

What Does Good Regulation Look Like?

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Abstract

The key regulatory reforms in the wake of the financial crisis are examined and considered in the context of how efforts to date can be improved to achieve “good regulation”. At the macro-level, the institutional design of systemic risk oversight needs to be re-focused on greater independence among committees and staff, while the conduct of macroprudential policy should be built around a clear set of rules and targets to achieve credibility and hence effective policymaking over time. Resolution mechanisms should be in place to provide a safety net for when macroprudential policy fails to halt the transmission of systemic risk, in order to protect the real economy from negative spill-over effects. Beneath this layer, more work needs to be done to achieve international coordination in the regulation of over-the-counter derivatives and to mitigate regulatory arbitrage. Steps to increase transparency and central clearing of derivatives are positive but domestic political agendas should not obstruct global agreement.

1. Introduction

Before knowing what “good regulation” looks like, we must first understand what it does not look like. A patchwork of inconsistent and incoherent rules imposed upon firms, products and actors, with both regulatory “overlap” and “underlap” – the former burdening institutions with excessive compliance costs, and the latter burdening society through the devastating effects of unmitigated systemic risk transmission. The situation described here sums up the regulatory framework in most developed countries before the financial crisis from 2008 onwards. That we are still experiencing significant headwinds, with markets continuing to gyrate wildly, indicates that much is still to be done to engender safer, more resilient markets. Crucially, trust and confidence on the part of investors in the robustness and fairness of the financial system is still sorely lacking; a clear barometer that we are still short of a satisfactory regulatory outcome.

It follows that “good regulation” can be described as the opposite of this situation. In general, policies and rules should be clear and consistent, and designed to ensure that: markets function competitively and as efficiently as possible; product innovation meets real needs (and in doing so generates social utility); and regulated entities function productively and profitably, to provide reasonable risk-adjusted returns to suppliers of capital. More fundamentally, the regulatory framework should ensure that the financial system serves the real economy while protecting it from negative spill-over effects.

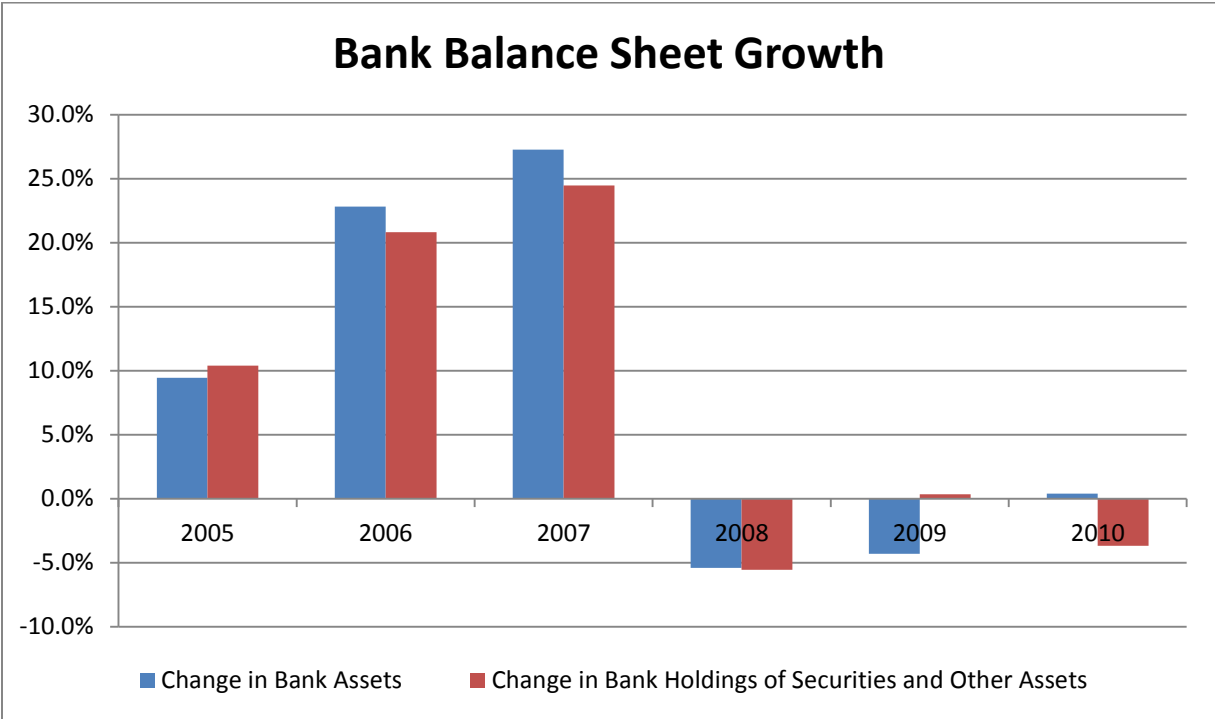
How do we achieve this vision? For a start, we clearly need a strong and credible framework for systemic risk detection and mitigation to address the fundamental issue outlined above. And beneath this layer, we need more effective and consistent rules for firms and markets themselves, most prominently in the form of stronger capital adequacy and liquidity requirements for banks and greater transparency surrounding financial instruments, among other things.

