Rebuilding the Financial

What needs to be done to strengthen financial regulation and supervision?

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WITH the most dangerous phase of the financial crisis that began in 2007 seemingly past, attention is turning to strengthening the financial system. Policymakers are focusing on how to correct the shortcomings in the financial architecture that contributed to the outbreak of the crisis.

The crisis itself was caused by many factors, the relative importance of which will be debated for years. But whatever the underlying causes, public opinion rightly expects the regulatory environment to be reformed to prevent a repetition of the economic and human costs of the crisis.

There is a natural desire in such circumstances for "more regulation." What is needed, however, is "better regulation," a regime that can more readily identify emerging vulnerabilities, that can properly price risks, and that strengthens incentives for prudent behavior. In some cases, this will require additional regulation; in others, a better-targeted use of powers that regulators already have. When implementing reforms, it will be important to pursue the objective of a financial system that is not only stable, but also efficient and innovative.

It is convenient to divide the reforms into those that affect the institutional *coverage* of regulation, those that change the substantive *content* of supervisory rules, and those that modify the *structure* of regulatory oversight bodies.

Widening the net

Traditionally, regulation has covered the three pillars of the financial system—banking, insurance, and securities markets. For a long time, it was easy to identify which institutions fell into which category and, together, the three pillars essentially covered the gamut of financial intermediation. In recent years, however, a much wider range of institutions have come to play important roles in the functioning of the financial system.

This has been particularly significant in connection with the emergence of the "originate-to-distribute" model of credit intermediation. More and more credit is intermediated through the capital markets. This has two advantages: it allows borrowers to tap deeper sources of liquidity and, in principle, it distributes risk to entities best able and willing to hold it. But the model requires a demanding set of preconditions for it to work efficiently and safely.

The originators of credit need incentives to appraise credit risks properly. The creators and distributors of securitized credit products have to provide adequate transparency. And the holders of securities need to understand the properties of the assets that they acquire. This means that a greater number of players are central to the secure working of the financial system.

Private pools of capital, such as hedge funds and private equity funds, have grown enormously. Money market mutual funds have come to raise and place increasing amounts of short-term funds. Investment banks have greatly expanded their trading activities. Mortgage originators are at the center of the creation of the assets that underlie the mortgage-backed securities markets.

In addition, service providers, such as clearing and settlement systems, credit-rating agencies, and auditing firms, play an increasingly important role in the efficient and secure distribution of credit. For these reasons, it will be necessary for the new architecture to provide adequate oversight of a much wider range of players than has been traditional.

Resetting regulation

Almost every financial crisis has at its core the twin problems of credit quality and excessive leverage. The factors contributing to these problems differ from episode to episode, but the prevalence of the two underlying causes cannot be disputed.

Durable reform of the regulatory architecture therefore requires supervisory techniques that counteract the tendencies to misprice credit risk and to take on excessive leverage. The mispricing of credit risk is part of what has recently become well known as the procyclicality of the financial system. In good times, risk sensitivity becomes dulled, measured risk appears to be reduced, and risk mitigators (such as collateral) are accorded greater value than they often merit. So lenders extend credit to borrowers on terms that do not reflect the risks that emerge when the cycle turns. Conversely, in bad times, excessive caution prevails, risk measures are adversely affected by recent loss experience, and collateral values plummet. The willingness to lend goes sharply into reverse.

In any reform of the system, it will be important to better reflect "through-the-cycle" risks and to limit the tendency toward procyclicality. The Basel Committee on Banking Supervision is discussing various ways in which this can be done. Most of them involve mechanisms to encourage banks to build up additional capital cushions during periods of benign credit conditions, so that when the cycle turns, this capital is available to absorb losses without forcing banks into a destructive downward spiral of credit contraction.

Excessive leverage is also part and parcel of procyclicality. Leverage and maturity transformation—such as taking short-term deposits and using them to make longer-term loans—is a major source of the value added by a financial system, but it depends on the maintenance of careful risk management and the holding of adequate capital. Reforms will have to place

additional weight on the prudent funding of banks' asset portfolios.

