Financial Sector Regulatory Reforms
International and national coordination

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Roadmap of presentation

1. Brief recap of what went wrong.
2. What is the needed regulatory reform agenda?
3. Challenges of international coordination
4. Challenges of national coordination

I: What went wrong?

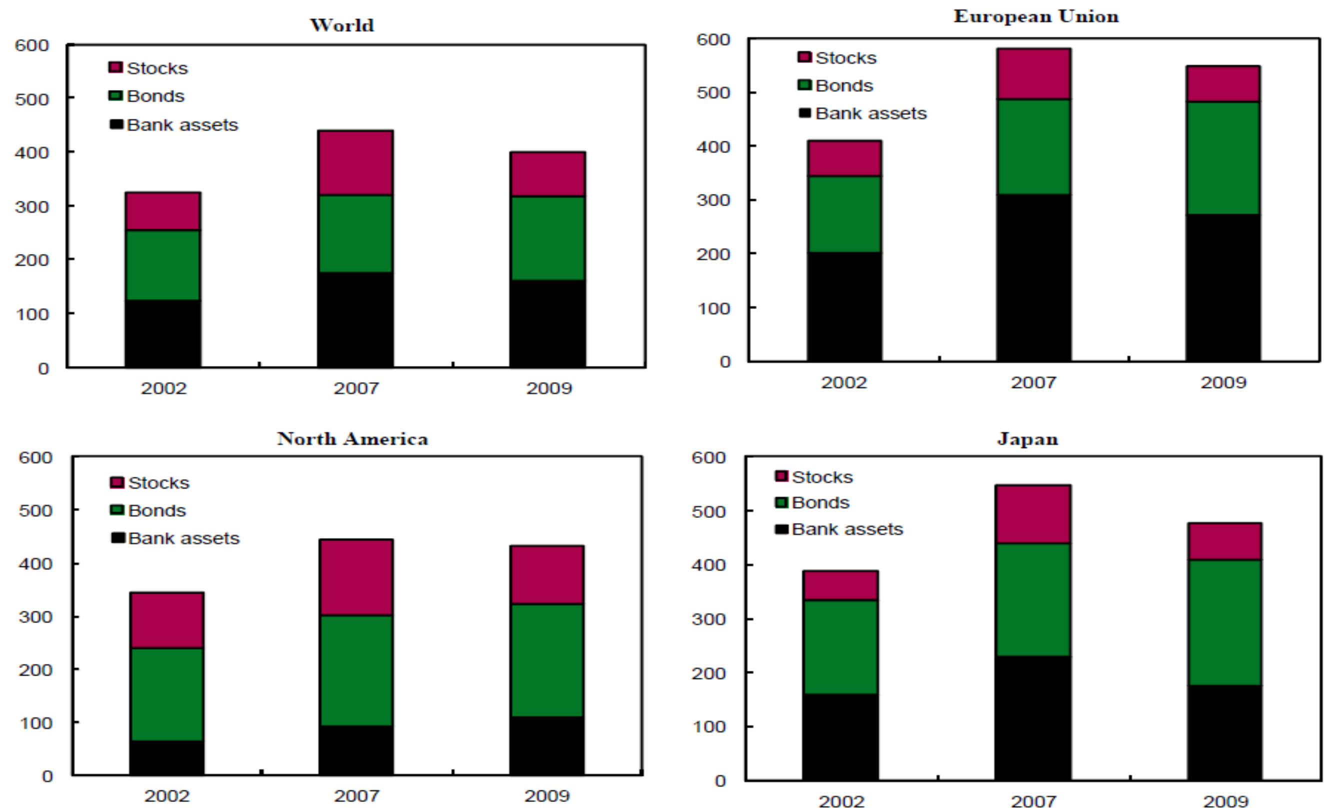
Financial Sector : What went wrong?

