

“Reforming Financial Regulation, Supervision, and Oversight:
What to Do and Who Should Do It”

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I. Introduction

In the midst of the most serious financial and economic crisis since the Great Depression, it is clear that major regulatory failure (in the long run-up to the crisis) was one of the key contributing factors. The two central questions are therefore what to do and who should do it. In what follows, I offer a summary of my recommendations.¹

II. What to Do

It is useful to group the proposed reforms under the following seven headings – corresponding to problem areas highlighted by the current crisis: (i) reducing leverage and increasing liquidity; (ii) counter-acting the pro-cyclicality of bank capital regulation; (iii) pricking asset-price bubbles; (iv) making financial failures less costly; (v) improving market incentives for prudent behavior; (vi) filling holes/gaps in the coverage of regulation; and (vii) early warning and monitoring. What should be included under each of these headings is sketched out below.

A. Reducing leverage and increasing liquidity.

1. increase significantly (e.g., double) the international minimums for total and Tier 1 risk-weighted bank capital under the Basle regime. If bank capital were much higher going into the crisis, banks would have had a bigger cushion for losses and there would be less need for public money directed at bank recapitalization.
2. introduce as part of the Basle regime a minimum (unweighted) leverage ratio for bank capital; this is useful to restrain the increase in leverage during the upswing of the business cycle; is also provides some protection against errors in the weights used for the risk-weighted capital measure.
3. consider introducing higher capital requirements for systemically-important financial institutions (since failure of these institutions imposes higher costs on the rest of the economy).
4. introduce a quantitative minimum liquidity requirement for banks and private-sector liquidity pools to deal respectively with inadequate holding and hoarding of liquidity (see my op-ed, “A Proposal to Improve Banks’ Regulatory Liquidity,” Financial Times, May 22, 2008). More principles and stress tests for liquidity risk management, as proposed in the latest report of the Basle Committee on Banking Supervision, will not do the job. Think where we would be today if there were only

¹ For a fuller discussion, see Morris Goldstein, “A Ten Plank Program for Financial Regulatory Reform,” manuscript, Peterson Institute for International Economics, Washington DC, December 2008.

principles for bank capital – not a minimum quantitative ratio. Yes, central banks can offer large-scale liquidity assistance to a broad range of market participants against a wide range of collateral, but the larger, more frequent, and longer lasting is such assistance, the greater the likelihood that the official lifeline will undermine incentives for market participants to self-insure adequately against liquidity risks. Also, while central banks can inject liquidity, hoarding of liquidity may prevent liquidity from going to those who need it most. Private-sector liquidity pools, cum overdrafts, loss-sharing, and -- as a condition of membership – lending to other pool members that are short of liquidity, can deal with the hoarding problem.

5. pressure the IMF to begin enforcing vigorously its guidelines on exchange rate surveillance. This is directed at how global imbalances and prolonged currency under-valuation in some emerging economies affects reserve accumulation, capital flowing into the advanced countries, and ultimately, the level of long-term interest rates. When these interest rates get too low, they encourage excessive borrowing and leverage.

B. Counter-acting pro-cyclicality in the bank capital regime.

1. introduce a range for minimal bank capital requirements where the lower part would apply during cyclical downturns and the upper part during upswings. This would counter-act the pro-cyclical tendency under the current regime for bank capital requirements (and hence, bank lending) to increase during the downswing and fall during the upswing. There are various ways of making required bank capital a function not only of the level of bank assets but also of the change in bank assets (cum other cyclical and risk indicators).
2. ensure that decisions on changes in required bank capital (and provisioning) reflect not only what is going on in individual financial institutions but also what is going on in the macro-economy. For example, it would be unwise to introduce a large increase in required bank capital while the economy is in a recession.

C. Pricking asset-price bubbles before they collapse.

1. reject the doctrine that says that neither central banks nor regulatory authorities should attempt to identify and to prick asset-price bubbles, and that once these bubbles burst, the mess can be cleaned up at low cost simply by reducing interest rates. The severity of the present crisis argues forcefully against this view.
2. central banks and regulatory authorities must coordinate much better on how they are going to react to building asset-price bubbles; if one doesn't act, the other must. If, for example, central banks decide that they are very limited in how much they can raise interest rates to deal with rapidly rising asset prices, then regulatory authorities will need to increase their response (using whatever regulatory and supervisory tools are at their disposal, including sterner warnings to lenders about rising concentration risk).

