The international regulation of systemic risk

John Eatwell

Centre for Financial Analysis and Policy

Judge Business School, Cambridge

Centre for Financial Analysis & Policy

CAMBRIDGE Judge Business School

Cambridge Finance

What do regulators do?

- Information (including accounting standards)
- Authorisation
- Guidance
- Surveillance
- Enforcement
- Policy

Theory of Regulation

- Market failure
  - Absence of markets
  - Information – apples v medical care
  - Asymmetric information
  - Public goods – radio, defense, the lighthouse
  - Monopolies and other market distortions
  - Externalities

Financial regulation

- Asymmetric information
  - Consumer protection
  - Conduct of business
- Moral hazard
- Externalities
  - Systemic risk
  - Macro-prudential risk

International financial regulation

- Regulators trapped in national jurisdictions
- Domain of the regulator should be the domain of the market that is regulated
- If activities relatively immobile then tendency to over-regulation in the attempt to limit systemic risk
- If mobile then regulatory arbitrage results in lowest common denominator regulation, or market segmentation

International financial regulation

- Don’t underestimate the importance of national jurisdictions
  - EU example
  - Resolution: “national regimes focus on the protection of national stakeholders’ interests” FSB Sept 2009
- Banks are global in life and national in death (40% of the US taxpayers’ funds for rescue of AIG were paid over to non-US counterparties).

International financial regulation

- “While the FSB can develop coherent policy proposals, only national authorities can assure implementation that is effective and consistent across borders” FSB Sept '09
- Is this missing the point? Is it failing to incorporate the needs of international regulation and falling back on a failed structure of national jurisdictions?

Financial Stability Forum

Endorsed by G7 Finance Ministers, April 2008

"A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms"

Alan Greenspan

“The modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year.”

23rd October 2008

Basel trilogy

- Greater transparency
- More disclosure
- More effective risk management by firms

- Regulation consists of removing market imperfections and enforcing best practice.

Micro-prudential regulation

- in normal times, when risk is predominantly confined to the individual institution, risk management reduces the probability of failure, and is stability enhancing.
- when interlinkages between firms and markets dominate behaviour, i.e. at times of extreme events, the price sensitive impact of common risk management techniques increases instability and market volatility.

Micro-prudential regulation

- Effective micro-prudential regulation increases systemic risks and results in destructive behaviour at times of stress.

- *Systemic* risk an externality.
- The market mis-prices risk.

Financial Services Authority

The Turner Review

A regulatory response to the global banking crisis

March 2009

FINANCIAL REGULATORY REFORM

A NEW FOUNDATION:

Rebuilding Financial Supervision and Regulation

DEPARTMENT OF THE TREASURY

THE HIGH-LEVEL GROUP
ON FINANCIAL SUPERVISION
IN THE EU

Chaired by
Jacques de Larosière

REPORT

Brussels, 25 February 2009

Geneva Reports on the World Economy – Preliminary Conference Draft 11 2009

The Fundamental Principles of Financial Regulation

Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash D. Persaud and Hyun Shin

PRELIMINARY CONFERENCE DRAFT

ICMB INTERNATIONAL CENTER FOR MONETARY AND BANKING STUDIES

CEPR

Macro-prudential regulation

- “Micro prudential concerns itself with factors that effect the stability of individual institutions. Macro prudential regulation concerns itself with factors that affect the stability of the system as a whole.
- ..the nature of regulation applied to an individual institution depends crucially on how “systemic” its activities are.
- This is related .. to its size, degree of leverage and interconnectedness ….”

(Brunnermeier, Crockett, Goodhart, Persaud and Shin, 2009)

Macro-prudential regulation

- *First*, regulators must introduce stress testing for the system as a whole.
  - FSA stress test 2005 identified Northern Rock and HBOS as serious systemic risks; nothing was done
  - Fed stress test did not examine inter-connections between banks

Macro-prudential regulation

- *Second*, financial institutions must be required to undertake pro-cyclical provisioning
  - note that this is use of capital as a buffer, *not* a charge
  - the provisioning requirements should be based on the health of the economy as a whole (compare Spanish dynamic provisioning)

Macro-prudential regulation

- *Third*, high leverage should attract high capital charges.
  - leverage (leverage collars) if capital
  - "aggregate indicators of financial leverage will be developed" FSB Sept '09.

Macro-prudential regulation

- *Fourth*, detailed supervision of firms' business models should be conducted within a context of macro-risk assessment.
  - the second pillar of Basel Two, "enhanced supervision", is firm-specific. As the failings of the Basel approach have become clear, more and more has been piled on this pillar.