- Lack of transparency led to highly complex and opaque institutions
- Excessive leverage and heavy interconnectedness
- Bad liquidity management led to massive liquidity risks
- Low levels of loss absorbing capital

Disproportionate growth in the financial sector

Figure 1. Size of the Financial Sector

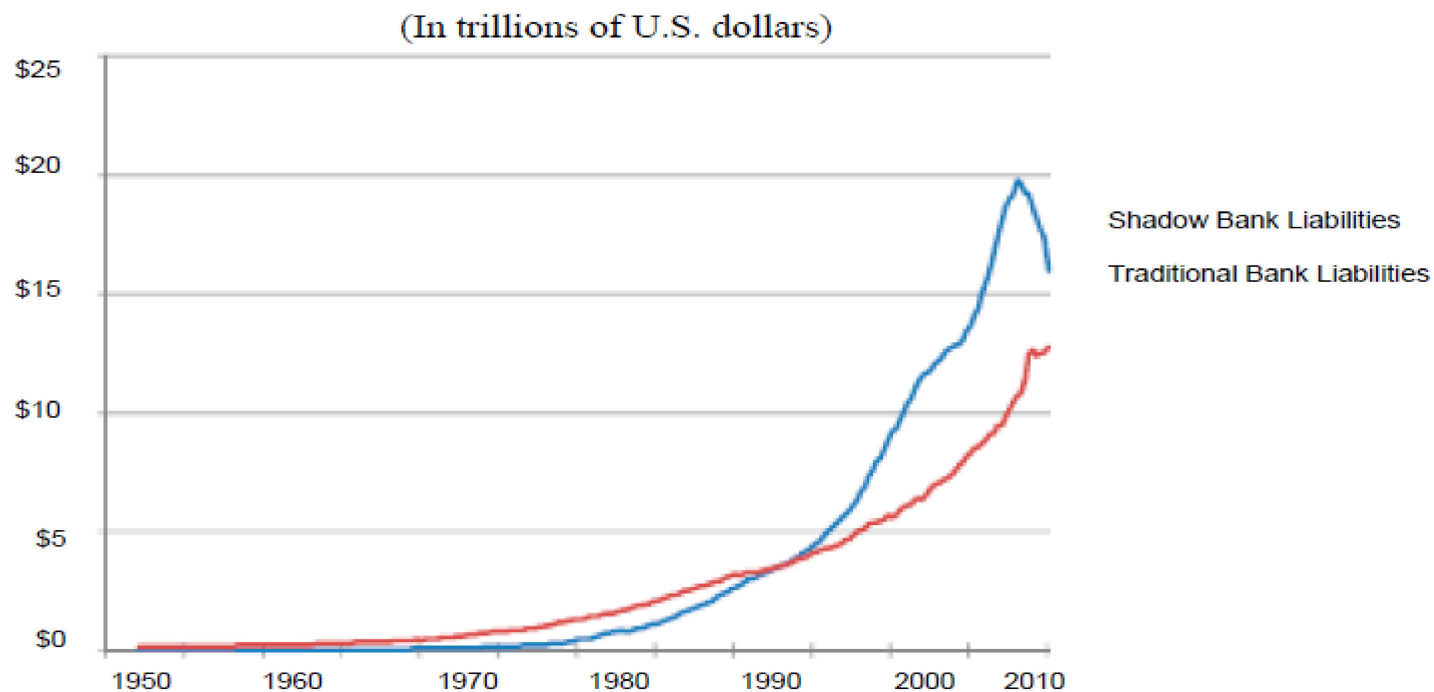
(In percent of GDP)



Source: IMF, Global Financial Stability Report, Table 3.

The Shadow Banking system

Figure 2. Growth of Nonbank Financial Institutions in the United States



Source: Pozsar and others (2010) from Flow of Fund Accounts of the United States as of Q1 2010 (FRB) and FRBNY.

