FINANCIAL REGULATORY REFORMS: At the cross-roads?

Remarks at the ICRIER conference, New Delhi, 8 October 2012

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Introduction

Financial sector failures were at the heart of the global crisis of the late 2000s. Failures both of risk management and corporate governance in many private financial institutions brought domestic financial systems in many countries, and the international financial system, close to total collapse. Institutions which had not been seen as systemic turned out to be so.

Financial regulators and supervisors bore their share of the blame also. The 'light touch' model, which had been seen by many as the way forward before the crisis, proved to be incapable of spotting vulnerabilities. But the 'heavy touch', more intrusive model of supervision also had spectacular failures. Very few were immune to their share of blame.

The policy response

The immediate priority in 2008 was to prevent the total collapse of the financial system. The US TARP, and similar measures to shore up banks in Europe and other advanced economies, achieved that by and large. There are still concerns about a number of institutions, in particular in Europe where (at least until the latest ECB intervention – the Outright Monetary Transactions scheme) fiscal and financial problems were becoming increasingly intertwined. But overall the financial world seems a safer place than it was 3 or 4 years ago.

It was not long after the crisis before policy-makers began to address the failures of regulation and supervision also[1]. The inaugural G20 Summit of heads of state and government in Washington in November 2008 launched a 47-point action plan based on the 'principles' of: transparency and accountability; sound regulation, prudential oversight, and risk management; integrity in financial markets; international cooperation; and reforming IFIs.

[1] The G20 put the blame for the financial crisis on "reckless and irresponsible risk taking by banks and other financial institutions, combined with major failures of regulation and supervision" (Seoul summit communiqué, November 2010).

At that time the G20 stressed that 'regulation is first and foremost the responsibility of national regulators'. But the rationale behind coordinated international action was clear – 'our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability'.

Since then the G20 programme to promote financial stability has stressed the importance of reforms to the international system of financial regulation and supervision, including:

- Strengthening of the Financial Stability Board;
- Instituting a new bank capital and liquidity framework to constrain leverage and maturity mismatches, including through capital buffers and leverage ratios;
- Addressing the 'too big to fail' issue through a resolution framework and more intensive supervisory oversight for systemically important financial institutions (SIFIs) as well as building a robust core financial market infrastructure
- Instituting mandatory international recovery and resolution planning and risk assessment by international supervisory colleges in order to increase the capacity of the global systemically important financial institutions (G-SIFIs) to absorb losses.

In addition, at the Seoul Summit last year the G20 mandated a further programme of work covering:

- International peer review of national supervisors;
- Strengthening regulation and supervision of hedge funds, over-the-counter derivatives, and credit rating agencies;
- Creating a single set of global accounting standards through convergence of International Accounting Standards Board and Financial Accounting Standards Board standards;
- Further work on macroprudential policy frameworks; and
- Strengthening regulation and supervision of the shadow banking system and commodity derivatives markets.

This agenda of reform has grown substantially in complexity. But at the risk of oversimplifying, we can identify five dimensions in which regulation and supervision have increased:

- The range of **institutions** covered by the supervisory net has risen dramatically, from banks and insurance companies initially, to bring into the net hedge funds, other forms of 'shadow banking', and the financial infrastructure institutions (clearing and settlement systems, and credit rating agencies);
- The coverage of **instruments** under detailed regulation has increased, notably for asset-backed securities, and OTC derivatives;
- The level of **detail** on capital, liquidity, leverage, accounting standards, and conduct of business issues has also mushroomed;
- The **processes** around supervision have also been strengthened, for example the setting up of supervisory colleges, and processes for bank resolution, especially for SIFIs;
- And measures have been introduced aimed at regulating the **behaviours** of financial institutions, eg guidelines on compensation, and corporate governance.

While these measures have all been taken forward in the international arena through the FSB and the panoply of standard-setting bodies (including the Basel Committee, the IASB and IOSCO), much of this agenda has to be implemented by the relevant national regulators and supervisors. And progress at the national level has been rather patchy and uneven, hence the emphasis within the FSB on monitoring implementation, including through the Coordination Framework for Implementation Monitoring.

Some countries – by and large the ones where the original failings were greatest (the US, the UK, and the EU) – want to go even further in some respects. In their different ways, the Dodd-Frank legislation in the US, the Vickers Commission[2] in the UK, and the European Commission's reform programme[3] all seek to push financial sector reforms even further. Each is following a slightly different

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[2] The Independent Commission on Banking set up in 2010.

[3] Since the crisis, more than a dozen European regulatory directives or regulations have been initiated, or reviewed, covering capital requirements, crisis management, deposit guarantees, short-selling, market abuse, investment funds, alternative investments, venture capital, OTC derivatives, markets in financial instruments, insurance, auditing and credit ratings.

approach, with the US banning prop-trading, the UK ring-fencing retail banking operations, and the EU adopting a very detailed rule-book approach.

Second thoughts

However, signs of disquiet about the overall direction of travel are emerging. There are three strands to this disquiet:

- Concerns that tighter regulation in general, and higher capital requirements in particular, are causing banks to curtail lending which in turn is stifling economic recovery;
- Worries that more stringent regulation is stifling innovation in the financial sector; and
- Question marks over how effective more detailed and complex regulation and supervision is, compared to simpler rules.

