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Regulation-supervision: the post-crisis outlook

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Following the G20 summit in April 2009, the principles defined by the Heads of State and Government must be turned into operational rules. Over the coming period, the weaknesses of the regulation-supervision system need to be considered and the associated risks integrated into any new measures that are defined in the current environment.

The current system has four major weaknesses:

- *limited coverage;*
- *fragmentation;*
- *heterogeneity;*
- *pro-cyclicality.*

There are five risks that need to be managed:

- *coordination between numerous bodies at multiple levels can render the system opaque and unresponsive;*
- *the potential accumulation of regulatory capital requirements;*
- *difficulty in establishing the relevant liquidity management tools;*
- *the increasing complexity of prudential supervision rules may hamper financial innovation;*
- *macroeconomic and microeconomic approaches are too frequently considered separately, preventing a proper assessment of the efficiency of monetary policy and its impact on the real economy.*

NB: The opinions expressed in this article represent the opinions of the author and not necessarily those of the institutions to which he belongs.

The conclusions of the G20 summit reflect the participants' intention to provide the financial system with a reference and action framework to help combine economic growth and financial equilibrium. The work accomplished at this international summit must be commended. Although the focus was admittedly more on stimulus measures, it is clear that a stimulus package without regulation has even less chance of working than before.

In the wake of this political discussion the time will come for applying the principles to operational rules. The resulting framework will evidently be the fruit of negotiations and will certainly be complex. In this context, it is useful and appropriate to clarify and rank in order of importance the principles that must govern the new system. Regulation and supervision will indeed play a key role in the new system, clarifying and implementing a reference framework at both the macrofinancial and the financial institution level.

According to the definition given in the report drawn up by the High Level Expert Group chaired by Jacques de Larosière, "regulation is the set of rules that govern financial institutions; their main objective is to foster financial stability and to protect the customers of financial services. Regulation can take different forms, ranging from information requirements to strict measures such as capital requirements. On the other hand, supervision is the process designed to oversee financial institutions in order to ensure that rules and standards are properly applied."

Although the roles and responsibilities of regulation and supervision are clearly distinct, it is necessary to consider them together as a single system in relation to other financial players, such as governments or financial institutions.

The relationship between regulation and supervision pertains to another rationale, which links the player who defines the rules to the player who monitors their application. This essential link explains why regulators are to a large extent responsible for developing regulation.

Therefore, there are two levels of general analysis that have proven useful both in determining the flaws and weaknesses of the current system governing financial activities (Section 1|) and in identifying the risks to be managed beyond the redefinition of this system (Section 2|).

1| A critical look at the functioning of regulation and supervision

The prevailing opinion regarding finance has often been that markets are efficient and naturally return to equilibrium.

The financial crisis that we are experiencing has revealed the limits of this theory and of the regulation-supervision system that in certain respects is based on it. We have identified four major weaknesses, which must be corrected if we wish to meet the common objective of financial stability.

First, the regulation-supervision system has limited coverage. This may be due to the choice of governments, which have a particular view of the way financial markets function and their role in the economy. It may also stem from the lack of coordination between States, which allows large unregulated areas to develop. Market players take advantage of this situation, creating an industry that generates jobs and other positive economic effects. The calling into question of this state of affairs is especially problematic given its scope. As a result, what started out as an anomaly becomes an integral part of the system. The underlying idea of the system's limited coverage is that the absence of rules would encourage the taking of initiatives and would therefore create value more rapidly than overly regulated systems. From this viewpoint it can be argued that minimum capital requirements or strict rules concerning fit and proper management constitute barriers to entry. It implies that a model based on initiative taking without constraints is more likely to create value.

These approaches nonetheless conflict with several realities: the absence or lack of sufficient capital can remove responsibility from the originator of the project, thus transferring the risk to the consumer or to the rest of society, depending on the size of the project. The absence of professional standards makes it more difficult to identify and therefore to sanction improper practices.

