Emerging from the Crisis – Building a Stronger International Financial System

Session 4: Issues Highlighted by the Crisis: Expanding the Regulatory Perimeter

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Why expanding the regulatory perimeter?

Among the lessons learned from the current crisis:

- Benign macroeconomic conditions in highly competitive environment resulted in lower due diligences and poor risk management practices performed by banks.
- Even banks with strong capital base can experience liquidity problems if they do not assess and manage this risk properly.
- Market discipline was apparently ineffective in constraining risk taking outside the banking sector: for example voluntary approaches have proved insufficient to ensure the integrity of the rating process and the ratings themselves.
- Investors in search of higher return ignored the risks implied by the complexity of the operations.
- Non-regulated entities could offer loans to risky borrowers with low credit standards.
Outline

1. Strengthening and widening the risks coverage
2. Expanding the scope of regulation to additional markets and market players
3. Will it be enough?
1. Strengthening the risk coverage

2. Expanding the scope of regulation to additional markets and all market players

3. Will it be enough?
1. Strengthening the risk coverage

The objective is to ensure that banks have strong capital and liquidity buffers and, as a result, are better able to absorb financial shocks.

This should be obtained by:

1. Reinforcing capital requirements and risk management for complex exposures (trading activities and securitisation positions),
2. Improving liquidity risk management and supervision,
3. Enhancing risk management in general,
4. Improving supervision of cross-border banking groups.
1. Strengthening the risk coverage

1.1. Reinforcing capital adequacy

- To better capture the risks associated with complex structured products:
  - Upgrade of the Trading book regime:
    - Supplementing the current VaR-based model with Incremental risk charge,
    - Addressing the shortcomings of the VaR: the “Stressed” VaR requirement,
    - No more gaming: Capital charges of the banking book and trading book are aligned.
  - Enhancements to the securitisation framework:
    - Higher capital charges for resecuritisation positions and ABCP liquidity lines,
    - Greater due diligence for rated products.

- And, to increase the quality and quantity of capital to cover exposures: Towards a common definition of regulatory capital? France supports a “basic tier 1”, based on common equity and reserves.
1. Strengthening the risk coverage

1.1. Reinforcing capital adequacy (cont.)

- To build additional shock absorbers into the capital framework that can be used in stress situations:
  - Countercyclical capital buffers and more prudent provisioning practices (“dynamic provisioning”),
  - Pillar 2 requirements,
  - Stress testing and, to the extent possible,
  - Through-the-cycle vs. point-in-time risk parameters.

- Towards a non risk-based measure of capital to supplement Basel 2 and contain the level of leverage in the banking system?
1. Strengthening the risk coverage

1.2. Improving liquidity management and supervision

➢ Raising the bar: a new global standard

➢ … Providing more consistency in liquidity supervision for cross-border banks
  ▪ Develop a common set of liquidity metrics,
  ▪ Ensure that banks hold sufficient highly liquid assets at all times,
  ▪ Ensure that regulation and supervision capture the diversity and complexity of banks’ liquidity risk profiles: How to deal with banks’ internal methodologies?
1. Strengthening the risk coverage

1.3. Enhancing risk management in general

➢ Supplemental Pillar 2 guidance (BCBS, January 2009)
  ▪ Reinforcing firm-wide governance and risk management, (CEBS High level principles for risk management),
  ▪ Capturing properly off-balance sheet exposures and securitisation activities, including reputational risk and implicit support,
  ▪ Managing risk and returns over long enough term.

➢ Sound fair valuation practices and rigorous stress testing
  ▪ BCBS guidance for assessing banks’ financial instrument fair value practices,
  ▪ BCBS Principles for sound stress testing practices and supervision.
1. Strengthening the risk coverage

1.3. Enhancing risk management in general

- **Additional initiatives**
  - Strengthening counterparty credit risk management, including setting up central counterparts (CCP) for Credit Default Swaps (CDS) markets,
  - More effective management of risk concentration and large exposures,
  - Review of corporate governance principles to strengthen the role of the risk management function.
1. Strengthening the risk coverage

1.4. Improving supervision of cross-border banking groups

- Cross-border bank resolution group of the BCBS:
  - Current arrangements (e.g. Close-out netting, Unwinding of financial transactions, Enforceability of parties’ rights to collateral, …) not designed to deal with cross-border banking crises.

  ➔ Towards enhanced Information sharing and Bridge banks?