Although the deficiencies in systemic risk oversight, insufficient transparency in securities markets, and inadequacies in banking regulation have been well documented, progress to date in tackling them is limited at best. All too often, domestic political priorities have interfered with the achievement of meaningful reforms, and have frustrated efforts at building international consensus.

In this essay, the respective policy approaches to each of these areas are examined, and considered in the context of how efforts to date can be improved to achieve “good regulation”.

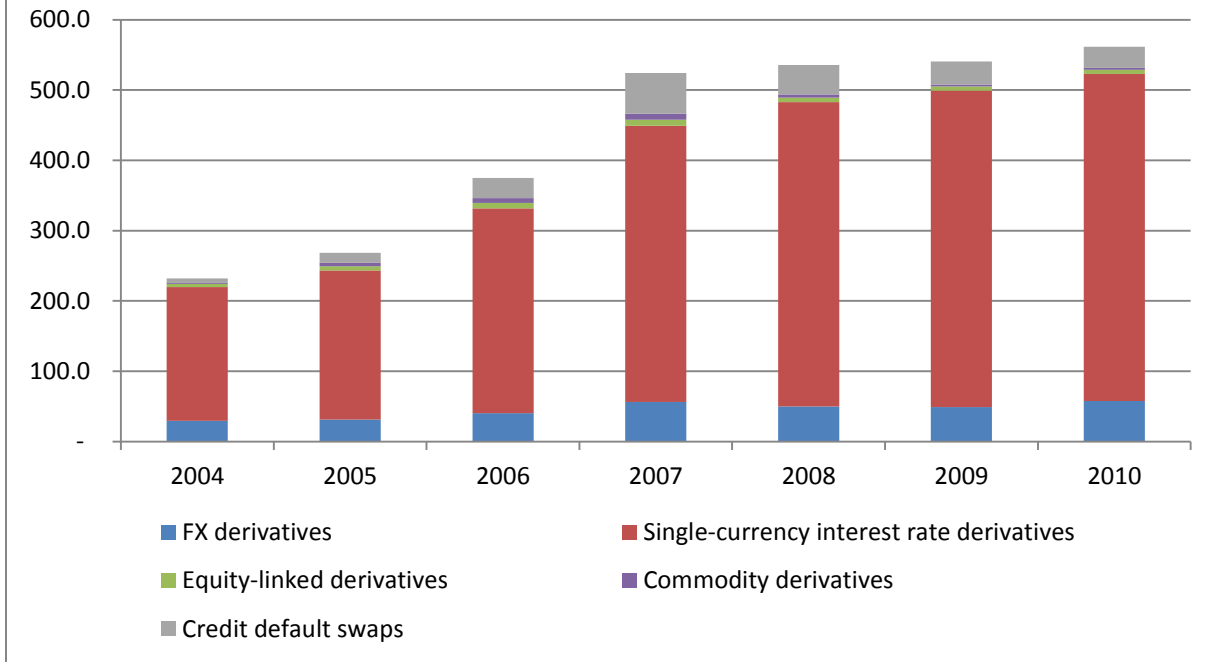
2. Macro Regulation: Systemic Risk Oversight

