Prudential Regulation and Level Playing Field

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Financial instability

- **As the turmoil exploded, triggered by the sub-prime crisis, <u>uncertainty on risk allocation</u> impaired <u>market confidence</u>. Spreads widened, liquidity dried up, securitisation markets closed, asset prices started to fall.**

- **As these trends persist, bank balance sheets, valued at <u>mark to market</u>, shrink, leading to bail-outs or even failures, as in the cases of Northern Rock and Lehman Brothers. The risk of a global credit crunch is concrete ("innocent bystanders may be hurt").**

- **The <u>present regulatory rules</u>, focused entirely on risk-taking by individual financial firms, have failed to mitigate systemic risk.**

- **In the context of similar prudential requirements at global level (Basel II), US supervisory practices have been less effective at preventing financial instability.**

Financial instability: the roots are global imbalances and low real interest rates

- **A global mismatch between asset demand (a *savings glut,* in the words of Greenspan*)* and asset supply (*asset shortage* in the words of Caballero)**

High asset prices and the US imbalances sustainable for only so long time.

- **After the burst of the Information & Technology (IT) bubble and September 11th (with subsequent deflationary fears) central banks steered real interest rates to unusually low levels.**

Credit demand generated an excessive accumulation of risks and excessive financial leverage.

Financial instability: the flaws of the Originate-To-Distribute (OTD) business model

- Securitisation and financial innovation allowed banks to meet the increased demand for credit. **Opacity**

- Simplified information (ratings) allowed an enlargement in the plateau of potential buyers. **Conflict of interest, lack of competition**

- Originate-To-Distribute (OTD) business model. Securitisation techniques allowed the pooling of credit risks and their distribution to a myriad of investors (often in an opaque way), freeing capital and lowering the cost of funding. **Opacity**

- Supervisors (and central bankers…), no less than market participants, were progressively affected by an "information gap" as to the extent and allocation of risks.

Financial instability: in the Euro area is less severe

There are at least two promising aspects.

1. **The <u>European Central Bank's operational framework</u> proved crucial and more adequate than others at addressing the abrupt re-pricing of funding liquidity and asset liquidity risks.**
   I. <u>Effective tools</u>: the single list of collateral framework as well as the common features of flexible and huge liquidity operations'.
   II. The governance, which follows a federal approach: capability to act promptly and effectively.

2. **The business model of universal and commercial banks has proved to be more sound in the present circumstances. European banks were more cautious in adopting the OTD model and the securitisation market was more self-regulated and transparent. European banks have suffered mainly as far as they were exposed to "US" risks.**

Financial instability: the way out

- **The Financial Stability Forum (FSF) and the International Institute of Finance (IIF) have issued recommendations drawn from the lessons of the recent financial crisis.**

- **Some of these recommendations address the flaws in the OTD business model. We share the view that the issue of securitisation needs regulation aimed at aligning the interests of trading parties (originators, distributors and investors).**

- **“The recommendations of the FSF and the IIF will, at best, take care of the future, but not of the present, as they cannot undo the effects of the crisis. In the short term the industry is confronted with the need to re-establish confidence in financial markets. More radical solutions may be required to sever the link between funding illiquidity, the shrinkage of banks’ balance sheets and possibly a credit crunch.” (Spaventa)**

- **Paulson’s plan (Troubled Assets Relief Program):**

  - Huge and flexible, it could increase the chances of a gradual easing of financial tensions. (Although volatility will remain high for sometime.)

  - It highlights, in a dramatic way, the potential costs that can arise from inadequate regulation and supervision.

What are the lessons for prudential regulation and supervision from the recent financial turmoil? (1)

There are four possible answers:

Hypothesis 1: the present arrangements are basically fine, but some improvement is needed, especially on the prudential rules and the supervisory practices. The financial turmoil was generated by excessive accumulation of risks and by excessive leverage. The main culprit is the <u>ability of pricing and management risk</u> in financial institutions. (ESF, IIF)

The proposals follow three directions:

- **Improve the incentive system**: implementation of Basel II, strengthen the criteria of capital requirements, more transparency and better valuation criteria;
- **Enhance systemic resilience**: financial system infrastructure, procedures for domestic and cross-border crisis management; enhanced transparency and market discipline;
- **Reduce the pro-cyclicality of the regulatory system,** mainly through the flexibility already embedded in the regulatory framework.

What are the lessons on prudential regulation and supervision from the recent financial turmoil? 2

Hypothesis 2: the present arrangements proved to be inadequate at preventing the turmoil and need substantial changes. Present regulatory rules, focused entirely on risk-taking by individual financial firms, have failed to mitigate systemic risk. The focus of regulation should shift from the prudential practices of individual institutions to the health of the financial system as a whole (system-wide stress tests of those scenarios most likely to produce systemic stress, target highly leveraged institutions, whatever their legal status).

- Basel II should be reformed in order to avoid pro-cyclicality of capital requirements.
- Trade-offs between certain regulators' objectives (e.g. transparency, market integrity, investor protection, efficiency) *vis-a- vis* stability and liquidity should be addressed.

This hypothesis is backed by prominent economists (among them L. Summers, J. Eatwell & A. Persaud, C. Goodhard, M. Pagano).

What are the lessons on prudential regulation and supervision from the recent financial turmoil? 3

Hypothesis 3: the present arrangements are part of the causes of the recent turmoil and need to be radically reviewed.

This hypothesis has two variants:

a) **too much regulation.** The activities of regulators have undermined the power of competition to stimulate improvement in risk management.