  ➔ Implementing Deposit Insurance Core Principles: Consultative paper (March 2009) “Core Principles for effective deposit insurance systems”.

- In the EU:
  - Current review of the Deposit Guarantee Schemes and winding-up Directive,
  - European Commission white paper on early intervention tools to be published in 2009.
1. Strengthening the risk coverage

1.4. Improving supervision of cross-border banking groups

- **The importance of colleges for cross-border groups**
  - Revised CRD will establish mandatory colleges for all major EU cross-border banks:
    - By December 2009, the top 36 EU cross-border groups will have established colleges.
  - Scope of information exchanges to be widened: from the validation of internal models to all significant issues including liquidity ones.

- **The importance of the cross-sectoral perspective**
  - The financial crisis has brought topics of common interest for bank and insurance supervisors (i.e. the “monolines”)…
  - … which deserve consistent responses.
1. Strengthening and widening the risks coverage

2. Expanding the scope of regulation to additional markets and market players

3. Will it be enough?
2. Expanding the scope of regulation

2.1. To unregulated markets and products, such as the OTC Derivatives markets

- Derivatives:
  - Have experienced rapid growth,
  - Have increasingly contributed to the emergence of systemic risks,
  - Play an important role in providing credit availability to the real economy.

- May 2009: Iosco Publishes Interim Recommendations

- Objective: To better address counterparty risk and promote transparency and safety via organized trading:
  - By encouraging the standardisation of derivative contracts,
  - By moving towards multilateral clearing of OTC derivative products via Central Counterparties (CCPs), and
  - By overseeing those CCPs in the main jurisdictions.
2. Expanding the scope of regulation

2.2. To new actors: the credit rating agencies

- **Mandatory registration and oversight as well as strengthened cooperation between authorities:** market discipline has not sufficient.

- **In the EU:** new regulation requiring credit rating agencies to register under the oversight of securities regulators:
  - Objectives: ensure the quality of both the ratings process and methodologies: e.g. prevent conflicts of interests, promote more robust (and differentiated) rating methodology for complex products;
  - Ensure transparency of the rating process.

- **In Basel,** on-going review of the regulatory reliance on external ratings (standardized approach, securitization framework in particular).
2. Expanding the scope of regulation

2.3. To new actors: the hedge funds

- **A new EU Draft Directive for regulating hedge funds**, private equity funds, commodity funds, real estate funds and infrastructure funds (about 2 trillion euros in the EU).

- **Objectives:**
  - Enhance the transparency of the activities of hedge funds for investors and public authorities;
  - Ensure that macro-prudential risks are properly captured: Registration of hedge funds and key service providers, including depositaries and administrators, exchange of information with regulators on their leverage…;
  - Improve risk management practices: governance standards and systems for the management of risks and possible conflicts of interest.
1. Strengthening and widening the risks coverage

2. Expanding the scope of regulation to additional markets and market players

3. Will it be enough?
3. Will it be enough?

3.1. Towards an effective interlinkage between macro-prudential and micro-prudential supervision

- The regulatory/supervisory systems will be reshaped to be able to better **identify and take account** macro-prudential risks;

- At the EU level, the **Larosière report sets out proposals at to how to improve** the EU supervisory framework in this respect.
3. Will it be enough?

3.2. ... To promote financial stability at the global level

- The Financial Stability Board (FSB) will cooperate with the IMF to provide early warning of macroeconomic and financial risks and call for the actions needed to address them.

- Among the objectives are:
  - A better understanding of interactions between the banks and other financial sectors;
  - Progress in horizontal reviews, use of early warning systems, ... The BCBS (with others) will develop recommendations to strengthen process.
3. Will it be enough?

3.3. Supervisory convergence is key

- **Regulatory consistency:** The convergence of international financial regulation should be promoted by the FSB, in conjunction with international standard setters such as the Basel Committee, IOSCO, ... 

- **... And supervisory consistency through enhanced cooperation among supervisors:** Consistency in the supervision of large complex cross-border financial groups calls for comprehensive risk-assessments of these groups, by their colleges of supervisors.
Conclusion

- Regulation and oversight are to be extended to all systemically important financial institutions, instruments and markets;

- New rules for banks (trading book, securitisation, large exposures, liquidity...), and other actors (rating agencies, hedge funds...) or markets (CCP for credit default swaps...);

- ... as well as a new framework for supervisors (including both micro-prudential and macro-prudential supervision) are being designed;

- ... to get better prepared for the future financial crisis.
Thank you for your attention.