Systemic risk oversight represents the key, over-arching component of the regulatory framework that was most manifestly deficient during the financial crisis, whereby regulators focused on supervision of individual firms but not the system as a whole via the interconnections between firms and markets. As a consequence, the financial system became exposed to endogenous shocks stemming from excessive growth of bank balance sheets (leading to an under-capitalised or over-leveraged banking system) and growth in exposures to risky assets – specifically over-the-counter (OTC) derivatives and structured products – traded in relatively opaque markets. These trends are illustrated in the charts below, along with the systemic consequences as reflected by the downturn in equity markets, which are symptomatic of cross-asset risk propagation and the wider economic malaise that has ensued.



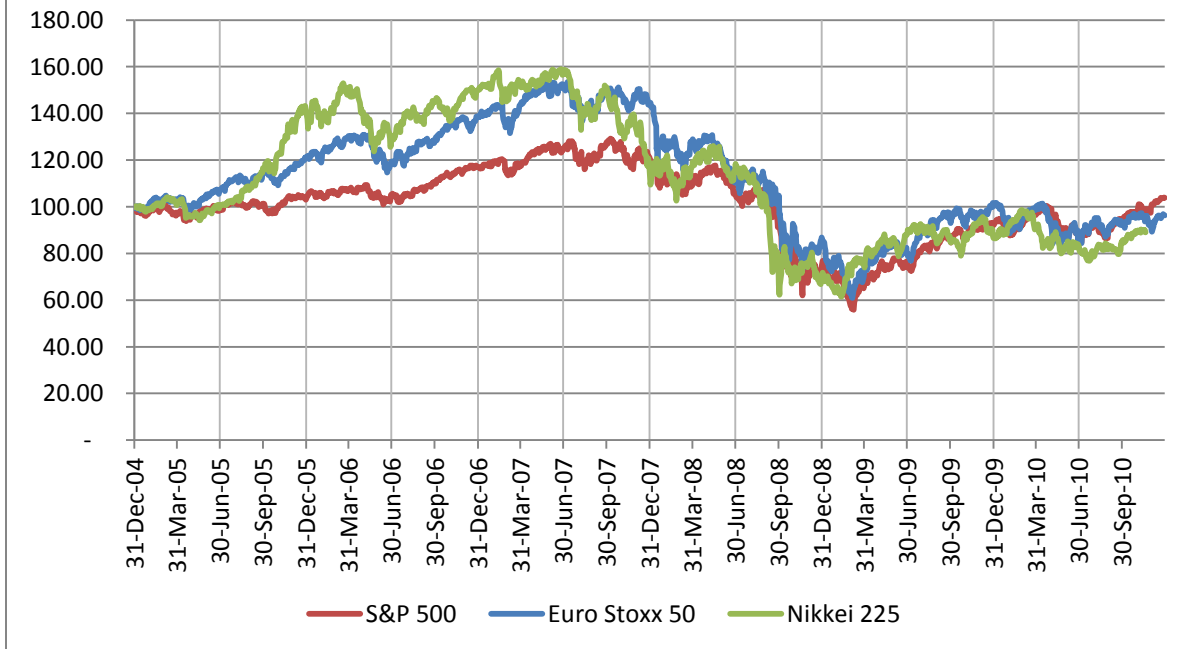
Source: Based on data from Bank for International Settlements

OTC Derivatives, Notional Amounts Outstanding (USD trillion)



Source: Based on data from Bank for International Settlements

Equity Market Indices (rebased)



Source: Based on data from Markit

A natural question at this juncture is why wasn't the issue of systemic risk previously recognised? The term itself is now widespread yet it was barely spoken about prior to 2008. Supervision was predicated on a belief that markets, populated by rational agents, were efficient¹. Specifically, acting in one's self-interest would lead to optimal outcomes, market discipline would limit harmful risk-taking and competition would ensure that only useful innovation would succeed. Because of the belief that agents would take rational decisions and that markets would self-correct, it followed that regulators would only need to focus on supervising individual firms, taking a "light touch" approach, and not worry about supervision of the system as a whole. The pervasiveness of this view was such that when systemic risk struck, it was both unforeseen and unmitigated throughout the developed economies.

