, and financial supervision.

Financial regulation

In the area of financial regulation, attention has focused mainly on macro-prudential regulation, although reforms in micro-prudential regulation, financial safety nets, and consumer and investor protection rules are also under way.

Macro-prudential regulation

Many experts believe that a major cause of the crisis was excessive risk-taking by market participants due to perverse incentives, pervasive conflicts of interest, and inaccurate measures of financial risk exposures. Compounding the failures by market participants was the inability of the authorities to contain the buildup of risks across the financial system. This inability stemmed from an excessive prudential focus on individual financial institutions, inadequate tools for analyzing systemic risks, and gaps in supervisory information and in the regulatory perimeter.¹

As a result, the most important regulatory change that has emerged from the crisis is the development of a macro-prudential framework that focuses on factors affecting the stability of



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Box **G-20 commitments on regulatory reform**

1 Gathered in London in April 2009, G-20 leaders committed to the following main regulatory measures in their Declaration on Strengthening the Financial System.

Financial Stability Board

- Establish, as a successor to the Financial Stability Forum (FSF), a new Financial Stability Board with greater capacity, expanded participation, and a stronger mandate for promoting financial stability

International cooperation

- Complete the creation of supervisory colleges for significant cross-border firms in 2009
- Implement the FSF principles for cross-border crisis management
- Support efforts to develop an international framework for cross-border bank resolution

Prudential regulation

- Maintain current international standards for minimum capital levels until recovery is assured, but then strengthen them
- Once recovery is assured, increase buffers above regulatory minimums, enhance the quality of capital, and develop guidelines for the harmonization of the definition of capital and for minimum capital levels internationally
- Implement recommendations to mitigate procyclicality, including anticyclical buffers
- Supplement risk-based capital requirements with an appropriate leverage ratio
- Improve incentives for risk management of securitization
- Progressively adopt the Basel II capital framework in all G-20 countries
- Develop a global framework for promoting stronger liquidity buffers at financial institutions

Scope of regulation

- Amend regulatory systems for macro-prudential risks and develop suitable tools for controlling such risks
- Ensure that national regulators are able to gather relevant information on all material financial institutions, markets, and instruments to assess systemic risk
- Produce guidelines for assessing whether a financial institution, market, or instrument is systemically important
- Require that hedge funds be registered and subject to oversight, including through disclosure to supervisors
- Require that institutions with hedge funds as counterparties have effective risk management
- Establish central clearing counterparties for credit derivatives that are subject to regulation
- Regularly review boundaries of the regulatory framework and promote good international practices

Compensation

- Endorse and ensure significant progress in implementing the FSF principles on pay and compensation in significant financial institutions by the 2009 remuneration round
- Require supervisors to monitor firms' compensation policies and intervene where necessary

Tax havens and noncooperative jurisdictions

- Encourage all jurisdictions to adhere to international standards on combating tax evasion, money laundering, and terrorist financing
- Develop a toolbox of effective countermeasures for noncooperative jurisdictions

Accounting standards

- Reduce the complexity of standards for financial instruments and improve standards for provisioning, off-balance-sheet exposures, and valuation uncertainty
- Strengthen accounting recognition of loan loss provisions by including more credit information
- Achieve clarity and consistency in the application of valuation standards internationally
- Make progress toward a single set of global accounting standards
- Improve the involvement of stakeholders in the process of setting accounting standards

Credit rating agencies

- Subject all credit rating agencies whose ratings are used for regulatory purposes to oversight that includes registration and is consistent with the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals
- Ensure that national authorities enforce compliance by credit rating agencies and require changes to their practices when needed
- Require that credit rating agencies differentiate ratings for structured products and provide full disclosure of their ratings track record and the information and assumptions underpinning the rating process
- Review the role of external ratings in prudential regulation and address any adverse incentives

the entire financial system—in contrast with the traditional emphasis on micro-prudential regulation focusing on individual financial institutions. Macro-prudential factors stem from the business cycle (time dimension) and from financial institutions that are “too big to fail” and links between different parts of the system (cross-sectional dimension).