A reference framework is therefore absolutely essential. However there is cause for adapting the framework so that it is constantly operational,

i.e. making it proportional to the degree of risk depending on the activity. Distortions can indeed appear between the different frameworks and activities, generating competition problems because of the many supervisors and regulators. These distortions are obviously the cause of numerous difficulties, hampering development, but also of opportunities for regulatory arbitrages or even of insecurity, although they are not likely to destabilise the whole system.

The lack of coordination between countries allows the development of unregulated areas that can destabilise systems. These areas include both countries with more 'relaxed laws' and actual tax havens. The two categories obviously do not have the same systemic impact. The reduction of this unregulated area is therefore a crucial issue for the stability of the financial system over the long term. This is not necessarily the case to the same degree during a crisis period.

The regulation-supervision system's second weakness is its fragmented nature, in view of globalised economies and financial markets. The resulting differences in standards have systemic impacts. The lack of coordination between players could also potentially aggravate the situation during crisis periods.

The fragmentation of regulators is manifest. Let us take the extreme example of the United States, where there is one insurance commissioner per State, none of which identified the monoline risk, where the large firms on Wall Street were poorly regulated by the Securities and Exchange Commission and the Federal Reserve which, faced with the complexity and fantastic speed at which the crisis developed, only fumbled. Not to mention that certain US regulators, such as those overseeing mortgage financing, had a vested interest in not imposing overly strict rules. Once the conditions for a crisis were there, i.e. risk of regulatory capture, the fragmented nature and lack of coordination of the system, the flaws and gaps in the system were responsible for aggravating the financial crisis. At the European level, although the situation does not appear quite so bleak, limits have also emerged. Regulators have not had the time to adapt, as they are not organised to do so. Supervisors are undoubtedly coordinated, but the results of their intervention are not apparent, due to the lack of a clear decision-making process. The European Central Bank (ECB) intervened in a timely fashion to provide the system with the necessary liquidity.

The only possible response to this situation is to rebuild the regulatory system's architecture and reconsider the regulation-supervision relationship.

At the top of the pyramid is the monitoring of systemic risks and the link that should be established with monetary and exchange rate policies conducted in the major economic areas, i.e. the United States, Europe and China, and their potential interaction combined with supervision rules. The impact of monetary policy on systemic risk, and particularly on the structure of systems and banking models, should henceforth be taken into account systematically.

The strengthening of the IMF's role, the increase in the responsibilities and the membership of the Financial Stability Board are evidently working towards this, as is the setting up of a European Systemic Risk Council under the auspices of the ECB.

However, this should not hide the fact that the United States does not apply the Basel II capital adequacy framework, or the fact that virtues have been ascribed to a leverage ratio that is ineffective in prudential terms and conducive to considerable distortions of competition.

The regulation-supervision relationship also needs to be re-examined. This point has been insufficiently analysed to date, despite the fact that it is one of the system's core elements. Supervisors will evidently continue to offer their experience, thus helping to fine-tune the rules and the ratios. The role played by the leading supervisor is naturally likely to strengthen the coherence of the system, as are the exchanges within supervisory colleges. This collective effort is tangible and indispensable. However, it may not be sufficient. There will certainly be grounds for making this dialogue more explicit and also for involving the industry in a clearer and more formal fashion. This approach should not be limited to consultation alone but taken as a shared responsibility, in order to assess both the risks and the opportunities.

The regulation-supervision system's third weakness is its heterogeneity. We should not forget that Basel II is now essentially a European system, which means that the banks of this region bear the brunt of the adjustment and pro-cyclicality of the measures related to this new regulation. US banks and regulators do not give the impression that this issue concerns them. European banks have invested a great amount to meet

these standards and are hoping to reap the benefits of their financial and human endeavours. They are drawing attention to the fact that the Basel II tools are, nevertheless, very useful during periods when counterparty risk deteriorates in terms of detecting risk and of forward-looking risk management thanks to the results of stress tests.