Belatedly recognising this weakness in approach, authorities have devoted significant time to establishing systemic risk oversight mechanisms in key jurisdictions. But how do these fare?

In the United States, the Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) to identify risks to financial stability and respond to emerging systemic threats. The FSOC is comprised of the heads of each of the regulatory bodies that oversees the U.S. financial system, along with the Treasury Secretary and Chairman of the Federal Reserve. It is supported by the Office of Financial Research (OFR), which is ostensibly an independent research agency housed within the Treasury.

However, there are a number of weaknesses to this structure. Firstly, The FSOC is made up of the same regulatory institutions that oversaw the industry and failed to detect the well-documented problems. While this "college of regulators" structure might do a better job as a collective body than its component entities, it is no certainty; indeed, the lack of independent voices on the council exposes it to the risks of group-think, and hence, ineffective decision-making. Moreover, there is an existential conflict of interest stemming from the fact that FSOC members are effectively adjudicating on their own decisions made at their respective regulatory institutions. Again, this dilutes the effectiveness of the council's decision making. Finally, the

¹ See, for example, U.K. Financial Services Authority, 2009, *The Turner Review*.

fact that the OFR is both established within the Treasury department and directed by the FSOC renders its analysis less than independent.

Efforts at a pan-European level to address systemic risk oversight suffer from similar drawbacks. The European Union (EU) established the European Systemic Risk Board (ESRB), which became operational in January 2011. The ESRB is tasked with conducting analysis on emerging systemic risks, and providing advice and early risk warnings to national regulatory authorities within the EU. However, its construction again suffers from the fact that its members are comprised from existing regulatory institutions; specifically, the three pan-European regulatory authorities², the heads of the European Central Bank (ECB) and each of the 27 national central banks within the EU, and representatives from the European Commission. The secretariat is also provided by the ECB. In other words, the ESRB is subject to similar conflicts of interest and lack of independence as the FSOC. A further potential problem is that, as an advisory body with non-binding powers, the ESRB is unable to mandate action. Hence it is not clear how its decisions will synchronize with those of national systemic risk oversight committees. The United Kingdom, for example, has established an interim Financial Policy Committee (FPC) to monitor and respond to emerging systemic risks. Whilst, analogously, the FPC is housed within the Bank of England, it at least benefits from having a majority of independent members on the committee.

Given the inadequacies in the current U.S. and European structures, it follows that the best approach to systemic risk oversight is to construct an independent body³. Jurisdictions yet to establish policy frameworks for systemic risk oversight should therefore focus on independence.

A systemic risk oversight committee that is comprised predominantly of independent board members, supported by dedicated, independent full-time staff, would likely deliver more objective advice and decision-making as it would be less exposed to conflicts of interest. Indeed, freedom from political interference or regulatory bias is crucial for the policy framework to be

² The European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA).

³ See, for example, the recommendations of the Investors' Working Group (2009), *U.S. Financial Regulatory Reform: The Investors' Perspective*.

credible; and in turn, credibility is necessary for outcomes to align with policy goals. Other important elements to achieve a strong systemic risk oversight structure include providing adequate funding and making systemic risk oversight bodies accountable to legislatures to strengthen their integrity. Such bodies should also be transparent about their objectives, policy tools, and decisions, by issuing public statements and periodic reports (for example, following the communication procedures commonly adopted for monetary policy). Finally, other institutions tasked with implementing the policy decisions of the systemic risk oversight body should also be accountable for their actions.

Having addressed the institutional design of systemic risk oversight, the conduct of policy must next be considered. Given its focus on system-wide risk and its interaction with financial institutions – particularly banking institutions – and across markets, such policy is commonly referred to as “macroprudential policy”. Here, there are two elements to consider, namely, the macroeconomic and financial indicators to monitor and the prudential tools to employ in response to systemic threats.

