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Some key elements of future financial regulation

Panel comments at the Brussels Economic Forum, 15 May 2009

Chairman, ladies and gentlemen,

I would like to begin by thanking the European Commission and Marco Buti for inviting me to attend the Brussels Economic Forum and to speak to you here today.

I will use my limited time to discuss some key elements of future financial regulation. However, before doing so I want to make clear that my choice of topic does not in any way imply that I think regulatory failures were the main causes of the financial crisis. On the contrary, it has to be stressed that the failures causing the crisis were broad based. They included macroeconomic causes, such as global current account imbalances and low real interest rates, which, along with the predominant forms of financial innovation, encouraged the build-up of excessive leverage, the search for yield and the underpricing of risk. The failures also included flawed systems for measuring and managing risk at financial institutions and inadequate corporate governance. And then there were misaligned incentives in the financial sector and, in some cases, excesses and abuses.

Of course there were also weaknesses in regulation and supervision. However, it is not clear that market failures on the one hand, and macroeconomic policy failures and economic imbalances on the other, would not have resulted in serious financial instability – and even a full-scale crisis – had there been no weaknesses. But that is in some sense irrelevant. It is incumbent on us to try to close the fault lines in regulation revealed by the crisis. And now is the time to start the process even if it is true that there will probably not be much need to rein in excessive risk-taking in the financial sector in the near future. The reasons were explained so well by Commissioner Joaquín Almunia and Jacques de Larosière yesterday, and again by José Viñals this morning, that I do not need to repeat them.

Looking at various reports issued by the public and private sectors in the last year or so, there seems to a relatively widespread consensus on what the regulatory failures were in the build-up to the crisis. Key among them are the following:

1. The perimeter of regulation and supervision did not sufficiently capture the build-up of systemic risk in what has become known as the “shadow” banking system.
2. Insufficient role of a macroprudential approach to regulation and supervision.
3. A lack of focus on liquidity risk.
4. Use of risk measurement and management techniques that were similar to those used by financial institutions themselves, techniques that the crisis has revealed to be inadequate.
5. Fault lines in the regulation and supervision of cross-border banks or, in the apt language of the Turner report, global finance without global government.

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In the interest of time let me leave aside liquidity and cross-border finance, except to say that the BIS international banking statistics available up to the fourth quarter of last year reveal a sharp retrenchment in cross-border lending.[2] This is clearly part of the de-globalisation of finance triggered by the crisis and driven by the shift in the financial institutions' perception of the risks of globalisation and possibly also by nationalistic tendencies in some responses to the crisis. If we are not able to move swiftly to bridge some of the gaps between globalised finance and national supervision and safety nets, the considerable benefits of regional and global financial integration might be at stake. For monitoring these developments, you might like to know that the next release of the BIS international banking statistics, which will cover the first quarter of this year, will be released in late July and analysed in the September BIS Quarterly Review (posted at www.bis.org).

Before I start on the other three topics, let me make clear that what I am going to say on these matters draws heavily on research done by the BIS over the years and by the financial stability committees located at the BIS.[3] However, as research on some of the issues is still a work in progress, the usual disclaimer applies even more forcefully.

Now, as a general principle, the obvious solution regarding the *perimeter of regulation* is to include within it institutions (and indeed also markets and instruments) that could, on their own or in interactions with others, contribute to systemic risk to the degree of being capable of causing material system-wide damage. This approach is needed, in any event, for the macroprudential approach to work. The feasibility of, and modalities for, putting this principle into practice are currently under review, but it will certainly imply a move away from the institutional approach to regulation and supervision.

There seems to be an emerging consensus on the need to strengthen what is called the *macroprudential approach to regulation and supervision*. Thus the G20 declaration in April this year on strengthening the financial system supported it, and the de Larosière report that we discussed yesterday is also a strong endorsement.

However, it seems to me that there is some lack of clarity about what is meant by macroprudential, and about how to make such an approach operational.

I define macroprudential in this context as the application of prudential tools to the overall stability of the financial sector, taking into account the fact that aggregate risk is *dependent on the collective behaviour of financial institutions*, which means that it is partly "endogenous". By contrast, the microprudential approach focuses on individual institutions, with the objective of limiting the risk of their failure, and it treats aggregate risk as independent of the actions of individual institutions. But this is very much how individual institutions themselves see it: they regard asset prices, market/credit conditions and economic activity as unaffected by their own decisions.

