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In the aftermath of the crisis: effective regulations on the financial market?

An effective, global regulatory framework for a more stable financial system

The financial crisis marks a watershed for the financial markets. The doctrine of "light-touch" regulation – and the "efficient markets" theory that underpins it – has failed. There is no question that an effective, global regulatory framework is an absolute must, if for no other reason than because it is in the interests of political hygiene: the state cannot hand out billions to prop up the markets and the banking sector and then simply sit back and assume that market discipline will make a better job of things in the future, because, after all, we're all supposed to learn from our mistakes. Submission to more stringent regulations is the price that the financial industry will have to pay for reaching out to the generous helping hand that has been extended to it. If these regulations translate into wise changes to the regulatory framework, then they are in the interests of the financial industry, signaling the sector's willingness to change and thus playing a key role in helping to win back customer confidence.

It would, however, be naïve to assume that a new, or even an optimal, regulatory framework would banish financial crises to the realms of extinction once and for all. The current crisis certainly isn't the first of its breed, nor will it be the last. The financial system has always had an inborn tendency to go over the top in both directions. As long as the "animal spirits" continue to influence the markets, phases characterized by collective exuberance or by abrupt mood changes will remain a recurring phenomenon. What can, however, be averted – and indeed must be averted, because capitalism most probably cannot afford a second crisis on the same scale as this one – is a situation in which the entire system becomes infected. Cries of "never again!" should not refer to the collapse of an individual investment bank, but solely in reference to the fact that this collapse brought the global financial system to the brink of a catastrophe, plunging the global economy into the most severe recession since the Second World War.

This is the benchmark that has to be applied to the current regulatory plans. The objective must therefore be to make each and every financial institution strong enough to ensure that the collapse of one business partner does not have the dreaded domino effect (micro-prudential perspective), while at the same time taking timely action to prevent absolute uniformity as regards market behavior so that the market does not reach a risky tipping point in the first place (macro-prudential perspective). If the policymakers manage to achieve this, they will have their secondary objective, namely a situation in which systemic risks do not force governments to spend billions of taxpayers' money in bank rescue operations, within their grasp at the same time. After all, the result would be a stable financial system, not in the sense of a system that is completely devoid of insolvencies and crises, but rather in the sense of a system that is able to cope with such upheaval under its own steam and in an open competitive environment.

A regulatory system with no loopholes

The previous regulatory system had shortcomings in both areas: micro-prudential supervision either left many institutions – the "shadow banking" system – out of the equation altogether or paid only insufficient attention to them, while macro-prudential supervision was simply non-existent.

In this respect, the fact that the regulatory debate is currently being restricted to banks is somewhat puzzling. Although there are still plans to create more transparency as far as hedge funds or rating agencies are concerned, for example, these plans would appear not to be at the top of the agenda at the moment. This is cause for concern in two respects: first, the very existence of "regulation-free" zones is a factor that undermines stability. Second, the need to close all possible loopholes is apparent now more than ever, with banks subject to far more stringent regulations and regulatory arbitrage incentives on the rise as a result. In this context, the much touted argument that hedge funds are more the victims than the bad boys of the financial crisis is unconvincing – even if it is certainly valid in many cases. After all, if the efforts to establish a new regulatory framework were aimed solely at coming to terms with the most recent crisis, they would be doomed to failure from the outset. The next crisis is bound *not* to be a reenactment of its predecessor, i.e. it is not unlikely that it will triggered by something outside of the banking sector.

Macro-prudential regulation

But even if the new framework does, in fact, manage to encompass the entire industry, it is not sufficient to simply concentrate on individual institutions. After all, the stability of individual players does not necessarily equate to the stability of the system as a whole. While, for example, one particular bank might not be encountering problems when trying to unwind risk positions at a particular point in time, this is not necessarily the case for all market participants who want to sell the same positions at the same time. Concerted behavior on the part of market participants when it comes to investment and risk management ("herd behavior") holds real potential for destabilizing the system, especially in crisis situations. Anyone who opts to focus only on the individual institutions and their risk strategies, and neglects to consider spillover effects and chain reactions, can no longer see the wood for the trees.

This means that one of the key lessons learned from the financial crisis is the understanding that the financial supervisory authorities have to keep a far closer eye on the stability of the system as a whole than they have in the past in order to identify possible systemic risks.

