

Review of the Differentiated Nature and Scope of Regulation
A report by the Joint Forum

Contribution to:

The Invisibilities of the Most Visible
The challenge of Supervising Large Complex Groups in the Financial Sector
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JFDNSR – Outline of the Presentation

- **G20 Mandate and targeted focus of the report.**
- **Some general “guiding principles” to be followed going forward.**
- **17 Recommendations in 5 key areas:**
 - I. Key Regulatory Differences Across Sectors
 - II. Group-wide Supervision
 - III. Mortgage Underwriting
 - IV. Hedge Fund Regulation
 - V. Credit Risk Transfer
- **Issues to be considered**

JFDNSR – G20 Mandate and targeted focus of the report

Excerpt from the November 2008 Declaration of the G20 Leaders:

*The appropriate bodies [i.e., the Joint Forum] should **review the differentiated nature of regulation in the banking, securities, and insurance sectors** and provide a report outlining the issues and making recommendations on needed improvements.*

*A **review of the scope of financial regulation**, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with **ensuring that all systemically-important institutions are appropriately regulated**, should also be undertaken.*

➤ The JF did not attempt to address all “inconsistencies” and regulatory “gaps” in regulation across sectors. Instead, it focused on several specific “inconsistencies” and “gaps” in regulation that contributed to the crisis or that pose significant systemic risk.

JFDNSR – Some general “guiding principles” to be followed going forward

- **Similar activities, products and markets should be subject to similar minimum supervision and regulation.**
 - ✓ To avoid “regulatory arbitrage” → Some differences in regulation across sectors simply do not make sense!

- **Consistency in regulation across sectors is necessary; however, legitimate differences can exist across the three sectors.**
 - ✓ For example in the scope of responsibilities or underlying activities

- **Supervision and regulation should consider the risks posed, which may arise not only in large financial institutions but also through interactions and interconnectedness among institutions of all sizes.**

- **Consistent implementation of international standards is critical to avoid competitive issues and regulatory arbitrage.**
 - ✓ It is not all about regulation → partial or inconsistent implementation!

JFDNSR – 17 recommendations in 5 areas

I. Key Regulatory Differences across Sectors.

II. Group-wide Supervision.

III. Mortgage underwriting.

IV. Hedge Funds.

V. Credit Default Swaps (CDS) and Financial Guarantee Insurance (FGI)

JFDNSR – I: Key Regulatory Differences Across Sectors

- 1. BCBS, IOSCO and IAIS should revise their Core Principles to take into account “systemic risk” and overall “financial system stability”.**
 - The emphasis in “objectives” of regulation varies across sectors

- 2. A global minimum capital standard should be in place for each of the banking, securities, and insurance sectors .**
 - Aims to achieve consistency in prudential regulation “within” sectors
 - **GAP:** Only the banking sector has an international prudential framework

- 3. BCBS, IOSCO, and IAIS should work together to develop common cross-sectoral standards .**
 - Aims for similar rules and standards for similar activities and products
 - **GAP:** Similar risks are treated differently across sectors (reg. arbitrage)

 - **Another GAP:** Consolidated supervision across sectors → Section II

JFDNSR – II: Group-wide Supervision

- 4. Financial groups should be subject to group-wide supervision (in particular, those providing services across borders).**
 - Banking, insurance, securities or well-diversified conglomerate alike.

- 5. The Joint Forum’s 1999 principles on the Supervision of Financial Conglomerates should be reviewed and updated.**
 - Mainly to include “unregulated” entities (OBS vehicles, NOHCs), but also to bring them in line with sectoral developments.

- 6. BCBS, IOSCO, and IAIS should work together to enhance the review of cross-sectoral issues by supervisory colleges.**
 - To improve coordination and cooperation with regard to supervision and potential cross-border resolution of financial groups

JFDNSR – III: Mortgage Underwriting

- 7. Supervisors should ensure that mortgage originators adopt minimum standards focused on borrower capacity to repay.**
 - To address the weakness that credit underwriting standards had relaxed

- 8. Originators (whether or not currently regulated) should be subject to consistent underwriting standards and regulatory oversight.**
 - To ensure similar products / activities are subject to consistent regulation

- 9. National policymakers should establish public disclosure of underwriting practices, and the FSB should consider reviewing such practices across countries.**
 - While harmonizing mortgage lending practices may be a bridge too far, individual markets can be evaluated to determine overall adequacy

JFDNSR – IV: Hedge Fund Regulation

10. Supervisors should introduce or strengthen proportionate minimum “risk management standards” for hedge funds operators.

- Scaled to the size and complexity of the fund

11. Supervisors should impose “reporting requirements” on hedge fund operators to capture information on systemic risk and to monitor systemically important funds.

- In order to monitor, evaluate, and exchange information on systemic risks on a cross-sectoral and cross-border basis

12. Supervisors should impose “minimum capital requirements” on operators of systemically important hedge funds.

- In view of the operational risks posed, as well as to allow for a more orderly winding down in the event of bankruptcy

JFDNSR – V: Credit Risk Transfer (CDS and FGI)

- 13. Supervisors should encourage or require greater “transparency” for credit default swaps (CDS) and financial guaranty insurance (FGI).**
 - Stimulating storage of trading data, firm level disclosures
- 14. Supervisors should foster “information sharing” and “regulatory cooperation” regarding CDS market information and regulatory issues.**
 - Same goes for stress testing outcomes on FGI
- 15. Supervisors should continue to review “prudential requirements” for CDS and FGI.**
 - Capital, liquidity, concentration, risk management, and corporate governance requirements
- 16. Supervisors should continue to promote efforts to strengthen “market infrastructure” for CDS.**
 - Standardisation of contracts, clearing through central counterparties
- 17. Policymakers should clarify that FGI is captured by regulation and subject to supervision.**

Issues to be considered

- **Several of these “gaps” identified in the report were well known gaps (e.g., cross-sectoral inconsistencies already pointed out for example by the Joint Forum in its 2001 and 2006 reports).**

So, is the current sectoral regulatory framework still fit for the reality of today's financial markets?

Also, when EU directives are transposed into nationally enforceable laws, to what extent do new inconsistencies arise and how should cross-border firms best deal with those?

Issues to be considered

- **Much of the current regulatory initiatives being considered in response to the crisis result in increased prudential requirements on the banking sector, paradoxically increasing incentives to shift risks to other regulated sectors or to unregulated sectors.**

So, which entities should be subject to what degrees of financial regulation and supervision?

And in what respect is the distinction between banking and insurance relevant, and in what respect it isn't?