The time dimension can be addressed through measures to mitigate procyclicality, a term referring to the complex dynamic mechanisms through which the financial system can amplify fluctuations in the business cycle and breed financial instability. Such measures would include raising systemwide capital levels as well as introducing countercyclical capital buffers, potential adjustments in the Basel II capital framework to dampen excessive cyclicality, tougher loan loss provisioning rules (such as earlier identification of and provisioning for credit losses, or anticyclical provisions like those in Spain), and greater use of quantitative monitoring indicators or constraints on margin and leverage (such as the leverage ratio used in the United States and Canada).²

The cross-sectional dimension can be addressed through measures to reduce systemic risk stemming from the size, illiquidity, leverage, and interconnectedness of financial instruments, institutions, and markets. Such measures would include expanding the regulatory perimeter to capture all systemically important financial institutions, increasing supervisory scrutiny and stress testing for such institutions, tightening liquidity requirements to address the negative feedback loop between deleveraging and loss of liquidity that has been observed in the financial crisis, and reducing counterparty risks from financial market links (such as by creating clearinghouses and using organized exchanges for credit derivatives). Other reforms in financial supervision (such as setting up supervisory colleges for significant cross-border firms) and in market infrastructure (such as improving accounting and governance standards) are also intended to support these macro-prudential objectives.

A few commentators have gone beyond these measures. Some have proposed, for example, that large, complex financial institutions be explicitly charged—through additional capital

requirements, taxes, or compulsory purchase of insurance—based on their contribution to systemic risk (Acharya and Richardson 2009). Others have proposed introducing additional, institution-specific capital requirements in the Basel II formula based on contribution to systemic risk (Brunnermeier and others 2009). Still others have called for a return to a narrow banking model that separates commercial and investment banking activities. Such measures are unlikely to be adopted without the broad consent and coordinated effort of large developed economies.

It remains unclear whether the macro-prudential measures outlined above will actually be implemented, how they would apply to systemically important nonbank financial institutions, or what their role relative to monetary policy would be in “leaning against” bubbles. Unless accompanied by additional systemwide responses, such measures would probably mitigate, but not eliminate, the buildup of bubbles. Systemwide responses could be structured either as rules-based laddered triggers (based on objective parameters such as credit growth or asset price increases) or by giving relevant authorities the discretion to tighten up if existing measures do not work.

On balance, it is likely that a macro-prudential framework will require significant discretion, which has implications for the design of appropriate institutional arrangements (see below). In any case, as the current crisis has shown yet again, rules can be—and often are—overridden during bad times.

Micro-prudential regulation

Although the buildup to the crisis took place in jurisdictions operating mostly under the Basel I framework, the crisis has nevertheless intensified the debate on the adequacy of Basel II, particularly the reliance on credit rating agencies and on banks’ internal risk management models. Even so, regulatory authorities in many countries remain determined to proceed with its implementation. Agreement has already been reached on measures to strengthen elements of the framework, such as tightening capital charges for securitized and trading book exposures under Pillar 1. In addition, the quality of capital was

confirmed as an important issue for review given the financial markets' focus on common equity as an indicator of banks' financial strength in the crisis.

Pillar 2, on the supervisory review process, has clearly emerged as the most critical component of the framework, since it offers the discretion to go beyond Pillar 1 requirements by introducing additional measures. Even if not originally envisaged, such measures could potentially include those with a macro-prudential orientation. Differences in the measures that different countries need to adopt call for extensive use of Pillar 2. But this approach risks a "race to the bottom," in which policy makers decide not to introduce certain measures out of fear of placing their domestic banking industry at a competitive disadvantage.