There is no clear definition of what is meant by “systemic risk”. The easiest way to describe it would be as the risk of a large-scale systemic crisis, i.e. the opposite of the targeted financial market stability. It describes a situation in which the financial system or parts of it are no longer able to perform their service function for the real economy, prompting major disruptions to monetary transactions, the supply of credit or risk-hedging, with a negative knock-on effect on growth and prosperity.

During the financial crisis that is just behind us, major intervention on the part of governments and central banks ultimately managed to ward off this sort of large-scale systemic crisis. Although the system’s vital functions remained intact, there were times when they were severely restricted - one of the main reasons why the economy slid into the deepest recession witnessed since the Second World War.

As a result, the need for macro-prudential supervision is beyond dispute. In order to secure the stability of the financial market in the long term, it is absolutely essential that capital and credit flows be analyzed at macro level to put a timely halt to any imbalances in the financial sector, e.g. credit bubbles; this forms the missing link between economic and monetary policy on the one hand, and micro-prudential supervision on the other.

The difficulties involved in macro-prudential supervision lie less in the design than in the implementation. The decisive question will be how binding the recommendations issued by newly created authorities such as the “European Systemic Risk Board” (ESRB) or the Financial Stability Boards (FSB) will prove to be in practice. It’s not as if alarm bells weren’t ringing even before the financial crisis as far as excessive trends in the financial system are concerned, it’s just that nobody took action. Since an (all-powerful) international authority with its own sovereign powers over all financial institutions across the globe would appear to be something of a pipe dream at present, it will be down to the national supervisory authorities to breathe life into the ESRB or FSB recommendations and make them part of their day-to-day supervisory practice. There is no doubt, however, that a macro-prudential supervisory system equipped with an effective tool box could have taken the edge off the financial crisis by taking productive measures in an attempt to prevent the dramatic increase in leverage in the financial sector – a development that was anything but a secret – before the crisis came to a head in the first place, for example by imposing additional, target-oriented capital requirements.

Strengthening micro-prudential supervision

If we turn our attention to micro-prudential supervision, the main issue – in addition to encompassing as many financial institutions as possible – is how to select the right tools for the job. Most of the measures currently being debated in the specialist committees are likely to meet with broad agreement in this respect, even though the specific impact that they will have remains a grey area and their detailed implementation, for example as regards timing or a transitional period, is still likely to cause a headache or two. Nevertheless, there is likely to be little doubt that it is correct, in principle, to:

- demand more, better bank capital,
- increase capital requirements for positions in the trading book and outside of the balance sheet,
- introduce anti-cyclical capital buffers,
- tighten up liquidity management processes,
- design remuneration structures with a longer-term focus and
- put effective insolvency legislation in place for financial institutions.

But these measures won't come free of charge either; the price will be slower growth on the financial markets and in the real economy. As far as the regulatory framework for banks is concerned, this catalogue of measures means no less than a fundamental overhaul and extension of the Basel II regulations – even though the latter have just been introduced ("Basel III"). There is no need for reforms on this scale in the insurance supervision sector. Solvency II means that there is already a regulatory framework which – provided it is implemented correctly – meets the demands of the post-crisis era. What is more, the fact that insurance companies proved to be extremely stable during the crisis – as long as they stuck to original insurance business – also argues against the need for any drastic changes. The regulatory and business models in place for insurers proved their worth when the crisis hit.

Over and above the Basel III considerations, however, a number of further-reaching and more problematic proposals are also currently a topic of discussion as far as the banking sector is concerned: additional capital for institutions of systemic importance, the introduction of a leverage ratio and the ideas being put forward by the US government as regards size and trading activities.

Regulating banks of systemic importance

The idea is that the implementation of additional regulations for what are known as banks of systemic importance, for example in the form of higher capital requirements for selected institutions, will help to maintain an even tighter rein on systemic risks. Nevertheless, the impact that such additional regulations would have would appear open to doubt. Despite seemingly clear-cut criteria such as size, substitutability and interconnectedness, the definition of what systemic importance means is ultimately a blurry concept, because the way in which these criteria are measured varies depending on the overall economic framework. As soon as the financial system is confronted with a stressful situation, even relatively small banks, such as IKB in Germany or the UK's Northern Rock – gain systemic importance: they literally become the straw that breaks the camel's back, because their demise catalyses mistrust into a (panic-driven) withdrawal of confidence, dealing the death blow to the stability of the system. And it's not as if this problem – to come back to the criteria used to define institutions of systemic importance – is a secret to the FSB either; a joint report by the FSB, the IMF and the BIZ to the G20 ("Guidance to assess the systemic importance of financial institutions, markets and instruments: initial considerations”) contained the telling admission that “All types of financial intermediaries, markets, and infrastructure can potentially be systemically important to some degree.”

