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"Global Financial Crisis and Regulatory Reform"

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Reform of the Financial Regulatory Framework"

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Ladies and gentlemen

The financial crisis is far from over. Despite some encouraging signs, crisis management is still the order of the day in some places. In this respect, our immediate tasks are twofold. Firstly, we have to restore the functioning of the international financial system. On some occasions, resolute decisions are indispensable for solving problems of liquidity and solvency. The problem of toxic assets is still being worked out. Financial system rescue packages have been coordinated and are being implemented at the international level.

Secondly, economic growth needs to be put back on track. Fiscal stimuli are in place in many countries and are now starting to take effect. Nevertheless, reviving world trade and investment is also essential. We must not repeat the historical mistakes of protectionism. We have to refrain from raising new barriers to trade in goods and services and, in particular, we must not retreat into measures that constrain worldwide capital flows, especially those to developing countries.

However, simply restoring of financial system functionality and economic growth will not be enough. We also have to commit ourselves to sensible regulatory reforms that are genuinely geared to bolstering the resilience of the international financial system. The allocation of capital and risks and the provision of an infrastructure for payment and securities transactions are key functions of the financial system – functions that only a well regulated financial system will be able to perform effectively and efficiently. Moreover, sensible regulation reduces uncertainty and generates positive external effects on the real economy, thereby contributing to greater economic prosperity. In other words, over a more long-term horizon, a well regulated financial system is a necessary, but not a sufficient condition for financial stability and sustained global growth.

I Regulatory reform

1 Some key elements of regulatory reform

Before enlarging on the regulatory lessons to be drawn from the crisis, let me start with an overview of some key elements of regulatory reform.

Firstly, what is meant exactly by "regulatory reform"? Has the current crisis ended the era of deregulation? Should authorities now rush towards re-regulation? Simply calling for *more* regulation misses the point somewhat. It is the quality not the quantity of regulation that counts. We have to aim for *good*

regulation, thereby striking a balance between safeguarding financial stability and allowing for innovation. The regulatory framework needs to be repaired rather than rewritten or massively expanded. By the same token – notwithstanding a great deal of pressure to act – accuracy is more important than speed. Half-baked reforms might lack consistency and could prove to be costly owing to their unintended side effects. Given market participants' ingenuity, such side effects could include opportunities for regulatory arbitrage. Good regulation is key.

Secondly, in the preferred model of a market-based economy and financial system, market discipline still has a role to play. I would therefore like to caution against trying to fully substitute sovereign regulation for market discipline. Rather, regulation needs to be designed and used to create market discipline – for example, imposing a suitable degree of transparency. This approach would allow more flexible and less costly market-based solutions.

Thirdly, I would like to put into perspective some of the high-flown notions concerning the scale of the required regulatory reform. More often than not, improving regulation is about getting into the boring nitty-gritty that determines incentives rather than taking the ambitious grand approach to revamping regulation. To give just one example, one of the factors that triggered the current crisis was the loosening of underwriting standards in the US mortgage market. In this respect, the required regulatory steps may be rather small, but to great

effect. And they have to be taken not at the international level but nationally or even locally.

Finally, I want to turn to the question of timing. Some people are saying that we must give top priority to crisis management and that the regulatory overhaul of the financial system will have to wait. However, I fear that the window of opportunity for bringing about lasting regulatory changes will not be open for long. We should use the momentum for reform while the crisis is still under way.

2 Lessons from the crisis suggesting specific regulatory changes

In order to achieve regulatory improvements that substantially strengthen financial stability, it is essential to undertake an in-depth analysis of the underlying causes of the crisis. In this context, the work of the Financial Stability Forum – recently re-established as the Financial Stability Board – deserves special attention. As early as April 2008, the FSF (commissioned by the G7) published its Report on Enhancing Market and Institutional Resilience. The report carefully analysed the causes of the crisis and set out 67 specific recommendations for strengthening the financial system. A follow-up report was published in October 2008 and the work of the FSF has been incorporated in the action plan agreed at the G20 summits in Washington and London. The 67 recommendations of the FSF

Report are still highly relevant today and have been – or are being – implemented.

Let me now pick out three areas where the lessons of the crisis suggest specific regulatory changes.

Firstly, the crisis has revealed shortcomings in prudential rules. Market participants have a natural tendency to try to find methods to evade regulatory rules. Financial institutions shifting credit risks to off-balance-sheet vehicles was a typical form of such regulatory arbitrage. In doing so, banks used a loophole in the old Basel I regime which did not capture these vehicles or the liquidity lines granted to them. This loophole has been closed by Basel II.