Pillar 3, on market discipline, has the least understood and most poorly defined objectives. By focusing exclusively on transparency and disclosure, it implicitly assumes that the market already has the ability to use information effectively to exercise discipline. But the crisis has shown how complacency and herd behavior can cause market participants to ignore warning signals when "everybody else is doing it"—and how attempting to impose discipline in the middle of a crisis (as in the case of Lehman Brothers) can be counterproductive. The crisis has also shown that market discipline can be a fairly crude *ex post* instrument.³ A major rethinking of its role and limitations as a prudential tool is still needed.

Financial safety nets

Deposit insurance coverage and "lender of last resort" facilities have been significantly expanded during the crisis, raising the question of longer-term changes to their design. Some changes already introduced may become permanent, such as higher ceilings for deposit coverage and the elimination of the coinsurance component. But the interplay between the new macro-prudential framework and safety net design—in particular, how to clearly demarcate the boundaries of safety nets under a broader regulatory perimeter and how to price safety nets appropriately—is still undefined.⁴

One of the main issues raised by the crisis has been the lack of an appropriate insolvency

regime that would allow systemically important financial institutions (particularly noninsured depository ones in the United States, such as bank holding companies, investment banks, and insurance groups) to be wound down efficiently and with minimal disruption to financial markets. The lack of such a regime has stymied the ability of the authorities to take over large and complex financial groups deemed too big to fail. The authorities have been forced instead to arrange takeovers by stronger rivals or to undertake ad hoc interventions in order to keep such financial groups alive. Some countries (such as the United Kingdom) have introduced special bank insolvency frameworks, while work on the cross-border resolution of complex banking groups is ongoing.

Consumer protection and regulation of market conduct

The crisis has exposed significant failures in the framework governing the relationship between financial institutions and their customers. There have been numerous instances of mis-selling of financial products to poorly informed households (whether subprime mortgages in the United States or foreign-currency-denominated loans in Eastern Europe) and of complex structured products to pension fund trustees who did not understand the risks. In response to the failures in financial education and consumer protection, several countries have already tightened their standards—for example, in information disclosure, dispute resolution, and personal data protection—although there has been no international consistency. In addition, some commentators (such as Warren 2008) and the U.S. Department of the Treasury (2009) have proposed the creation of a Consumer Financial Protection Agency to vet consumer-oriented financial products.

On the investor front, the Madoff scandal and the other Ponzi schemes that have emerged will likely lead to stronger oversight of investment advisers and stricter rules for the segregation of client funds through the use of independent custodians.

Market infrastructure

Reforms in market infrastructure include four distinct issues: accounting and financial report-

ing standards, the credit rating industry, payments and securities settlement systems, and bank governance and remuneration.

Accounting and financial reporting

The crisis has accelerated the process of revising accounting standards, particularly with respect to loan loss provisioning, consolidation of off-balance-sheet exposures, and fair-value accounting. The concept of fair-value accounting has been around for a long time and is considered an essential ingredient of market integrity. But some have argued that it has exacerbated the crisis by forcing institutions to value illiquid assets at artificially depressed prices. While the principle is clear (mark-to-market only when markets are liquid), the issue is how to define a liquid market and what to do when liquid markets become illiquid. Recent changes to accounting standards by the International Accounting Standards Board (IASB) and the U.S.-based Financial Accounting Standards Board (FASB) gave banks breathing space to deal with these problems by allowing them to reclassify financial assets from fair-value accounting obligations under certain conditions. But these changes came at the cost of greater opacity in financial statements and complaints by investors about inadequate disclosures and about political expediency in the timing of their introduction.

Additional financial reporting was proposed as a solution to earlier crises and will undoubtedly be proposed once again in the present one. But given the size and complexity of financial statements issued by financial institutions these days, there is growing concern about the value of more information and the ability of market participants to accurately process it. This is an area where more work by the relevant authorities is likely to be needed.