This view ties in with our experience of the financial crisis, not least with the Lehman Brothers case. The Lehman Brothers bank was not systemically important *per se* – otherwise, the competent supervisory authorities would most certainly not have sat on their hands as the investment bank limped towards a slow and public death. If the overall conditions had been more or less normal, the insolvency would not have triggered crippling losses at business partners (counterparty risk) or throttled monetary transactions and/or the credit supply to the real economy either. In this respect, the view initially taken by the authorities, namely that the financial system and the real economy could handle the heat of the Lehman Brothers insolvency, was correct. What everyone failed to consider was the reaction of the investors who then turned Lehman Brothers into a “systemic case”: investors assumed that the problem assets that had sealed Lehman Brothers’ fate were also lurking in the balance sheets of many other banks, although they were unable to tell to just what extent. Their reaction was to stop making funds available to banks in general after the state had refused to shoulder the losses (as it had done with Bear Stearns). In other words: Lehman Brothers’ insolvency was not a systemic risk *per se*, but it was in its capacity as *pars pro toto*, which prompted corresponding reactions from market participants. The decisive factor was not Lehman’s size or interconnectedness (Lehman as a one-off case), but rather the largely uniform behavior displayed by banks in the forefront of the crisis (Lehman as part of market-wide imbalances).

This quandary of classifying individual institutions as being of “systemic importance” is one argument against attaching permanent supervisory law consequences to this criterion. It does not take much flight of fancy to imagine that carving the financial system up into areas that are “of systemic importance” and areas that are “of no systemic importance”, each subject to varying degrees of regulation, would lay the perfect foundation for the next crisis, particular in the case of the latter. Ultimately, this sort of dichotomization of financial market regulations could actually see the system veer towards instability, because it makes evasive action on the part of those involved appear all the more of a necessity. The objective of preventing systemic crises can be achieved far better by taking the macro-prudential supervision approach and analyzing undesirable market-wide developments while keeping *all* financial institutions and activities in the spotlight. By contrast, the introduction of increased capital requirements, or the imposition of bans, across the board for only a small number of institutions that are supposedly of systemic importance, with no link to any macro-prudential system, would appear to be neither productive nor justified.

So the answer cannot be to set up a plethora of special regulations for large and complex institutions. It is far more important that adjustments are made to the supervisory structure: global institutions have to be monitored by international supervisory authorities; this is the only way to ensure that the powers and perspective of the supervisory authorities are appropriate in view of the possible business risks. After all, it goes without saying that nobody looking at these institutions can deny that the stability of the individual parts does not automatically translate into the stability of the whole group. This calls for a supervisory authority that has the same global standing as the institutions that it is supervising, but that takes account of country-specific features and legislation in cooperation with the national supervisory authorities as well.

As well as serving to safeguard financial stability, one oft-cited argument in favor of additional capital buffers for institutions of systemic importance is that these institutions can always bank on being rescued by the state. In this respect, too, however, the financial crisis has shown that the fine line between institutions that have to be saved at all costs and institutions that can be left to go insolvent without any risk emerging for the system as a whole, cannot be drawn *ex ante*. In the event of a crisis, the formation of groups like these would be more likely to restrict the state's required room for maneuver, throwing obstacles in the path of any support measures. Experience to date also shows that there are two sides to the cost argument story as well: the US government now expects to generate a profit from the capital measures taken for the country's major banks, while tax-payers look set to lose out as far as cases such as AIG, GM, Fannie Mae/Freddie Mac – and the liquidation of numerous small banks – are concerned.

Leverage ratio

Another of the new micro-prudential supervisory tools that is on the agenda is a leverage ratio, with the Basel Committee explicitly mentioning the possibility of its introduction – initially as a Pillar 2 tool. Nevertheless, a non risk-sensitive leverage ratio would appear far from conducive to limiting the size of financial institutions. With Basel II and Solvency II, the international regimes in place for financial institutions had taken a conscious step in the direction of risk-based regulatory systems, based on a consensus that crude regulatory structures employing unsophisticated risk metrics could be too susceptible to management errors and regulatory arbitrage. The crisis has done nothing to dispel this consensus.