Note: Shadow banking liabilities include commercial paper, medium-term notes, asset-backed commercial paper, asset-backed securities, repurchase agreements, total return swaps, hybrid and repo/TRS conduits, ABS CDOs, ABS CDO-squareds, bonds, capital notes, and 1$ NAV shares (shadow bank "deposits").

What reforms are needed?

The regulatory reform agenda

Five key goals:

- *Strong microprudential regulation that is globally coordinated.*
- *A robust and globally consistent cross-border resolution framework.*
- *A macroprudential dimension.*
- *A larger regulatory perimeter.*
- *Effective supervision.*

International Coordination

The Many Dimensions of Regulatory Coordination

Regulation, Supervision, Resolution

Formal / Informal

Ongoing/ Crisis

Bilateral / Multilateral

Domestic / Cross-border

Forums

Info Sharing / Coordinated or Joint Action; Letters / MOUs/Treaties; Visits /Colleges

Hierarchy and Instruments

Where has there been progress?

- A globally coordinated response is emerging on **micro-prudential rules**
  - more and better quality capital and more liquid assets;
  - maintain an internationally harmonized leverage ratio to constrain excessive risk taking;
  - build-up capital buffers in good times;
  - maintain minimum global liquidity standards;
  - and observe stronger standards for supervision, public disclosure and risk management.

Where has there been less progress?

- Less progress in the macro-prudential framework;
- And in cross border resolution;
- And in the non-bank arena.

Reasons for slow progress (1)

- Perception of pushback by industry or national interests
- Some "more affected" countries seen as front-running the reforms and thus raising issues of international inconsistency
- Some "less affected" members seeing this as "not their crisis" and hence not owning the reforms

Reasons for the slow progress (2)

- Countries still struggling to recover from the effects of the crisis need to balance between stability and growth.
- Regional supervisory groupings not always effective in forging common ground
- In international bodies, representation is still uneven and can slow acceptance
- Supervisory will and ability to act remains to be strengthened in many jurisdictions

Coordination challenges ahead

- This crisis elevated the requirements of both cross-border and cross-sector coordination.
- Need to move from arbitrage and level playing field issues to include crisis management and resolution issues; and from bank focused approaches to financial firms in general
- Agreement on resolution of complex cross-border financial institutions seen as the Achilles Heel of the International Financial System
- Even if agreement is reached on pending design issues, coordinated and effective implementation will be critical for success

National Coordination

Pre-crisis regulatory and supervisory architecture

Three models for organizing regulation and supervision

- **Stand-alone financial supervisory agencies.**
- **Single integrated regulator (SIR)**, separate from the central bank.
- Third, a **twin peaks** model which straddles the first two and emphasizes the idea of "regulation by objectives or domain".

And the winner is…

No one arrangement worked consistently better across countries .

- Central Bank involvement in banking supervision (light in Australia, Canada and the UK, and heavy in the US, France, Spain, and Germany) did not appear to influence how well the countries dealt with the crisis.
- The integrated model (UK, Iceland, Ireland, Latvia, the UAE and Hungary); while standalone models were followed in the US, Spain, Russia and Lithuania. And countries in both groups fell victim to the crisis.

National regulatory coordination

- Many countries—those that were at the epicenter and those at the periphery are looking again at their regulatory and supervisory apparatus.
- Changes that are being considered or are underway in the U.S. and in India.
- But first a look at Australia

Australia—a pioneer in domain based regulation (1)

- Through 1960–supervision exercised through direct control of banks
- NBFCs emerged to fill the gap
- Campbell Committee (1979) led to deregulation and lower entry barriers
- Deregulation came with major benefits—technological innovation, greater choice for consumers and integration with global financial markets.
- But banks were able to take on greater risk without efficient risk assessment procedures

Australia—a pioneer in domain based regulation (2)

- Wallis Committee 1996, was to recommend changes to ensure an 'efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.'
- When risk profiles and institutions were matched, it made sense to regulate by institutions.
- With fewer distinctions between different kinds of institution, it made more sense to design prudential regulations around financial functions.