Credit rating agencies

While the corporate fraud scandals of the early 2000s led to reforms of a broad set of financial market “gatekeepers” (auditors, lawyers, underwriters), during this crisis regulatory attention has focused mainly on credit rating agencies. Some commentators have called for the authorities to eliminate the “hardwiring” of ratings in regulation, to revise the “issuer pays” model of compensation, and to enhance competition in

the ratings market. But the policy responses announced thus far have been more limited and pragmatic. They are intended to address the demonstrated failings of credit rating agencies in structured finance as well as to increase the oversight of these agencies to a level commensurate with the reliance on ratings for regulatory purposes. They include measures to improve the transparency and quality of the rating process as well as to restrict and manage conflicts of interest. As currently proposed, these measures are likely to do little to change the business model or the cartelized industry structure.

Payments and settlement systems

While payments and settlement systems have not featured in G-20 headlines, key elements of these systems are receiving greater emphasis as part of the longer-term agenda to develop sound financial market infrastructure. Reforms under discussion include the development of collateralized markets and central bank facilities for intraday liquidity provision, the settlement of foreign exchange transactions on a payment-versus-payment basis (as done by CLS Bank, for example), the design of clearing and settlement mechanisms for over-the-counter financial derivatives (particularly credit default swaps), the application of international standards for central counterparties, and the design of better oversight and coordination mechanisms.

Bank governance and remuneration

Bank governance arrangements are being reevaluated in the light of the crisis. International standard-setters have focused mainly—and perhaps excessively—on executive remuneration plans in an attempt to align incentive structures. They have developed principles on sound compensation practices and asked supervisors to monitor them.

More fundamentally, the failure of widely differing types of financial institutions indicates the difficulties of understanding today’s complex financial market risks. Regulatory solutions introduced to address this problem may include a larger role for risk managers as well as greater independence, stronger qualification standards, and greater involvement in risk management issues for board members.

Financial supervision

As with financial regulation, the crisis has prompted a fundamental rethinking of the supervisory philosophy. In addition, the crisis has brought to the fore lingering questions about home-host supervision, institutional arrangements for financial sector oversight, and appropriate design and governance of supervisory agencies.

Supervisory philosophy

Despite differing approaches, the supervisory philosophy in many developed countries had relied heavily on the self-correcting properties of markets and the self-interest of sophisticated financial institutions. The crisis has forced a fundamental reconsideration of this philosophy. The result will likely be more intensive supervision and greater questioning of financial institutions' business models and financial reporting practices.⁵

Home-host supervision

Home-host supervisory issues have come to the fore as a result of the internationalization of financial institutions' activities and the transmission of problems from the home jurisdiction across borders. The crisis has shown yet again the fundamental inconsistency of having internationally active banks while central banks (lenders of last resort), governments (fiscal support), and bankruptcy regimes remain national. For this reason, today's policy responses—such as the creation of supervisory colleges for significant cross-border financial institutions and the implementation of the Financial Stability Forum principles for cross-border crisis management—are unlikely to be sufficient in times of crisis. Moreover, implementing a macro-prudential framework would require distinct country-specific measures given the differences in the synchronicity of national credit and asset cycles.

All this is likely to result in host countries exercising greater authority in the future by “ring fencing” (to the extent possible) the domestic operations of foreign banks. And it will probably resurrect the debate over the supervision of branches versus subsidiaries.

Institutional arrangements

The implementation of a macro-prudential framework may lead to a rethinking of institu-

tional arrangements for financial sector oversight. Recent pronouncements by the international community do not clarify the roles of different actors in such a framework, and countries are likely to adopt different approaches.⁶ In addition, some countries may decide to fold supervisory agencies into central banks in an attempt to strengthen financial stability. International experience shows that such solutions do not necessarily improve supervision and may even backfire if not properly implemented.