As the economic recovery struggles to establish itself in many advanced economies, questions are being raised as to whether the increasing capital requirements[4] on banks in particular are causing them to further deleverage, preventing them from lending to firms, to allow them to invest and grow. The UK government, for example, has become so worried about this trend that it has tried a number of schemes to encourage banks to increase lending, culminating with the latest announcement that they are setting up a new bank to lend to SMEs. Meanwhile in Europe banks have increasingly retreated back to their home territories, leaving countries which are reliant on foreign banks starved of bank finance.

Another line of attack is that the increasing weight of regulation is stifling competition in the financial services sector. The Vickers Commission was set up with a remit to provide a "more stable and competitive [*my emphasis*] basis for UK banking". But pressures to curtail 'casino banking' and to regulate more tightly the sectors and instruments that have hitherto been less tightly regulated are likely to have some impact on firms' ability and willingness to innovate. Not only does this potentially reduce the financial sector's contribution to growth across the economy, but also the financial sector in many advanced economies is now large enough by itself to have a material impact on measured growth.

[4] Large banks in Europe have been required to increase their Core Tier 1 capital to 9 percent by the end of June 2012.

In a recent speech[5] Andy Haldane of the Bank of England raises a third set of issues which raise even more fundamental questions as to whether regulators and supervisors are capable of running more intrusive regimes, and whether these regimes are more or less effective at spotting incipient risks to financial stability. His main argument is that for decision-making under uncertainty, simple rules outperform complex rules in a large number of areas. They are not only less costly, but they also outperform in terms of predictive value. Haldane reruns history for a sample of about 100 large and complex global banks, and finds that a simple leverage ratio with assets equally weighted performs better – and statistically significantly better – than Tier 1 regulatory capital ratios with assets risk-weighted. He also finds that market-based measures of capital substantially outperform Basel-defined ratios.

And yet over time there has been a step change in the level of complexity in regulation – Basel I ran to 30 pages, Basel II to 347 pages, and Basel III to 616 pages. That process has accelerated rapidly since 2008, out of the best of intentions: to prevent another such crisis occurring again. But Haldane's results raise fundamental questions about the direction of reform.

A preliminary assessment

It is clearly the case that governments need to have a more robust way to spot risks to financial stability, and address them, than they had five years ago. The costs of financial crises are enormous, as Reinhardt and Rogoff have clearly displayed. And the proliferation of financial stability risk assessment boards and processes shows that policy-makers are taking the risks seriously.

But the ever-increasing depth and complexity of regulation and supervision has started to raise concerns. It is clear in retrospect, and with 20:20 hindsight, that regulation and supervision was too lax at the start of the crisis. As long as the state guarantees, either implicitly or explicitly, important institutions, sectors or instruments of the financial system (so that they are too important to fail), some private institutions will be tempted to take too many risks. And unless failing institutions can be ring-fenced, one failure can bring down the entire system. So regulation and supervision has to aim towards zero failure.

[5] "The dog and the frisbee": speech given at the Jackson Hole conference, August 2012.

But ultimately zero failure carries large costs in terms of the efficiency of the financial sector, and the way in which it facilitates general economic activity. At some point governments have to weigh up the benefits of tighter regulation in terms of reducing risks to financial stability, against the costs in terms of potential economic growth.

Furthermore, if Haldane is right, more complex regulation and supervision is actually worse for financial stability than simpler rules and more judgement and discretion by supervisors.

What does this mean for the G20's agenda of financial regulatory reform? I draw three messages:

- First, completing and implementing fully the existing commitments to tighter regulation has to be achieved. The financial crisis caused great traumas over the last five years, and the clear conclusion is that regulation had to be tightened. Also, the financial sector still attracts considerable political odium; and reversing the direction of travel of regulation and supervision now would send unhelpful and inconsistent messages to financial institutions that are rapidly regaining their appetite for risk. For all these reasons it seems to me there would be huge costs in not completing the current agenda. In particular, ensuring that there are effective mechanisms in place to resolve the biggest and most complex institutions is a priority.
- Second, tighter regulation of banks has meant that credit is harder to come by at the moment, especially for SMEs; and this is hindering the economic recovery. But I would argue that if there is a sector-specific problem, governments should find sector-specific solutions. A general loosening of standards again would represent a huge reversal.
- Third, however, the reform agenda may be nearing the point of diminishing (or even negative) returns. We may be at the point where the G20 should declare a time to draw breath on new initiatives. This would have the advantage of giving hard-pressed regulators and supervisors the time to concentrate on implementing what has already been agreed and partially adopted. But it would also allow a period of reflection on what form of regulation and supervision works best in practice. Is the best course to heap yet more and tighter rules on the financial sector? And should supervisory bodies world-wide employ yet more staff to scrutinise financial institutions in ever greater detail? Or should those rules be simplified, and supervisors

given more scope to make judgements about which institutions pose the greatest risk to financial stability, and the powers to address those risks? The answers are not clear yet, but it seems to me that there is enough evidence to make policy-makers pause before rushing headlong further down the path they are currently on.