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on financial supervision and regulation - the future model

Special Committee on the Financial, Economic and Social Crisis

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The current crisis has revealed major failures in the financial regulatory and supervisory frameworks, which did not succeed to identify potential risks and prevent the escalation of the crisis. This is now widely recognised at different levels, in particular, it is worth mentioning the thorough analysis on the origins of the financial crisis undertaken by the De Larosière report[1] and the Turner report[2].

The challenge now is how to reshape the financial system to make it more robust, while at the same time ensuring that it maintains its scope for innovation and for fostering economic growth. Put simply: a financial system that does not come at the expense of citizens but at their service.

The current financial market turbulence highlighted the increasing gap between ever more globally active financial institutions and purely national supervision[3]. There is broad consensus that the main culprits responsible for the current crisis are:

- Risk-taking incentives for banks and financial institutions and a supervision model that failed to adapt;
- Mispriced guarantees awarded to the financial sector;
- Increasing opaqueness of the financial sector and resulting counter-party externality;
- Focus of regulation on institution-level risk rather than on aggregate systemic risk[4].

These factors were not contained by regulatory or supervisory policy or practice. The provisions for capital requirements for banks relied too much on the banks managing risk themselves and on the adequacy of ratings. There was too much focus on individual institutions instead of general developments in sectors or markets. The increase in off-balance sheet vehicles and the expansion of derivative markets led to opacity and a lack of transparency. This points to serious limitations in the existing regulatory and supervisory framework, both in a national and cross-border context[5].

Incomplete information and the lack of available data, together with the attitude of national authorities not sharing information with each other, made effective supervision impossible. Regulators and supervisors focused too much on micro-prudential supervision and not sufficiently on macro-systemic risks of contagion.

The crisis worsened as the European Union does not possess an appropriate crisis

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1 The High Level Group on Financial Supervision in the EU, Report, 25 February 2009 (De Larosière report).

2. FSA, The Turner Review, A regulatory Response, March 2009, (the Turner report).

3 Following the cross border expansion and consolidation of the European banking and financial industry in recent years, a small number (compared to the total number of more than 8,000 banks in the EU) of multi-jurisdictional banks and financial conglomerates account for a disproportionate share of total assets (note that already in 2003 the top-50 EU banks accounted for more than 60% of total assets of all EU banks) (Marco Lamandini, Briefing paper: "To What Extent Did Financial Regulation and Supervision Fail in Preventing the Crisis?", PE 433.435, p. 7).

4 Acharya/Richardson, Restoring Financial Stability, p. 25.

5 The High Level Group on Financial Supervision in the EU, Report, 25 February 2009 (De Larosière report). p. 10.

management infrastructure. Due to the lack of cooperation between the different national authorities, crisis response, despite the liquidity induction by the ECB, remained national and therefore occasionally had negative spill-over effects on other Member States.

This is, of course, an incomplete account of the problems the financial regulatory and supervisory faced. It demonstrates, however, that there is a vital need for an overhaul of financial market regulation and supervision in the European Union to address these regulatory gaps, guard against future crises, restore confidence and create a viable and sustainable financial system which protects growth and jobs.

Towards a new financial supervisory architecture

The current financial turmoil clearly showed that big financial conglomerates raised significant cross-border externalities that can undermine financial stability[1]. Fragmented national supervision led to regulatory arbitrage and provided incentives to national supervisors to compete via lax supervisory standards and practices to avoid putting national industry in a less competitive position or out of fear that some institutions would shift part of their business to less strict regulatory systems. This behaviour signals a moral hazard, which is bound to cause subsequent difficulties[2].

The legislative proposals currently under consideration lack the ambitious vision necessary to overcome the aforementioned deficiencies. Splitting micro- and macro-prudential supervision hampers the necessary information exchange on critical institutions from the supervisory authorities (micro-prudential level) to the central banks (macro-prudential)[3].