Design and governance of supervisory agencies

While much of the public debate has focused on apparent gaps in regulatory authority, many of the failures actually occurred in financial institutions that were subject to extensive supervision. There is strong (though anecdotal) evidence that political interference and industry capture compromised the ability of supervisory agencies to take appropriate actions to avoid or minimize the crisis.⁷ This issue will become even more important if these agencies are called on to play a role in macro-prudential supervision, which is likely to involve an even greater amount of politically sensitive judgment and discretion. A credible framework would therefore be needed to ensure that supervisors have the incentives and skills to deal with bubbles, and to put into place mechanisms to protect them from undue external influence.

Conclusion

Until recently the policy responses to the crisis could easily be criticized as a “whack a mole” strategy that does not fundamentally change the way that financial regulation is conducted. Recent pronouncements by the G-20 and related work by the Financial Stability Forum represent an important, though not radical, shift toward a more cohesive framework focusing on tighter and more macro-prudential regulation with less trust in free markets.

The intellectual underpinnings of this regulatory shift remain unclear, since they represent an uneasy compromise between different schools of thought about the proper role of prudential regulation.⁸ Moreover, the reform agenda is still incomplete. It does not fully address likely key

causes of the crisis, such as the role of supervisory (rather than regulatory) failures. And much remains to be worked out on the institutional arrangements needed to implement the new framework and on actual country uptake, particularly as it relates to macro-prudential regulation. Experimentation is likely in the foreseeable future as countries try different approaches and increase the “ring fencing” of domestic financial systems. Whether the proposed reforms actually treat the root causes of the crisis, rather than just its symptoms, can be assessed only in the years to come. Indeed, the true test of the new framework will come only after the measures to control the crisis are fully rolled back.

What do these reforms mean for emerging economies? As in the past, these countries are likely to follow the new rules that will be decided by the standard-setting bodies, even though several of them—such as a revised Basel II framework—may not be relevant or even appropriate. For most emerging economies, the existing financial sector reform agenda—developing institutional and legal underpinnings for the financial system and promoting financial access—remains valid. But for those that are characterized by weak financial oversight structures and are prone to more volatile economic cycles, the adoption of capital buffers as part of a macro-prudential regime may be a useful complement to their current reform agenda.

Notes

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1. For a discussion, see Acharya and Richardson (2009); Brunnermeier and others (2009); de Larosiere Group (2009); FSA (2009); and Group of Thirty (2009).
2. For details, see FSF (2009).
3. For example, the demise of Bear Stearns before its arranged takeover has been attributed to the decision of other market players not to roll over short-term repurchase agreements with it, resulting in a rapid loss of working cash.
4. For example, in the United States the crisis-provoked temporary decision to insure money market

funds has resulted in recommendations (Group of Thirty 2009) that such funds be regulated as banking institutions rather than as collective investment schemes.

5. See FSA (2009) for a description of such an approach in the United Kingdom.
6. These include the central bank as the systemic stability regulator, as has been proposed in the United States (U.S. Department of the Treasury 2009); shared responsibilities between the central bank and a supervisory agency, as in the United Kingdom (FSA 2009); or the creation of a European Systemic Risk Council under the auspices of the European Central Bank complemented by a European System of Financial Supervisors to coordinate supervision in the European Union (de Larosiere Group 2009). See Nier (2009) for a discussion on the role of central banks in financial stability following the crisis.
7. Examples include weak institutional mandates and related resources (such as in the case of the Office of Federal Housing Enterprise Oversight, which supervised Fannie Mae and Freddie Mac); lack of new regulations on rapidly growing financial players and markets (the U.S. Federal Reserve in the case of over-the-counter derivatives); nonintrusive, “arm’s length” supervision (the U.K. Financial Services Authority); loosening of existing regulatory restrictions (the U.S. Securities and Exchange Commission, which relaxed leverage ratio limits for broker-dealers in 2004); and general leniency in the oversight of politically popular financial sector activities (residential mortgage financing, including subprime lending).
8. See, for example, de la Torre and Ize (2009) on the distinctions and policy implications for prudential regulation arising from the moral hazard, externalities, and uncertainty paradigms.

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