A leverage ratio might make sense only as an additional criterion that provides information for business and risk management processes and forms an additional topic of discussion for talks between the supervisory authorities and financial institutions or hedge funds. This is, however, subject to the proviso that a uniform global definition of a leverage ratio is pinned down as regards numerators, denominators, off-balance sheet exposures, relief provided by netting and assets that mitigate risk. It is crucial to ensure that this benchmark is given equal treatment under both the IFRS and US GAAP.

New proposals made by the US government

The assumption is still that the resolutions passed by the G20 states will be binding, and that the general course has been charted for a global regulatory framework. What is decisive to ensure that this framework is effective is that it is transposed into national legislation in a concerted effort. The process is, however, becoming an increasingly political issue that is being shifted to the national stage; this makes a common, global answer to the crisis more difficult to track down, increasing the risk of market fragmentation at the same time. The new proposals made by the US government are particularly problematic in this respect. While the idea of at least a partial return to the separation of commercial and investment banking may appear acceptable in the US, the long history of positive experience with universal banks means that this is not the case in Europe.

Furthermore, the proposals are far from convincing in terms of content, too, one example being the proposals on limiting the size of institutions. Neither the experience of the crisis nor theoretical considerations lead to the conclusion that there is a positive correlation between size and stability risks. The only argument in favor of state intervention in this area would be based on competitive aspects; otherwise, shareholders are the ones who decide on the business models of the banks affected.

It's a similar story as far as calls to limit proprietary trading, as well as investments in hedge funds and private equity, are concerned. The theory is that this would help take some of the risk out of the banking business. And yet, the idea of "security that you can bank on" carries risks of its own. The very nature of the banking business is to assume risks (in a responsible manner); this is the added value that they create and that enables them to make attractive offers to their shareholders and customers. If banks have to limit themselves to "safe" transactions ("narrow banks", "utility banks"), they will be forced to reduce the services that they offer, which means lower returns for shareholders and lower interest rates for savers. This would mean that in stable times characterized by a growing risk appetite, investors would turn their attention to alternatives outside of the banking sector that offer higher returns. The risks would then start to escalate in these areas, with virtually no supervisory controls in place. Consequently, banning certain activities for certain financial market participants would likely be counterproductive as far as the stability of the financial markets is concerned. What is really needed is transparency and clear capital requirements for *all* transactions based on the risk associated with them, independently, however, of the institutional framework in which they are executed. Participants shouldn't be lured towards taking evasive action in areas where high-risk transactions are simply re-labeled. This would ultimately be tantamount to the same sort of regulatory arbitrage seen before the crisis.

So it can only be hoped that the proposals unveiled by the US government will not pose a serious obstacle to the establishment of effective regulations that can be implemented and enforced at global level. Attempts by individual national governments to outdo each other with draconian measures have to be staved off at all costs, because otherwise, one would have to expect governments to protect the international competitive standing of their financial industry in other areas (e.g. as regards issues relating to market access or the free movement of capital) in return. The stability and efficiency of the international system would be left by the wayside. Today, in the aftermath of the crisis, the dream of a harmonized, global competitive environment is almost within our grasp; this opportunity should not be sacrificed in favor of short-term national policy considerations.

All in all, policymakers and central banks have so far achieved a remarkable feat in the face of the crisis. While they certainly deserve thanks and recognition for these efforts, their job is far from done. It is only when the way in which we say goodbye to the crisis is just as successful as the way in which we tackled it in the first place that we can really say that we've mastered it. And part of this exit strategy must include laying the foundation for a global regulatory framework. In this respect, 2010 will be the decisive year. The odds of success are still looking good thanks to the preliminary work performed by the G20, FSB and the Basel Committee. Here, too, however, it would appear increasingly important to bear in mind that old saying used by mountaineers, namely that the descent tends to be more dangerous than the climb up to the summit. We still have something of a hike in front of us before we make it "back" down to the security of a more stable financial system based on global rules. Capital requirements will have to be at the core of any changes: the objective has to be to take appropriate measures to boost quantity and quality, and to curb cyclical effects. Extensive and risk-commensurate capital requirements are the key to keeping the risk appetites of all market participants at a sensible level, strengthening market discipline, reducing the risk of infectious trends and making sure that profit expectations remain grounded. This will automatically force market participants to develop sustainable business models without the need for a deluge of additional restrictions or bans.