The U.S.: The Dodd Frank Act (1)

- The Act creates the Financial Stability Oversight Council.

- And a new Office of Financial Research will serve as the information-gathering arm of the Council.

The Dodd-Frank Act (2)

- The Council has wide ranging powers to:
  - identify "systemically important" nonbank financial companies, thus bringing such companies under regulation by the Federal Reserve,
  - recommend heightened prudential standards for the Federal Reserve to impose on these companies.
  - recommend heightened prudential standards to primary financial regulators to any activity that the Council identifies as contributing to systemic risk.

The Dodd-Frank Act (3)

- **The Financial Stability Oversight Council (the "Council"),** will have 10 voting and 5 nonvoting members.
- The voting members are the Treasury Secretary, who serves as chairman, and the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection (the "**Consumer Bureau"), SEC, FDIC, CFTC, FHFA, NCUA and an** independent member with insurance expertise.
- The nonvoting members are the Directors of the Office of Financial Research (the "**OFR") and the Federal Insurance Office (the "FIO"), a state** insurance commissioner, a state banking supervisor and a state securities commissioner.

India—Raghuram Rajan Committee Report Recommendations

- Unify all regulatory and supervisory functions connected with organized financial trading into SEBI.
- Consolidate of all deposit-taking entities under the RBI
- Consolidate of monetary policy and banking supervision with RBI (for now)
- Bring all financial intermediaries governed by special statutes under general statutes
- Streamline tier 2 regulators
- Create a Financial Sector Oversight Agency

India—Percy Mistry Committee Report

- Consolidation of regulatory functions to four regulators
- Integration of all financial regulation into a single agency
- Shift away from "entity-based regulation" towards "domain based regulation".

The Financial Stability and Development Council

- An oversight board or committee of regulators with the following features:
  - Clear mandate for systemic risk assessment;
  - Appropriate representation at the level of principals of all supervisory agencies
  - A permanent secretariat with analytical capacity;
  - Authority to obtain and share information from or on supervised institutions, activities, products and markets and in-house capacity to analyze this information;
  - Ability to recommend actions with regard to bringing institutions and activities within the regulatory perimeter;
  - Residual authority to recommend actions for unregulated institutions, activities, markets and products; and
  - Requirement to provide periodic systemic risk assessments to other stakeholders.

A Final note: Supervision

- Beyond the structure of regulation, what are the elements needed for good supervision.
  - (i) legal authority and independence;
  - (ii) a governance structure with accountability and transparency;
  - (iii) credibility with industry, government and politicians, the public, and foreign counterparts;
  - (iv) adequate resources;
  - (v) regulatory and supervisory structure that promotes a level playing field across insurance, banking and securities industries, while minimizing gaps in supervisory coverage and limiting opportunities for regulatory arbitrage.

Some guiding principles for supervision

What is good supervision?

- Good supervision is intrusive.
- Good supervision is skeptical but proactive.
- Good supervision is comprehensive.
- Good supervision is adaptive.
- Good supervision is conclusive.

Concluding Remarks

- Some progress made in strengthening capital requirements, reducing leverage, and improving liquidity.
- But progress has slowed and resistance to reforms rising
- What is the balance between tighter regulations and economic growth and financial inclusion?
- Will tighter regulation once again push activity into the shadow banking system?
- And is greater international coordination in resolution a reaslistic goal that can go beyond good intentions?

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The Ability to Act (backup)

Elements of Ability

- **Legal authority.**
- **Adequate resources.**
- **Clear strategy.**
- **Robust internal organization.**
- **Effective working relationships with other agencies.**

The Will to Act (back up)

What creates the will to act?

- A clear and unambiguous mandate.
- Operational independence.
- Accountability.
- Skilled staff.
- A healthy relationship with industry.
- An effective partnership with boards.