Regulatory Lessons from the Crisis: A view from Down Under

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Outline

OECD Policy Framework

- Financial Landscape
- Policy Objectives
- Policy instruments
- System design and implementation

Questions

What were the main regulatory lessons from the crisis?

How do these align with the OECD framework?

How well are we implementing the necessary changes?

Four areas of lessons

1. Regulatory Architecture

All regulatory failures are ultimately failures of implementation – but architecture can support or inhibit sound implementation

The fragmented, industry-based, and competitive regulatory architecture in the US has been heavily discredited:

- Gaps: "regulatory system must be comprehensive and eliminate gaps in coverage" (Geithner) … iBanks / State insurance
- Jurisdiction shopping: "must end practice of allowing financial companies to choose their regulator simply by changing their charters" (Geithner)
- Arbitrage: Risk held at the point of lowest regulatory cost (holding of sub-prime in SIVs, CDS in insurance and hedge funds, etc)
- Consolidated supervision: Fed, SEC, OTS all weak
- Too much focus on trees and not enough on forest

Architecture (cont.)

Unified model of the UK FSA has also been criticised – but was it a failure of the model or of how it was implemented?

- Northern Rock highlighted the need to keep a proper balance between prudential and conduct regulation
- Bank failures highlighted the risks that attach to blurring prudential objectives with market development objectives – was FSA a captive of the industry?

The home/host regulatory model also failed to deliver

- Iceland put paid to the idea of unfettered cross-border branch banking
- International coordination was poor – and well below what had been expected – replicated domestic failures
- Countries closed ranks and sought to "protect their own"

Alignment with OECD Framework

IV. System design and implementation

A. Matching objectives and instruments to agencies

c. Assignment should:

i. Maximise synergies

ii. Ensure consistency of instruments

iii. Align incentives

d. Surveillance should avoid gaps and ensure completeness

B. Coordination and oversight

a. Agencies should coordinate through:

i. Committees and legal mechanisms

How are we doing?

US response

- Eliminate OTS
- Consolidated supervision (by the Fed) of Tier 1 FIs
- New Consumer Financial Protection Agency
- New Oversight Council
- Some step–up in market oversight and bank resolution

UK response

- If Conservatives get in – they will undo the FSA

International response

- Colleges of regulators
- Retreat into silos

Comment

Response has been totally inadequate – yet highly predictable

- Arguably not inconsistent with OECD Principles ....
- The problem is that financial conglomerates span industry sectors, domestic boundaries and international boundaries
- Unless agency authorities align with industry structures the regulators are massively handicapped in attempting to regulate the group – who regulated AIG Financial Products Unit?
- AIG perpetuated a massive capital “arbitrage” because the banking and insurance regulators were in silos
- We know what is needed …. But it is just too hard politically
- But let’s not pretend the problem has been solved

2. Prudential Tools and Methods

Prudential regulators have much about which to be modest

- Regulatory capital was inadequate
  - No international consistency
  - Market risk – (credit in TB and market in BB) plus 3 x 10 day VaR
  - Looking at the wrong part of the distribution
- Liquidity was inadequate
- Risk concentration – need to look beneath the surface
- Consolidated supervision was inadequate
- Pro-cyclicality in regulatory and accounting rules
- Regulatory cynicism beats a rulebook any day

Alignment with OECD Framework

III. Policy Instruments

B. Matching Instruments to Objectives

a) Instruments should address market failure

b) Balance efficiency and effectiveness

C. Principles of Regulation

a) Policy makers should anticipate risks

b) Regulation should be risk based

c) Regulation should align incentives

d) Should address all market failures

e) Should be consistent and competitively neutral

f) Enforcement high quality and transparent

g) International convergence

h) Coordination of regulation of international groups

How are we doing?