In addition, dividing supervisory authorities into sectors (banking, securities, insurance) creates an extra regulatory burden entailing loss of competitiveness for Europe's financial industry and inadequate protection of investors. Geographical fragmentation between London, Frankfurt and Paris bears the risk of impeding the flow and coordination of information between the different bodies. Since problems with proper information exchange have already manifested themselves as one of the major failures that led to the crisis, it would be inadequate to carry on with a structure that did not succeed in the first place.

Therefore, the European Parliament should call for a bolder approach in presenting plans for a European Financial Services Authority (EFSA), which should merge the supervision of overlapping industries of banking, insurance and securities and build on a network of national supervisory authorities. National supervisory authorities have detailed knowledge and expertise and should be in charge of the day-to-day supervision on a micro-level. On the other hand, EFSA will be of crucial importance in coordinating supervision on a more supranational level, since national supervisors do not possess a full overview and cannot coordinate and communicate responses in an efficient and timely manner.

In setting up EFSA it has to be ensured that it has adequate staffing and resources to perform

1 Marco Lamandini, Towards a new Architecture for European Banking Supervision, paper presented at the ABI Conferences on "The future of the European Banking Supervision Architecture", Rome, October 2008.
2 Guy Verhofstadt, The financial crisis – how Europe can save the world, 2009, p. 58.
3 Bini Smaghi, A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market", paper presented at the CFM-IMF Conference in Frankfurt am Main, 26 September 2008, p. 2.

its supervisory functions. In order to address systemic risk, supervisors should be at the forefront of risk assessment and not lagging behind the institutions they are meant to supervise.

Towards a new financial regulatory framework

The EU needs strong financial regulation in order to ensure confidence in capital markets and to preserve the integrity of the financial system. The ultimate goal is to enable capital markets to fulfil their main purpose of allocating capital in the most efficient way and to provide resources to the real economy.

If it were to be successful, prudential regulation should be based on general principles such as simplicity, clarity, coherence and transparency. Prudential regulation should aim at enhancing the resilience and soundness of the financial system.

One of the problems in the current regulatory framework is the lack of a proper understanding of bank activities, upon which prudential regulation should be based. Therefore, a full assessment of the financial system's behaviour is a key to designing an effective and adequate prudential regulation, able to address the inherent risks of bank activities. For instance, if regulators had a better understanding of the subprime mortgage scheme, they would have been able to design rules able to prevent or mitigate the effects we have experienced during the financial crisis.

Another important element is that different financial institutions face different risks and risk-averseness. Hence, the 'one size fits all' approach is not appropriate: prudential regulation needs to be calibrated to the variety of structures and purposes of financial institutions.

In addition, prudential regulation has to provide incentives for prudent behaviour so that the necessary self-correcting process in the market can take place. Financial institutions need to be motivated to improve the quality of their risk management schemes and to adopt strategies and business models, which internalise the contribution of their activities to systemic risk. This will promote greater financial stability. Furthermore, regulation needs to impose constraints to reduce excessive risk taking and to encourage “real entrepreneurship”, by shifting the model from aiming at the short term-gains to long-term benefits[1].

The current crisis showed that the failure of a cross-border institution can have substantial implications on financial stability across national borders. Therefore, a well-designed rules-based European deposit guarantee scheme could be the first step in protecting the banking system from future financial crises.

The following areas of financial regulation deserve particular attention:

- **Leverage, liquidity and capital requirements**

It is now a shared concern that bank capital regulation may amplify business cycles. While the Basel II framework represents an improvement over previous approaches, it is still pro-cyclical. Policy making should focus on the "boom-bust" cycle. Mistakes in risk assessment are made during the boom period (period of strong growth in bank balance sheets and credit, a

[1] Guy Verhofstadt, The financial crisis – how Europe can save the world, 2009, p. 91.

rise in leverage, etc.)[1]. Hence, better regulation during boom periods could limit the amplitude of the bust. Therefore, the Basel framework should be revised to become counter cyclical. The revised framework needs to ensure that banks are putting aside an increasing amount of capital in more prosperous economic times, which can be released in situations of economic distress. Furthermore, the proper global implementation of those rules (including US) is of crucial importance.