However, at the European level, heterogeneous practices in the definition of capital leads, in practice, to abnormal market pressure from cursory calculations which, in a climate of great uncertainty, are set up as management principles. The concept of solvency ratios thus differs from one country to another, which leads to a certain degree of incomprehension (at the least) between experts and markets.

In some respects, the market has thus taken the place of the regulators, as there is currently no established instrument that enables the comparison of the main European financial institutions' capital ratios. Clarification and harmonisation in this area are therefore urgent.

The regulation-supervision system's fourth weakness is its pro-cyclical nature. This is a well-known issue. In this context, the point that should be highlighted is what has turned out to be a devastating combination of prudential and accounting rules, which will deliver its full effect over the coming months.

The instability of markets leads to significant variations (via VaR models) in capital requirements. The deterioration in counterparties' ratings in the loan portfolio has the same impact. Overall, this additional capital requirement cannot be met by the market, and the system seizes up. In the absence of public intervention, the credit supply can only contract, thus increasing the pressure on the economy. The risk of a credit crunch thus becomes the direct consequence of the very prudential standard and accounting system that was trying to avoid it.

The practice of counter-cyclical provisions such as those introduced in Spain is one response to the loan portfolio issue.

The conditions governing the use of VaR in the event of extreme volatility should be re-examined. The limits of this tool are well known. The economic significance of prices in the markets is uncertain when the markets are unhinged and arbitrages are no longer possible owing to the scarcity of liquidity. At this stage, the accounting and prudential fields are totally interlinked. A separate approach is no longer acceptable either, which raises the question of regulators' powers in terms of accounting. Financial markets cannot be compared to other markets, since their specific nature and their role in the economy justify a specific regime, coordinated with the IASB, but with sufficient independence from the latter and the crucial presence of regulators at the decision-making stage.

Analysis of these weaknesses has led to a number of recommendations that should be taken into account when developing the new system.

In so doing, other risks related to the new architecture are worth identifying and taking into account.

This is the focus of the second section of this article.

2| Risks associated with the development of a new regulation-supervision system

Five main risks may be isolated. This is obviously not an exhaustive analysis; what follows merely reflects the concerns of a market participant.

The first risk stems from coordination between numerous bodies at multiple levels, without an explicit approach — so far at least — or a sufficiently clear decision-making process. No one is contesting countries' sovereignty, but it is important that the IMF and the Financial Stability Board formulate opinions and, better still, recommendations, and that these should be published in a given form and at a given frequency, in order to focus the attention of market participants, the media, and more generally any players who could influence government decisions.

The complexity of negotiations between policy makers is evident. Europe is an excellent illustration of this, and a number of the recommendations in the Larosière report show the very recent difficulties

encountered in the attempt to move forward, even slightly, in this field. However, clarifying the roles and the coordination process, defining the form of opinions or recommendations and their publication are factors that exert pressure and therefore help to make progress. Sharing and disseminating tools is also a powerful means of harmonising, as it is based on a more fine-tuned and explicit analysis of financial mechanisms. Establishing clearer procedures and the sharing of tools between public and private sector players should help to facilitate and strengthen links and therefore remove certain barriers and spread information more effectively. These are all factors that could improve the efficiency of monetary policy transmission and the assessment of its potential impact on the economy.

It would be desirable for Europe to play a pioneering role in this area. This is necessary in order to strengthen the area's monetary union at a time when its economies are diverging. Europe is less coordinated and less responsive than the United States and therefore cannot take the additional risk of importing rules and standards without drawing appropriate conclusions. Since this importing has already taken place, it is forcing a more complex coordination in a European alliance that remains divided, but which is all the more necessary for precisely this reason.

The second risk is that capital requirements could accumulate, at a time when markets will not respond satisfactorily to demand from the financial sector.

This accumulation is foreseeable since we are concomitantly witnessing the strengthening of capital requirements related to market activities, another related to the loan portfolio deterioration and a third subsequent to the detection of a flawed remuneration system for market operators, which is considered responsible for encouraging excessive risk-taking. Not to mention an additional requirement related to liquidity risk management or the possibility of the leverage ratio being taken into account. In addition to this are the consequences in terms of regulatory capital under Pillar 2 in the Capital Requirements Directive (CRD). Of course, it is not certain that all of these mechanisms will be set up and implemented concomitantly, but their number alone indicates that an impact study of their combined effects is necessary. The safety desired by all market players should not end up stifling the system.