D. Making financial failures less costly.

1. require all countries to implement a prompt-corrective-action and orderly closure rule for systemically-important financial institutions – be they banks or non-banks (along the lines of what we have banks in the US under FDICIA and CEBA). Without prompt corrective action, regulators will wait too long to impose needed corrective actions on faltering financial institutions. Without an orderly closure rule, authorities will be confronted with two unappealing options; put the failing institution into the normal bankruptcy regime and accept creditor stays and potential market lock-ups not helpful to restoring financial stability, OR make a quick decision over the weekend to implement a large bail-out on terms not necessarily favorable to taxpayers. What we need is a framework that combines continuity of operations (e.g. a 'bridge bank'), good moral hazard properties (wipe out shareholders, change management, guarantee some liabilities at estimated recovery cost, not par), gives some discretion to crisis managers for payment priorities, and also provides crisis managers with "time to think." Such a prompt-corrective-action and orderly closure regime would have been helpful in the cases of Bear Stearns, Lehman, Merrill-Lynch, and AIG, among others.
2. establish clearinghouses in the OTC derivatives markets. According to the BIS, there was almost \$600 trillion of OTC derivative contracts outstanding as of end-2007. The problem with so much of trading taking place on the OTC market is that it doesn't offer the same level of systemic protection as on organized exchanges (or more generally, where there is a central clearing party); what we need is a well-capitalized central-clearing party that acts as a counterparty on all trades, initial and maintenance margins that are strictly enforced, each participant's net position to be known in real time and recorded electronically, and price information to be transmitted accurately and rapidly to all traders. Yes, you can't get the same level of customization on an organized exchange as you get in the OTC market, but the higher level of systemic risk (in OTC markets) is too high a price to pay for it. Establishing a central clearing party in the CDS market is a good start – but only a start. If it takes too long to establish these clearinghouses, consideration should be given to using the bank capital regime and/or the bankruptcy regime to create incentives for shifting more of trading to the organized exchanges.
3. suspend temporarily the use of credit ratings and banks' internal as risk weights in the Basle II bank capital regime (in favor of weights chosen by bank supervisors). Although officials seem loathe to make yet another significant change in the international bank capital regime given the long and arduous approval process for Basle II, the promised benefits of using credit ratings and bank's internal models as risk weights have been undermined by the dreadful performance of such ratings and models during the run-up to this crisis.
4. toughen-up IMF surveillance of currency mismatches. Currency mismatches have been at the heart of all the major emerging-market financial crises of the past dozen years. Unfortunately, we are once again seeing their systemic adverse impact – this time among the economies of Eastern Europe. Although the IMF has argued that it has for some time been given increased attention to such balance-sheet effects, it is

clear that more needs to be done to reduce those mismatches, so that large exchange rate depreciations do not have such devastating effects on borrowers' net worth.²

E. Improving market incentives for more prudent behavior.

1. offer financial firms an incentive in the form of a lower capital charge to implement sensible deferred compensation plans. If you pay top managers bonuses based on annual profits but you don't claw back the losses when tail risk materializes, you create strong incentives for taking on such tail risk. The antidote is to have a deferred compensation plan where you get only part of your bonus upfront and the rest only when superior performance is confirmed over a period of years.
2. require originators/packagers of securitized instruments (including securitized home mortgages) to take an equity slice in products that they sell/distribute to others. Such an equity stake will give such originators and packagers "more to lose" if they don't perform adequate due diligence on the creditworthiness and transparency of the borrowers and instruments. A polar example of such an arrangement is the covered bonds instrument that has proved so popular in Europe.
3. improve the disclosure and documentation for complex structured products – and restrict their sale to 'sophisticated investors,' as recommended recently by the Counterparty Risk Management Group III (2008). This will reduce the chance that investors in these products will be unaware of what they are buying.
4. reduce conflict of interest in the major credit rating agencies by restricting the ratings agencies to their ratings business; their consulting activities should be split into separate firms. Firewalls within the same firm will not work. In this connection, we should follow the example of what was done in the auditing/accounting industry after the Enron (and similar) scandals.

F. Filling holes/gaps in the coverage of financial regulation.

1. there should be serious oversight and supervision of all systemically-important financial institutions, where "systemically important" is a function of size, degree of inter-connectedness in financial markets, and leverage. Who gets regulated should not depend on whether the institution is classified as a commercial bank, or an investment bank, or an insurance company, or a hedge fund.
2. all systemically-important financial institutions that operate globally should have a well-functioning college of supervisors. The existing degree of cooperation between home and host-country supervisors is not adequate for overseeing the operations of global financial firms.
3. whatever their institutional frameworks, all national supervisory systems should have one institution that has the mandate for maintaining overall financial market stability, with the requisite authority to investigate sources of systemic risk and to identify and recommend appropriate corrective actions.

² For some specific recommendations on how to reduce currency mismatching in emerging economies, see Morris Goldstein and Philip Turner, Controlling Currency Mismatches in Emerging Markets, Institute for International Economics, Washington DC, 2004.

4. any remaining regulatory capital bias in favor of off-balance-sheet entities should be eliminated. The current crisis has demonstrated vividly what happens when there is not a genuine transfer of risk (including reputational risk) from parents to off-balance-sheet vehicles and when this risk has to be transferred back to the parent (after a failure) at sizeable cost.
5. the membership of the Financial Stability Forum (FSF) should be expanded to include the larger emerging economies. The increasing weight of these economies in the global financial marketplace argues persuasively for including them in the FSF; to keep the size of the group manageable for an effective discussion, some other participants will need to accept a reduction in the size of their representation.
6. improve further the collaboration between the IMF and the FSF – so that they together can get a better fix on systemic risk. Each of these institutions has a distinct comparative advantage that will be useful in identifying systemic risk; if they collaborate effectively, we increase the likelihood of building an effective early warning system.