In addition, different institutions (asset holders) have different capacities for different risks. The way to reduce systemic risk is to encourage the flow of risk to financial institutions with a structural capacity of holding that risk and not a statistical capacity[2]. The capacity for risk is related to the maturity of funding and not to the type of the institution. Diversifying assets and risk holders would make the system more resilient and it would prevent a situation of "liquidity dry-up", where traders sell or buy when everyone does the same[3].

- **“Too-big-to fail”**

Since the hit of the financial crisis governments across the globe have injected hundreds of billions of taxpayers' money into failing financial institutions, deemed "too-big-to-fail". Ever since, the public debate revolved around the question on how to deal with such institutions in order to prevent the systemic breakdown threats they pose. Currently, plans in the US (by introduction of the Volcker-rule) suggest that such institutions should be limited in their size. We do not believe that this is a viable option. “Too-big-to-fail” institutions can be regulated in a way that at least partially offsets the risks they pose to the rest of the financial system.

First, regulators need to keep firms from becoming too risky as a proactive measure. Second, the regulation has to make it easier to resolve a financial institution when things do fail. Third, proper macro-surveillance should combine monitoring of financial systemic risks and mitigating the spill over effect that these may have on the business cycle.

- **Reform of the accounting and financial reporting rules**

During the financial crisis, financial reporting standards — particularly those relating to "mark-to-market" accounting — came under tremendous pressure, with respect to both the transparency of financial statements under existing accounting standards and the clarity of related disclosures.

In revising accounting standards, policy makers should focus on designing rules capable of providing verifiable information that market participants can use both as inputs in their own valuation and as calibration for their own and others’ unverifiable information.

In addition, specific accounting rules are necessary to address the miss-match in the maturity of assets and liabilities. The tendency of financial institutions to rely on less expensive, short-term funding increases systemic fragility.

[1] Avinash Persaud, CRIS hearing on "Financial regulation and supervision", 25 February 2010.
[2] Avinash Persaud, CRIS hearing on "Financial regulation and supervision", 25 February 2010.
[3] Avinash Persaud, Too much capital, note enough safety?, at www.voxEU.org , 13 June 2009,.

- **Consumer/investor protection**

The MiFID regime was barely in place when the financial turmoil came to its height. It is based on the assumption that financial intermediaries could advise on or sell any type of product as long as they apply suitability or appropriateness tests depending on the type of client they deal with. To put it simply, this would mean that more risky products would be deemed unsuitable or inappropriate for less experienced clients. However, these rules do not apply to transactions between financial institutions, based on the assumption that more sophisticated counterparties do not need the MiFID safeguards since they can assess and manage risks properly. Yet, history has shown that those institutions were not able to do so.

It becomes clear that the MiFID rules alone would not have been sufficient to prevent the spread of highly innovative and risky financial instruments, which were at the core of the crisis. Therefore, the MiFID model has to be complemented by additional rules to ensure that financial innovation does not lead to highly complex and opaque instruments, which even highly sophisticated investors cannot manage properly. One possible solution would be to guarantee the quality of the financial products on offer by introducing quality and risk label.

Concluding remarks

The EU needs stronger European supervisory architecture and prudential regulation that could foster financial stability.

The crisis has clearly shown that distress situations could not remain contained within a single country, but have spill over effects at European and global level. Many discussions and statements at the global level (G20 and BIS) have taken place, but not many concrete results in the form of actual revised regulation have materialised. Therefore, EU needs to play active role at the global stage in pursuing a major reform of the global financial system. Where, however, progress at international level is not sufficiently far reaching, EU should lead by example.

It is important to stress that all countries should be obliged to follow the rules agreed upon in Basel to eliminate regulatory arbitrage and foster financial stability on an global level.

The current crisis has provided a unique opportunity to reform the financial regulatory and supervisory system by creating a momentum that EU policy makers need to use in order to bring forward the current model of financial regulation and supervision.