Development of macroprudential policy is still in its formative stages. Whilst international consensus is emerging over its instruments, these remain untested for the most part, and the framework is still a work-in-progress. Specific challenges relate to building a complete data set to monitor for emerging risks and developing models that accurately capture the complex linkages between the financial sector and the real economy. Importantly, macroprudential analysis must take account not only of the banking sector but developments in the non-bank (or “shadow banking”) financial sector.

A number of international bodies have published papers on macroprudential policy⁴ that provide a good account of progress to date. Examples of systemic risk indicators are provided in FSB, IMF and BIS (2011) and include the following categories: aggregate indicators of imbalances (including macroeconomic indicators such as rapid asset price growth, and balance sheet indicators such as credit growth relative to GDP, bank leverage, and maturity mismatches);

⁴ See, for example, Financial Stability Board, International Monetary Fund and Bank for International Settlements (2011), Group of Thirty (2011), Institute of International Finance (2011), European Central Bank (2011), and Bank of England (2009).

indicators of market conditions (including financial instrument spreads and risk premia); measures of risk concentration (such as identification of systemically important financial institutions (SIFIs) as measured by their size, interconnectedness and substitutability); macro stress testing of the financial system as a whole; and monitoring systems, such as dashboards, heat-maps and composite indicators to provide a more integrated view of conditions.

Regarding the policy toolkit, the most commonly suggested instruments include time-varying capital requirements (e.g. modifying the risk-weights attached to different types of assets at different times in the economic cycle and imposing counter-cyclical capital buffers, in order to mitigate pro-cyclicality); dynamic provisioning (providing for expected loan losses through the economic cycle); additional loss absorbency capacity for SIFIs; limits on credit growth; caps on loan-to-value ratios and debt service-to-income ratios; limits on maturity mismatches, and so on.

The length of these lists highlights both the complexity of systemic risk and the challenge in mitigating it. Additionally, it is not yet clear which tools will prove most effective. However, at this stage, the broad approach to the nascent development of the conduct of macroprudential policy should be welcomed.

An important aspect of the macroprudential policy framework which has received less attention is the need to establish a set of rules to govern the conduct of policy. One of the features of the policy response to the financial crisis has been its ad-hoc, sometimes unpredictable and/or politically-motivated nature. Given the very difficult circumstances, this is perhaps not surprising. However, over time, the transmission mechanism of macroprudential policy will not function effectively if the policy framework is not credible; and for it to be credible, there needs to be a clear set of rules and targets around which decisions are based, as opposed to an ad-hoc approach. Such a rules-based approach helps to anchor expectations and therefore strengthens the link between policy goals and outcomes, thereby enabling policymaking to remain optimal over time. A rules-based framework should include targets for various systemic risk indicators as outlined above, and these should be clearly communicated to firms and market participants in order to anchor expectations. At the same time, the framework should allow flexibility in the choice of instruments and to allow such instruments to be operated in varying degrees.

Although macroprudential tools are mostly forward-looking instruments – that is, they are designed to deflate the build-up of systemic risk before it causes harm to the real economy – it is perhaps inevitable that macroprudential policy will not function perfectly. For that reason, it is important to establish a safety net in the form of effective resolution mechanisms for financial institutions that do fail. In other words, if macroprudential tools fail to stem systemic risk, mechanisms should be in place to limit the fall-out. Progress to date in this area has been weak. Although there has been much dialogue on the issue of “living wills” (essentially, the creation of detailed plans for the orderly winding-down of a financial institution), such plans are yet to be drawn-up by financial institutions. Moreover, resolution authority in key jurisdictions remains unclear and ill-defined. Consequently, the issue of “too big to fail” continues to present risks to the global economy. Whilst the incidence of bank failure should be lower under an effective-functioning macroprudential policy framework, more work is needed to ensure that, when failure does occur, financial institutions can be wound-down in a manner that limits negative spill-over effects on the real economy.