'*It is by no means clear a priori why the public sector should be thought better equipped than the private sector to design a risk measurement framework for commercial banks. Moreover, it is clear that some of the important decisions about the framework, such as the minimum capital requirement… were based on no secure logical foundation, but were to a substantial degree arbitrary'. In addition, 'detailed regulation implies moral hazard.*'. (Allen & Wood, 2006).

b) **too much de-regulation.** Financial markets are structurally unstable (H. Minsky). The origin of the recent financial turmoil is the market deregulation and financial globalisation. This has opened the way to uncontrolled risk contagion, opaque markets, excessive concentration of risk, speculation, unethical behaviour and bubbles.

This hypothesis is particularly popular among politicians (including the German President and former IMF executive director Mr Kohler, the Russian President Mr Medvedev and the Italian Minister of Finance, Mr Tremonti).

→ Review the supervisory framework

The gap between the financial market reality and global regulation and supervision

- **Cross-border financial groups are a source of added value, may be a tool of financial stability (as far as they diversify risks, spread best practices and manage risks with appropriate governance), but may also be a source and a transmission channel of financial instability.**

- **While markets are global and cross-border financial groups are a reality, the international supervisory and regulatory system, developed in a piecemeal fashion, is now seriously out of date and inadequate. This makes handling the crisis harder.**

The gap between the financial market reality and EU regulation and supervision

The presence of cross-border financial groups has increased substantially in the EU:

- **In the EU, the 46 largest banking groups hold 68% of all banking assets (in 2001 the 41 largest banks held 54%).**
- **The share of these 46 groups' assets which is held outside the home country is 23%. For UCG the percentage, at the end of 2007, was 58.5%.**

"The current supervisory framework may limit the incentives to work toward a common EU-wide stability framework: a "scramble" for assets in a crisis, involving a large and complex financial institution, is likely to occur."

"The current legal framework does not ensure that national authorities take into account the effect of their decisions on the financial stability of another Member State. The lack of incentives to cooperate might be detrimental not only to creditors, but also to shareholders and employees of cross-border banks (and ultimately to tax payers in the instance of failure)." (IMF)

Supervisory convergence (level playing field) and financial stability

- Global bodies should be reorganised. The logic for this is that new international issues “are not easily soluble in any of the existing Committees acting alone”. In the short to medium term strengthening the FSF would be the best answer. (Davies & Green, 2008)

- “Supervisory convergence is a key objective not only from a financial integration point of view, but also from a financial stability perspective. (ECB)

- The federal regulatory framework within the US market, although ineffective in preventing the crisis, has been crucial in dealing quickly and effectively with the crisis management. Had the Euro-area found itself in a similar predicament, the fragmentation of supervisory responsibilities would have constituted a dangerous obstacle to the need to acquire full information and take rapid decisions with systemic consequences. The only area where this has proved possible in the Eurozone is in the area of liquidity provisions, where responsibility falls entirely with the ECB.

EU banking supervision: short term

In the short term, harmonisation in EU banking supervision could be enhanced by the convergence of supervisory requirements fostered by a stronger home supervisor in a college of supervisors which is enlarged to non-EU countries. The level playing field could be enhanced by convergence in supervisory practices.

There are three concrete measures under discussion:

a) the introduction of a European mandate in the statutes of national authorities (envisaged by the review of the CRD);

b) the extension of the tasks of the three committees of supervisors (envisaged in the Amendments on Commission decisions establishing the committees).

c) the establishment of colleges of supervisors (CRD revision). Furthermore, a Memorandum of Understanding (MOU) on cross-border financial stability, which describes the procedures for crisis resolution, has been signed by relevant authorities, including central banks, bank supervisors, and finance ministers and entered into force in July 2008.

These are important and feasible steps. However, even if they are introduced (as we hope), we will still be far from an integrated supervisory architecture adequate to the reality of European financial groups.

A legal basis to European cross-border financial groups

- **There is a need to give a legal basis to European cross-border financial groups. The *Societas Europea* is probably the right way forward: however, as currently in force, it has proved to be inadequate for financial groups and needs to be reviewed.**
- **One of the issues is to find an <u>appropriate balance between the interests of the parent company to effectively manage the entire group and to minimize its costs, and the interests of local stakeholders and minorities in subsidiaries</u>. The draft Solvency II Directive for insurance companies partially moves in this direction (group supervision).**
- **The Italian banking law appears suitable as it clearly allocates the responsibility and the consequent powers to the parent company, with respect to the pursuit of financial stability of the entire group. A proper definition of duties and responsibilities of the parent company versus subsidiaries would also ease the solution on the issues of burden sharing and deposit insurance.**
- **The Commission is now of the opinion that a clear definition of the role of an EU-wide banking group is needed in order to put efficient crisis prevention mechanisms and stabilisation tools into place. This will need changes in company law and in the provisions covering the liquidation of banks. The Commission will present a White Paper in June in order to elaborate what needs to be done to deal with financial crises in an efficient manner; it will include proposals on the definition of the banking group.**

Conclusions

- The present regulatory rules have failed to mitigate systemic risk.
- Authorities (monetary authorities, inadequate architecture of supervision), as well as financial institutions (OTD), bear responsibility for the crisis.
- To resolve the crisis it is necessary to sever the link between funding illiquidity and shrinkage of banks' balance sheets.
- The present arrangements of prudential regulation and supervision (including Basel II) need to be reviewed.
- More effective supervision is needed instead of excessive prudential regulation.
- The global and EU architecture of regulation and supervision needs to take into account to the reality of cross-border groups.
- In the EU there are short-term, feasible steps that need to be speeded up, facilitating possible a longer-term solution.
- It is necessary to give a legal basis to European cross-border financial groups.