The accumulation of capital requirements is an easy option for regulators and governments. It is reassuring at a time when confidence in banks has broken down, but it does not guarantee optimal financing of the economy. Fighting against this tendency amounts to taking a gamble on long-term growth rather than Malthusian approach.

The third risk is linked to the new tools that need to be implemented in order to improve liquidity management and avoid — both at the level of institutions and of the entire system — hitting the wall of liquidity and suffering the disasterous consequences. The Basel Committee and the various national regulators are trying to assess the liquidity phenomenon and the corresponding risks through the use of models, stress tests and additional capital requirements. Obviously, the transformation performed by credit institutions must be limited and their refinancing capacity, including during periods of market instability, must be correctly assessed. However, it must also be acknowledged that liquidity is an insufficiently understood mechanism that may be permanently linked to information asymmetry between players, as well as sudden changes in behaviour when uncertainty increases abruptly (a succession of rating downgrades by rating agencies, for example, has this kind of impact). We should thus accept the idea that the prudential mechanisms currently being set up are amendable. Investing in a better understanding of liquidity phenomena and integrating this knowledge into steering systems is indispensable. Liquidity has a large behavioural component. This is closely related to players' perception of the state of the system at a given moment. This image can change. The factors that explain the sometimes sudden changes of perception are worth closer analysis and clarification. Progress in behavioural analysis applied to economics should help to do this.

So, it does not all come down to ratios, and safety cushions are necessary. However, we should avoid making credit institutions bear the brunt of what is partly a flaw in the oversight of the system by certain regulators.

Lastly, in the euro area at least, a cross-border approach is indispensable, and logically should even constitute a prerequisite for the implementation of new requirements.

The fourth risk is that the increasing complexity of prudential regulation may hamper financial innovation, when the latter is indispensable in improving the financing of the economy.

This risk is difficult to assess. In the current context, we must rely on the quality of the dialogue between supervisors and market players. The crisis has reminded us that inadequate control and monitoring of some innovations can have destructive consequences. Therefore, we cannot leave it up to the market's spontaneous functioning alone. A framework is essential. This would not necessarily block innovation automatically. Innovation does not preclude regulation. One of the possible solutions is experimentation, analysed and controlled stage by stage. The smooth functioning of *Comités NAP* (*Nouvelle Activité, Nouveau Produit* — bank committees for new activities and new products) can help to control creativity without unduly restricting it. After all, this is the method used in scientific research laboratories.

The fifth risk stems from the fact that it is extremely difficult to combine micro and macro approaches in both the real economy and the monetary policy sphere. They are often considered as separate worlds, even in academic studies. This is not a satisfactory situation.

Therefore, systematic and in-depth assessments of the impact of monetary policy on financial markets are necessary. The same applies to planned changes in the area of regulation, even though this type of practice is already frequent.

Moreover, the observed limits of models that are inevitably based on historic precedents must be taken into account, and the use of scenario approaches should be increased to help identify risk frontiers, although they do not always necessarily need to be quantified. This type of analysis prepares the ground for crisis management and constitutes an appropriate way of strengthening the operational coordination between public and private sector players.

The regulation-supervision system will undergo new developments, or even a transformation over the coming months. This is crucial in order to ensure the stability of the financial system more effectively. In taking this approach, which aims to protect the public interest, we must make sure that the financial system's performance, particularly that of the various market players, is properly taken into account.

It would be paradoxical if European construction, which is founded on such sound and well-established principles as financial stability, were to become handicapped by rules imported from elsewhere (where they are not even followed) without sufficient examination of how they are likely to function or interact. Regulators and banks share the same objective of reaching the best possible balance between stability, security and performance in order to continue ensuring the financing of the economy as effectively as possible.