Macro-prudential regulation

- *Fifth*, there should be strict regulation of non-tradable financial instruments, encouraging instead the issue of standardised instruments, readily susceptible to central clearing.
  - The problem is not transparency, but *complexity*.
  - “Glass-Steagall lite”.

Macro-prudential regulation

- *Sixth*, to secure effective macro-risk management financial regulation must escape from its present focus on the nature of institutions
  - Systemically relevant institutions

Institutional challenges

- Macro-prudential regulation will require a different “national” institutional framework. This is clear in the proposals advanced by the US, the EU, and the UK.
- US Financial Services Oversight Council
- EU European Systemic Risk Board
- UK Council for Financial Stability

G20 Summit Sept. '09
Strengthening the International Financial Regulatory System

- All firms whose failure could pose a risk to financial stability must be subject to consistent, consolidated supervision and regulation with high standards.

- ….we call on our Finance Ministers and Central Bank Governors to reach agreement on an international framework of reform in the following critical areas:

Building high quality capital and mitigating pro-cyclicality

- We commit to developing internationally agreed *rules* to improve both the quantity and quality of bank capital and to discourage excessive leverage.
  - The *national* implementation of higher level and better quality capital requirements, counter-cyclical capital buffers, higher capital requirements for risky products and off-balance sheet activities
  - strengthened liquidity risk requirements and forward-looking provisioning
  - a leverage ratio, harmonized *internationally*, fully adjusting for differences in accounting.

Reforming compensation practices to support financial stability

- Excessive compensation in the financial sector has both reflected and encouraged excessive risk taking.
- Supervisors should have the responsibility to review firms’ compensation policies and structures with institutional and systemic risk in mind and, if necessary to apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices

Improving over-the-counter derivatives markets

- All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.
- OTC derivative contracts should be reported to trade repositories.
- Non-centrally cleared contracts should be subject to higher capital requirements.

Addressing cross-border resolutions and systemically important financial institutions

- *internationally*-consistent firm-specific contingency and resolution plans.
- crisis management groups for the major *cross-border* firms
- resolution tools to mitigate the disruption of failures and reduce moral hazard.

Jacques de Larosière

“When you exercise macro-prudential regulation you are bound to ask yourself questions of economic policy. Let us not hide ourselves from reality. Often…fiscal policies can be part of systemic risk”

Evidence to Economic Affairs Committee, House of Lords, 10th March 2009

International micro-regulation

- Micro-prudential regulation is readily susceptible extension to an international environment
  - object of regulation is readily identifiable once home-host issues are sorted out
  - principles based (standards and codes)
  - apparently not linked other aspects of national policy

International macro-regulation

- Macro-prudential regulation is less amenable to the international environment
  - which macro economy? Stress tests?
  - home-host and the lender of last resort
  - rules based
  - closely linked to other aspects of national policy (macro-economic management) and international macroeconomics

The curious case of international mismatches

- Currency mismatches
  - Micro-regulation of mis-matches emulates macro-controls: the Korean case
  - Better managed by capital controls in emerging markets? A macro response to a macro problem?

Institutions - FSF

- Transformed into the FSB
  - G20 membership
  - Given responsibility for developing *international* financial regulation
- Relation to Basel Committees
  - Non-treaty organisation
  - Soft law

Institutions - IMF

- Treaty-based organisation with responsibility for macro-economic stability.
- Moves to increase role in financial markets
  - FSAPs
  - International Capital Markets Department, 2001. Now Monetary and Capital Markets Dept. “to enhance … surveillance, crisis prevention and crisis management activities”. It is proposed the new Department’s responsibilities will include “systematic liaison with the institutions which supply the bulk of private capital worldwide”.

Institutions - IMF

- Little recent experience of “supervising” developed economies.
- “Baggage” in emerging economies
- Too large

- G20 solution: FSB piggy backed on the IMF

Research tasks

- Understand liquidity – how is growth of liquidity to be modelled?
- Understand systemic risk – what sort of models?
- Understand disintermediation – how do financial networks actually work?
- Understand households – how do households make financial decisions, what is their relationship to financial markets as a whole?
- Finance and the real economy – have the transmission mechanisms changed?

Scope

- What sort of regulation is appropriate to the international domain?
- Will “coherence” and “cooperation” be enough?

World Financial Authority

- A forum for developing policy
- Surveillance (peer reviews)
- Enforcement (non-compliant regimes)
- Information and data and resolving disputes
- A template by which to judge international regulatory measures.
- The domain of the regulator

Global Finance at Risk

THE CASE FOR INTERNATIONAL REGULATION

JOHN EATWELL and LANCE TAYLOR