G. Early warning and monitoring.

1. the focus of an early warning system should be on the monitoring of systemic risk.
2. both top-down (starting at the country level) and bottom-up (starting at the level of the individual large financial institution or market segment) approaches to monitoring and measuring systemic risk are useful.
3. analyzing “contagion” must be an integral part of any systemic risk exercise.
4. when sources of systemic risk are identified, there should be a “graduated” response (from the strictly confidential at one end, to publication at the other) in communicating that risk to the relevant parties.
5. new regulatory and supervisory measures will be of little use unless compliance with those measures is regularly assessed and unless there are pressures of one kind or another placed on those countries/institutions that are out of compliance.

III. Who Should Do What

If the framework for regulation, supervision, and oversight is to be strengthened – at both the national and international levels, there will be plenty of work to do for the IMF, the FSF, international standard-setting bodies, and national regulators and supervisors. Below, I sketch out some thoughts on their assignments. I believe that the case for establishing a new super international regulator is weak – both because there is not the political will to cede the requisite authority to such a new institution and because – if reformed properly – the network of existing institutions can do the job.

A. The IMF

1. Once a new international regulatory and supervisory template is agreed upon, the Fund should expand its FSAP (Financial Sector Assessment Program) and ROSC (Review of Standards and Codes) exercises so that it can evaluate countries’

compliance with the new template. Such exercises should be mandatory for all Fund member countries and the results should be published.

2. The Fund's membership should agree that FSAPs will be done for systemically-important countries at least once every 12-18 months; for other member countries, FSAPs would be done once every 2-3 years.
3. The Fund should strengthen its early warning capabilities – particularly its focus on monitoring systemic risk-- by performing a regular quarterly exercise that ranks countries' vulnerability to currency, banking, and debt crises. The Fund should also present regularly the kind of global credit loss analysis and projections that has appeared in the last few Global Financial Stability Reports.
4. Along with the FSF, the Fund should be informed before the fact when member countries are planning to introduce crisis management measures related to the financial sector (e.g. government guarantees on bank liabilities, capital injections, etc) that could have important spillover effects on other countries' crisis management plans.
5. As suggested earlier, the Fund needs to raise its game on exchange rate surveillance and on identification and publication of currency mismatches.

B. The FSF

1. The FSF should make recommendations to the standard-setting bodies whenever a clear majority of its members conclude that there is a significant hole in the existing regulatory structure and/or when a recent regulatory change is viewed as insufficient to deal with the problem addressed by that regulation.
2. The standard-setting bodies should submit to the FSF for review new proposed regulatory measures so that the FSF can offer a view on whether the acroeconomic impact of those proposed regulations would be pro-cyclical or not.
3. The FSF should intensify its work on monitoring systemic risk – covering both micro and macro-economic factors.
4. Following a proposal made by Sir Andrew Crockett, the Managing Director of the IMF and the head of the FSF should be given the authority to offer a joint public early warning on systemic risk when they feel that circumstances are serious enough to warrant such a statement.

C. The international standard-setting bodies (BCBS, IOSCO, etc).

1. The standard-setting bodies should translate the broader principles on reform of financial regulation, supervision, and oversight agreed by the G-20, the FSF, and the IMF into more specific operational guidelines that can be incorporated into national regulatory and supervisory frameworks (including the relevant legislation). In so doing, these bodies should be mindful that an earlier excessive reliance on self-regulation and on principles so broad as to provide little constraint on imprudent behavior has not been helpful.

D. National regulators and supervisors.

1. they should examine the lessons of the crisis to determine which demonstrated shortcomings in their national financial systems are country-specific in nature and are therefore less amenable to international standards and codes of conduct; they should then act accordingly to remedy such shortcomings (so long as such actions do not jeopardize the recovery from the crisis). For example, in the United States, there is a compelling case for reforming housing finance – ranging from putting more resources into education about mortgage financing, to designing a simple template for home mortgages, to establishing a federal regulator for the home mortgage industry, to putting Fannie and Freddie into receivership (on the way, inter alia, to breaking them up into smaller units and privatizing them). Similarly, the crisis has raised serious questions about the desirability of retaining 50 state regulators for the insurance industry instead of a national one, and about the adequacy of existing regulations covering prudent behavior by money-market funds. As suggested in the US Treasury ‘blueprint,’ there is likewise a strong case for streamlining the US regulatory structure along functional lines. And over the longer term, there is a serious question as to whether the ‘too big to fail’ problem can really be solved other than by restrictions on the size and activities of financial institutions themselves – as suggested in a recent Group of Thirty (2009) report on financial regulatory reform. Other G-20 countries have their own country-specific regulatory shortcomings to deal with.
2. Once a new international template for regulation, supervision, and oversight is agreed, national regulators will have the primary responsibility for seeing to it that the new template is reflected in domestic legislation and that a monitoring framework is established to ensure that financial institutions under their oversight are complying with the new international regulations.

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