There are two basic dimensions to risk in the financial system as a whole. The first concerns how risk is distributed within the system *at a given point in time* – the "cross-sectional

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[2] See Bank for International Settlements, *Provisional international banking statistics, fourth quarter 2008,* Basel, 28 April 2009 and analysis in the June BIS Quarterly Review to be posted at www.bis.org on 8 June 2009.

[3] See, for instance, C Borio, "Towards a macroprudential framework for financial supervision and regulation?" *BIS Working Papers,* no 128, Basel, February 2003; C Borio, C Furfine and P Lowe, "Procyclicality of the financial system and financial stability: issues and policy options", *BIS Papers,* no 1, Basel, March 2001, pp 1–57; C Borio and W White, "Whither monetary and financial stability? The implications of evolving policy regimes", *BIS Working Papers*, no 147, Basel, February 2004; Committee on the Global Financial System, "The role of valuation and leverage in procyclicality", *CGFS Publications,* no 34, Basel, April 2009; Note for the FSF Working Group on Market and Institutional Resilience "Addressing financial system procyclicality: a possible framework", BIS, 1 September 2008.

dimension", if you like. Here the key issues are correlations of exposures across financial institutions and what is called failure externalities. The second concerns how risk evolves *over time* – the "time dimension", if you like. Here the key issue is how system-wide risk can be amplified by interactions within the financial system and with the real economy. This is what procyclicality of the financial system is basically all about.

In some sense the macroprudential approach is a point of view and could be made operational without a major overhaul of existing tools and frameworks. However, to gain real traction in dealing with the distribution of systemic risk across institutions and through time, a strengthening of the toolkit and a sound institutional structure are needed.

For the time dimension we need countercyclical capital buffers or dynamic provisioning of some kind. There are several alternative designs, and work is under way to assess the relative merits of those. Also an open issue is the degree to which such buffers should be rules based or subject to discretion. My sense is that we need both. Rules protect against political interference and errors in judgment. However, we should not pretend to have the knowledge to design fully robust rules, and we need the leeway to deal with the unexpected.

For the cross-sectional dimension we could, for instance, have capital charges that vary with the contribution of individual institutions to systemic risk. That of course presupposes that we can measure it. Work is currently under way at the BIS on this issue and part of the results will be presented in this year's *Annual Report*. I will not wet the powder too much here, partly because some of this is being formulated as I speak. However, you will not be surprised to learn that the contributing factors include the risk exposures of individual banks, sensitivity to common factors, and the size and number of banks. What you might not be aware of is that the contribution to systemic risk increases more than proportionally with bank size. For further details, see the *79th Annual Report* of the BIS, to be released on 29 June at 12.00 pm.[4]

Turning to the institutional aspect, the key issue is that the macroprudential has to marry the tools of the supervisors with the macro-orientation of the central bankers. In principle, there are many ways to do that. Where bank supervision is inside the central bank, the solution to this problem should be easier. Where it is not, other methods have to be found. The proposal of the de Larosière report seems to go a long way towards solving this problem as far as the euro area is concerned.

Having heard all of this you might ask the questions: is this not too complex, and are we not falling into the same trap that contributed to the crisis – pretending too much knowledge – and should we not meet complexity with simplicity? There is a grain of truth in this. However, we cannot, and should not, discard the more complex and "sophisticated" approaches. After all, we are dealing with a complex system. What we should do instead is complement them with some simple safeguards, taking care the whole time not to believe blindly in any one approach. Thus we need to keep the modern risk-based approaches, and the Pillar I of Basel II, although in an improved form. But they could be complemented by limits on simple leverage ratios and possibly other tools. This is currently the Swiss approach to bank regulation.

If we are successful in the coming months in finishing most of the current work streams under the auspices of the G20 and the Financial Stability Board and subsequently reform financial regulation, will we have done our job in restoring financial stability and preserving it for the long run? I fear not. In the same way as the current crisis had broader causes than flaws in financial regulation and supervision, preserving financial stability requires stability-

[4] The BIS's *79th Annual Report* will be posted at www.bis.org.

oriented macroeconomic policies and the cooperation and coordination of governments, central banks and supervisory authorities, while every one of these keeps its independence within its specific remit. The framework for this has, for instance, been discussed in recent *Annual Reports* of the BIS.[5] Elaborating on that would, however, be a topic for another talk.

Thank you very much.

[5] See, for instance, Bank for International Settlements, "Conclusion: how might imbalances be fixed?" in *75th Annual Report*, Basel, June 2005, pp 140–52 and "Conclusion: the difficult task of damage control", 78th Annual Report, Basel, June 2009, pp 137–49.