3. Other measures

Beneath the layer of systemic risk oversight, it is important to strengthen the resiliency of banks at the microprudential level and to enhance the transparency of financial instruments and markets in order build a more robust and efficient financial system⁵.

Much focus has been given internationally to reform of the banking sector. Under the Basel III accord, banks will be required to hold minimum equity capital of seven per cent of risk-weighted assets by 2019. Basel III also includes provisions for a gross leverage ratio; a liquidity coverage ratio (requiring banks to hold sufficient liquidity to fund their net cash flows for the next 30 days); and a net stable funding ratio, a longer-term structural liquidity ratio. But a clear fault of the new accord is that it continues to allow certain sovereign bonds to carry a zero per cent risk weight, even though, as recent experience shows, such bonds are not always risk-free. A zero per cent risk weighting merely enhances systemic risk as it encourages banks to hold more sovereign debt, thereby increasing their exposure to the fiscal position of the sovereign issuer.

⁵ Other aspects of regulation to be addressed, but not covered in this paper, include capital adequacy for insurance firms, strengthened conduct of business requirements for investment firms, and stronger rules surrounding disclosures and sales practices for financial products, among others.

Regarding the transparency of financial instruments and markets, the most pressing area for reform remains the OTC derivatives markets. The opacity of certain segments of these markets allowed exposures to build-up undetected, thereby increasing the severity of systemic risk and making it all the more difficult for regulators to tackle. To date, broad international consensus has emerged on the need for certain types of standardised, sufficiently liquid and clearing-eligible derivatives contracts to be traded on exchanges with prices publically disseminated. Additionally, such contracts are to be cleared through central counterparties (CCPs), with details of transactions stored in trade repositories, which are data warehouses that collect and store aggregate information.

However, while these measures are certainly welcome, much remains to be done before the G-20 goal of exchange trading and central clearing for standardised contracts can be realised by the target date of end-2012. The implementation details remain mired in political wrangling and commercial lobbying, frustrating efforts at building a coordinated global framework. Some of the issues that vary between jurisdictions and require better coordination include the scope of exemptions from the requirements for certain contracts as well as exemptions for end-users; and the type of collateral that will be permitted to serve as margin, as well as the level of margin, required by different CCPs in different jurisdictions. There should be agreements on the capital requirements for bilaterally traded and cleared contracts to push more derivatives trading through CCPs. A further issue is the extra-territoriality of some of these requirements, with some jurisdictions seeking to impose their own rules elsewhere without first seeking international agreement.

However, with all of these issues, the geographically unconstrained nature of the OTC derivatives markets means that, absent global coordination, regulatory arbitrage is the likely outcome. In this scenario, market participants seek to exploit divergent rules to conduct transactions in the most lax jurisdiction. This risks undermining all other efforts at building a safer, more resilient financial system. Although there have been calls from some to slow the reform process, there is a greater risk of a longer period of uncertainty and differing requirements borne from different implementation timetables between jurisdictions. Accordingly, improved international coordination of reforming the OTC derivatives markets should be a regulatory priority.

4. Conclusion

Taking a holistic view of efforts to reform the regulatory framework in the wake of the financial crisis, it seems that while many of the initiatives are well-founded, a number of structural weaknesses remain. Most prominently, the institutional design of systemic risk oversight needs to be re-oriented towards achieving greater independence, and the macroprudential policy framework should be built around a clear set of rules. Collectively, these measures are essential to achieve credibility and hence effective policymaking. Additionally, resolution mechanisms should be in place to provide a safety net for when macroprudential policy does fail to halt the transmission of systemic risk, in order to protect the real economy from negative spill-over effects.

To complement these initiatives, national authorities must shift their focus away from domestic political agendas and engage in constructive dialogue to accelerate reforms in the OTC derivatives markets. Better international coordination among regulatory authorities is needed in this area above all others to avoid regulatory arbitrage.

By adhering to these principles, the financial system will become stronger, more transparent, and more resilient to shocks. Only then can the regulatory framework be described as “good”.

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