However, Basel II has also shown some weaknesses. For example, significant amounts of structured credit products are held in banks' trading books, where Basel II capital requirements reflect market risk but not default risk which is captured only in the banking book. In other words, capital requirements afforded an opportunity to economise on regulatory capital by holding structured credit exposures in the trading book.

In light of this and other similar experiences, refinements of Basel II are necessary. The Basel Committee on Banking Supervision has already proposed a number of such refinements and is working on further improvements. But it is

important that regulators will act cautiously. While there is a broad consensus on raising the level and quality of capital required in the banking system, there is also broad consensus on not doing so while the crisis is in full swing. Until recovery is assured, the standard for the minimum level of capital should remain unchanged.

Secondly, the financial turmoil has revealed a number of shortcomings in the credit rating process. Rating agencies have underestimated the credit risks contained in structured products, thereby contributing to both the build-up and the unfolding of recent events. At the same time, credit ratings are referred to in various regulatory and supervisory frameworks. Against this backdrop, what now seems to be warranted is a system of registration and oversight for the agencies. This system should aim at safeguarding rating quality and proper management of the agencies' inherent conflicts of interest. The IOSCO Code of Conduct Fundamentals are an excellent point of reference in respect of good governance at rating agencies. Regulation across the world should be in line with this Code.

Regulation of rating agencies, however, must not be construed as an official seal of approval for their ratings. Ratings cannot and should never replace appropriate risk analysis and management on the part of investors. Investors need to make independent judgements of risks and perform their own due diligence. In order to enable this due diligence, rating agencies should provide full disclosure regarding the methodologies used

as well as the assumptions underlying the ratings. Moreover, since the risk properties of structured products differ considerably from those of traditional bonds, agencies should use separate rating scales.

Beyond establishing an oversight regime for credit rating agencies, authorities are reviewing the roles they have assigned to ratings in regulations and supervisory rules. The G20 have asked the Basel Committee to take forward its review of the role played by external ratings in prudential regulation. Unfortunately, there is, at present, no prospect of a suitable alternative to the regulatory use of credit ratings.

Thirdly, I want to turn to the subject of transparency. Transparency is necessary for the identification and assessment of risks as well as their management. It is also essential for making market discipline work and is an important means of maintaining confidence among market participants under stress. Complex financial instruments used for credit risk transfer have significantly changed financial systems over recent years. However, the risks contained in these derivatives are often still unclear.

While there is broad consensus on the need for greater product and market transparency, I believe this is not necessarily, first and foremost, a regulatory issue. Rather, we need to differentiate.

Regarding securitisations, arrangers of these securities are called upon to provide the necessary degree of transparency. Promising work is being performed under the auspices of the European and American Securitisation Fora.

Regarding credit default swaps (CDS), this OTC market is opaque by its nature. But we are witnessing gradual improvements in market transparency. The establishment of central clearing facilities will further enhance transparency.

Private sector initiatives are key for ensuring transparency in this area. Only if these efforts are not finalised or are not implemented properly, regulators will have to think about exacting the provision of relevant information and data.

3 Lessons from the crisis suggesting change in regulatory philosophy

Having discussed these specific regulatory lessons, we should take a somewhat broader approach and take a look at challenges regarding the philosophies that lie behind regulatory regimes. Two issues need to be highlighted: first, the need for a system-wide approach to regulation and supervision and, second, the scope of regulation.

The last few months have clearly demonstrated that a system-wide approach to regulation and supervision is required. This means that we always have to ask ourselves "What does it

mean in the aggregate?". In other words, what might be good at the level of the individual financial institution might have negative side-effects on the system as a whole if it is widely applied.

Regulation can be procyclical, that is amplify the natural upswings and downswings of the financial system and subsequently the economy. If this leads to boom-bust cycles, the functional viability of the financial system is jeopardised. An example of cyclical elements within our current regulatory framework may be found in the risk-sensitive minimum capital requirements under Basel II. These are based on probabilities of default that tend to rise in downturns. In addition, fair value accounting, which leads to valuations fluctuating along with market prices, has also come under scrutiny as regards procyclicality. During the upswing, fair value accounting contributed to the build-up of the massive leverage in the system. After the cycle had turned, fair value accounting accelerated the deleveraging, thereby aggravating the financial crisis.