- Higher capital in general … how much is enough?
- Harmonizing the measurement of capital
- Simple leverage ratio … what does it really add?
- Market risk revisited
- Stress testing/living wills
- Liquidity – a whole new ball game
- Risk concentration – look beneath the surface
- Consolidated supervision – two steps forward and one step back
- Procyclicality – under review

Comment

Focus has been too much on the tools and rules – and not enough on methodology

- The "tinkering" with the rules has been more an attempt to bolster the impact of existing rules than to examine the efficiency and effectiveness of the tools themselves
- Need to start thinking outside the box – e.g. how to take proper account of tail risk
- Some harmonisation has been started but across sectors and international borders we are closing last year's stable gate after the horse has bolted
- We need to rethink what we mean by competitive neutrality
- Despite some good guidance in the OECD principles, the lessons on methodology do not appear to have been learned – we still look to rules and more rules as the solution - we need to regulate smarter, not more

3. Conduct Tools and Methods

Need to return to fundamental propositions that individuals and firms respond to incentives and act in their own interests

- Need to better address conflicts of interest:
  - Ratings agencies
  - Agents and advisors in the distribution chain
  - Institutions will obfuscate if allowed to
  - Incentive schemes drive outcomes
- Information “black (and “grey”) holes”
- Danger of regulatory capture (Markopolos)
- Blurring of the line between prudential and conduct

Alignment with OECD Framework

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How are we doing?

- IOSCO Code of Conduct for CRAs
- Heavy-handed one-off responses on compensation
- Calls for systemically important financial institutions, markets, and instruments to be “prudentially” regulated
- OTC derivatives to clear through central counterparties – in US draft legislation (11 Bills at last count)
- Originators to retain some residual risk in structured products

Comment

Some progress in recommendations but implementation still to come

- CRA Code does not resolve the conflict – do we need to go further?
- Regulatory response to remuneration policy is better balanced than political intervention – but the latter is understandable
- Not sure anyone knows exactly how to “prudentially” regulate (non-financial) systemically important financial institutions, markets, and instruments – remember the market failures
- OTC recommendations make sense for transparency – but also need to consider public information
- Need more focus on regulating the “food chain” in product delivery

4. Systemic Stability

The crisis showed that there is much more to systemic stability management than we thought:

- Systemically significant institutions are more than just big banks
- First challenge will be gaining access to the right information at both the aggregated and disaggregated levels
- Second challenge will be conducting relevant stress tests and using them to build crisis management strategies
- Third challenge will be keeping the trees separated from the forest (architecture will matter here – AIG yet again)
- The show stopper is cross-border certainty on liquidation (BCCI)

Alignment with OECD Framework

I. Financial Landscape

C. Surveillance and Analysis

b) Tools to monitor international trends and risks

c) Conduct market failure analysis

d) Share across borders

How are we doing?

- Much talk about "macro-prudential" oversight – but little light on exactly what this means – though it is not a new concept
- G20 talks about FSB and IMF collaborating to provide early warning signals
- National authorities are also developing FS units and tools
- Some countries are broadening the definition of systemically important institutions
- Some scenario analyses taking place
- Much discussion of the need for stronger resolution schemes for failed financial institutions but nothing definitive (e.g. G20 identifies weaknesses in cross-border resolution mechanisms but makes no explicit recommendation)

Comment

Don’t expect too much

- While there has been a lot of criticism of international agencies for missing the warning signs there is ample evidence that they were not blind
- Regulators were arguably more culpable for allowing the capital arbitrage that fueled the sub-prime market
- Even with perfect policies bubbles will still happen
- Leaning against a perceived bubble ex ante (either through monetary policy or regulatory intervention) is a tough call – whatever the merits
- Choosing among scenarios is equally difficult when it requires adjustment of policy
- Not much on information
- Not enough on resolving cross border failures

Closing Comments

- There have been many important lessons from the crisis
- There is much good guidance about how to respond – though it is sometimes too general
- It is still early days and we have yet to see which recommendations are translated into practice
- However, the early indications are that we will address the easy problems – not the important ones
- We will retain major weaknesses in:
  - Architecture – domestic and international
  - Alignment of tools with market failures
  - Supervisory methodology
  - Resolving conflicts of interest
  - But we will have more of everything …..