Higher levels of capital will clearly be needed in the financial system, particularly to cover the risks of trading activities. But it will be important not to use capital requirements on banks as an undifferentiated response to systemic risks. Indeed, beyond a certain point, higher capital requirements, by raising costs, can drive intermediation into less-regulated channels, where risks may turn out to be greater. Capital augmentation has to be matched with a focus on better risk management. In particular, there needs to be an enhanced focus on the management of liquidity risks, perhaps supported by quantitative rules covering maturity transformation.

Reorganizing the regulators

In recent years, the traditional model of regulation, in which separate bodies oversaw banks, insurance companies, and securities markets, was challenged by the emergence of integrated regulators—in Japan, Germany, and the United Kingdom, among others—and by the Australian and Dutch "twin peaks" model, which separated prudential supervision from conduct of business and consumer protection regulation. The current crisis, however, calls for a more fundamental reevaluation of the structure of regulatory responsibilities. Where supervisory responsibilities are divided, there will have to be stronger mechanisms for cooperation among different regulators and, where the central bank is not the regulator, with the monetary authority.

In addition, the global nature of the financial industry and of the current crisis underscores the importance not just of national regulatory structures, but also of adequate coordinating mechanisms at the global level.

Attempting to secure systemic stability solely by ensuring the prudent operation of individual financial institutions is increasingly recognized as inadequate. Microprudential supervision can fail to identify risks that emerge at the macroprudential level. These risks can emerge when a shock simultaneously affects all financial institutions and/or when responses to shocks generate inherently destabilizing market dynamics.

The most obvious example occurs when an institution, following a negative shock to its portfolios, attempts to withdraw from risk by liquidating assets. Asset sales drive down prices, leading to losses for other institutions, which in turn seek to protect themselves by liquidating assets. A spiral of asset price declines and portfolio liquidation is thereby set in train.

Many countries are considering creating a systemic risk regulator, which would have responsibility for the stability of the financial system as a whole. Such a systemic risk regulator would be expected to identify gaps in regulatory structures and to spot emerging vulnerabilities in financial trends. There is considerable debate about which agency should be the systemic risk regulator. One view is that the central bank should take this responsibility, given its traditional concern for financial stability, its direct involvement in markets, and its capacity, through its balance sheet, to act as lender of last resort in a crisis.

An alternative view is that giving the central bank such a responsibility would confer too much power on a single institution, which would risk a greater degree of politicization. Moreover, to make the central bank the systemic regulator could sacrifice some of the insights coming from other regulators. The responsibility for systemic oversight could therefore be placed with a council of regulators, perhaps with its own independent staff charged with assessment of systemic risks. Intermediate solutions are also possible.

An important aspect of the regulatory structure is the design of international coordination. Finance is increasingly international, with global markets and large cross-border financial institutions. It is desirable for financial intermediation to be subject to consistent, high-quality regulation in all major jurisdictions. This would increase security, reduce opportunities for regulatory arbitrage, avoid costly and duplicative supervision, and promote a level competitive playing field.

The easiest way to achieve this would be to have a single global financial authority, but this is not a realistic option for the foreseeable future. Regulatory responsibilities are a matter of national sovereignty, and anyway national governments must make the costly decisions when one of their private institutions faces difficulties. So, in practice, coordination of regulation will have to be achieved through international bodies relying on understandings and peer pressure. It would be desirable, nevertheless, to give more authority to such institutions and groupings to implement their recommendations.

The key bodies are the IMF, the Bank for International Settlements, the Financial Stability Board, and the various sectoral standard setters (the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, the International Association of Insurance Supervisors, and the International Accounting Standards Board). To the extent these bodies can receive support from appropriately representative groups (such as the leaders of the G-20 nations), their recommendations and decisions will carry greater weight.

Getting it right

Much can be done to place financial regulation and supervision on a sounder footing, to enhance the stability of the system while preserving its vital contribution to the efficient working of the wider economy. The debate under way seems to be asking the right questions and going in the right direction. Still, it will be important to subject proposed outcomes to rigorous scrutiny, to avoid fighting the last war or falling victim to the law of unintended consequences. ■

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