Besides procyclicality, regulation and supervisory action taken to stabilise individual institutions may have adverse effects in the aggregate. This can endanger the whole system. Moreover, it is extremely difficult to capture the behaviour of financial market participants because of interlinkages and feedback effects. These may amplify any shock to the financial system

into a systemic danger. “Systemic relevance” needs to be explored in all its aspects and taken into account.

At any rate, the crisis has made it clear that a holistic, system-oriented policy approach to regulation and supervision is essential. The traditional, primarily microprudential approach (that is, looking separately at individual institutions) has proven to be too narrow. We have to complement microprudential supervision with a macroprudential perspective. This must include taking due account of the macroeconomic background.

To achieve all this, cooperation is key. Any system-oriented approach depends crucially on effective collaboration between regulators, supervisors and central banks. This cross-border communication and cooperation needs to be carried out in a more systematic way. As an example, I would like to mention the recent call [in the De-Larosière report] for a European Systemic Risk Council (ESRC). An ESRC would be responsible for pooling and analysing all information relevant to financial stability, pertaining to macroeconomic conditions and to macroprudential developments. This concept points in the right direction, although many questions of detail still remain to be settled.

Having emphasised the necessity of a system-wide approach, let me highlight my second issue, which is the scope of regulation. While there used to be major differences in regulatory philosophy regarding the scope of regulation, we

have recently witnessed some international convergence in attitudes. There is now a common understanding among the G20 members that all systemically important financial institutions, markets, and instruments should be subject to appropriate regulation and oversight. Filling out the details of this general agreement will be difficult nevertheless; the definition of systemic relevance is only a start in this respect. A measured approach is needed to redefining the appropriate perimeter and intensity of regulation. Authorities must be able to identify and take account of risks across the whole financial system; however they need not regulate everything in great detail.

As an example, I want to point out hedge funds. A typical feature of hedge funds is their use of high financial leverage. This means that the actual volumes of their transactions far exceed reported assets under management. Given their major importance and large transaction volumes, they can both cause and intensify market disruptions. Moreover, they are borrowers from and counterparties to systemically important financial institutions.

Hedge funds are, however, not at the centre of the ongoing crisis. But as a part of the so-called shadow banking system, they played a role in the strong pre-crisis expansion of credit. And there are good reasons to see them as a major force in the process of – at times – very rapid deleveraging.

In the future, the hedge funds will become subject to reporting requirements. They will have to provide, on an ongoing basis, macroprudential information which should at least encompass assets under management, leverage and broadly grouped investment exposures – while detailed reporting of positions need not be required.

II Regulatory landscape following the Washington and London summits

Before concluding, I would like to direct your attention to some material changes in the regulatory landscape that have been brought about by the crisis.

The first material change is – obviously – the implementation of lessons from the crisis into regulatory standards. This is also a window of opportunity for enforcing global adherence to international standards, which must include offshore financial centres.

The second trend has been an intensification of international cooperation. Overall, cross-boarder communication and cooperation have worked fairly well when financial institutions have run into difficulties. There is no doubt that international cooperation will be stepped up further. For instance, 28 supervisory colleges for significant cross-border firms have already been put in place and the others will be established by

June 2009. This will further enhance cross-border exchange of information among supervisors.

Thirdly, I want to draw your attention to recent changes in the institutional set-up regarding international financial regulation and financial stability. In this respect, an important change is that systemically relevant emerging market economies, not the least China, now fully participate in all aspects regarding international economic and financial cooperation, and rightly so. This can be seen clearly from the fact that the most relevant arena for financial issues is now the G20 rather than the previously dominant G7. The increased importance of emerging market economies is also reflected by the expansion in membership of the former Financial Stability Forum and the Basel Committee on Banking Supervision.

Another important fact has been the decision of the G20 to enhance the role of the FSF. Its mandate to promote financial stability has been strengthened and it has been re-established with a stronger institutional basis as the Financial Stability Board (FSB). This means that the FSB is in a position to go on playing its leading role in global financial regulation.

III Concluding remarks

Ladies and gentlemen

At the risk of oversimplification, I would like to conclude with five statements :

1. Regulatory reform is good only if it produces *good* regulation.
2. Good regulation pays attention to the macro picture and to what it does to the *system as a whole*.
3. International cooperation is indispensable in devising good regulation for the global financial system.
4. Good regulation needs a companion, and that companion is good supervision that enforces regulation.
5. Supervision needs to act on early warnings of risk.

Thank you very much for your attention.

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