US & EU Reforms to Improve Management of Systemic Financial Risk

by Garry Schinasi

The Euro and the Dollar in the Crisis and Beyond

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The views expressed are personal.

Road Map

- Pre-crisis policy framework for safeguarding global financial stability
- How/Why did this architecture fail?
- Reform proposals
- Unaddressed systemic weaknesses
- Time Permitting: My preferred options for governing global finance

Three Main Points to Take Away

- The pre-crisis patchwork global architecture for preventing and resolving systemic problems failed in many areas
- EU and US reform efforts are still works in progress – with few tangible results yet and not much effective coordination
- There are several important weaknesses revealed by the crisis that have yet to be addressed or even fully recognized

Road Map

- Pre-crisis policy framework for safeguarding global financial stability

Sources of global systemic risk

- Financial Institutions – primarily large, international banks/groups.
- Global Financial Markets – FX, bond, and over-the-counter derivatives markets.
- Unregulated Financial Activities – Institutional investors (insurance, pensions, hedge funds)
- Financial Infrastructures – such as clearance, settlement, and payments systems (not discussed here)

Lines of defense against systemic risk

- Private risk management and governance
- Market discipline – adequate disclosure via financial reporting and market transparency
- Appropriate regulations, oversight of financial institutions and markets, and legal enforcement
- Crisis management and resolution (more detail later)

Oversight Regimes for Systemic Risk Management

	Sources of Global Financial Systemic Risk		
Lines of Defense	Global Financial Institutions	Global Money and OTC Derivatives Markets	Unregulated Activities
Pvt. Risk Mgt & Market Discipline	Partial	Primarily	Exclusively
Market and Banking Regulation	National with cooperation	Not really; over-the-counter transactions	No
Prudential Supervision	National and Home/Host Issues	n.a.	No
Market Surveillance	Indirect, as participant	Direct; National and International	Indirect, as participant

Source: Adapted from Tables in Schinasi (2007), 'Remarks on Causes and Conditions for Cross-Border Threats to Financial Stability,' chapter in FRB Chicago Conference Volume.

Road Map

- Existing policy framework for safeguarding global financial stability
- How/Why did this architecture fail?

What went wrong? Failures in all lines of defence.

- Markets dysfunctioned because of
  - Imperfect information
  - Opaque instruments and exposures
  - Poor incentive structures; excessive leverage
  - Inadequate governance/control by top management
  - Insufficient 'ex ante' market discipline
  - Loss of trust
- Official supervision failed to promote safety and soundness of major institutions
- Market surveillance failed to identify build up of imbalances
- Central bank and treasury tools proved to be too limited to address liquidity/solvency issues in restoring market trust and confidence

Why did existing architecture fail?

- Periphery of sup and reg inadequate – Balance sheet, national, and banking orientation of supervision and surveillance needs reform
- Central banks could address immediacy of liquidity problems. But, underlying problem was credit/counterparty concerns? Need new tools

Why did existing architecture fail?
(continued)

- Absence of regional and global financing mechanisms to recapitalize systemic cross-border institutions when deemed appropriate and necessary.
- Coordinated government efforts to recapitalize cross-border institutions (for example, Lehman Brothers and Fortis) reverted immediately to national ring-fencing and solutions.

Road Map

- Existing policy framework for safeguarding global financial stability
- How/Why did this architecture fail?
- Reform Proposals

US Reform Proposals

- *Systemic risk regulation*
- *Market regulation*
- *Consumer and investor protection*
- *Crisis-management tools*
- *Raise international standards*

EU Reform Proposals

- *EU Macro-prudential surveillance*
- *EU Micro-prudential supervision*
- *Reform of Over-the-Counter Derivatives*
- *Other EU initiatives*

Sufficient reforms?

- Could significantly improve resilience if fully translated into legislation, fully implemented, and fully enforced
- But, great uncertainty about US Congress outcome and EU member state agreement.
- Moreover, some unaddressed issues that are relevant for safeguarding systemic stability

Road Map

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- Unaddressed systemic weaknesses

Unaddressed Systemic Weaknesses

- Re-align balance between market discipline and official oversight (ex ante and ex post)
- Reconsider inter-temporal benefits and costs of too-big-to-fail SIFIs
- Consider global regulation and surveillance of global over-the-counter derivatives markets
- Ensure central banks have tools to co-manage both monetary and financial stability
- Meet other challenges of greater global governance of finance

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Options for reforming systemic risk assessment and management

- Centralized/coordinated surveillance of global ‘interbank’ markets to monitor systemic risk
- Two-tier banking supervision
  - Centralized supervision for cross-border/wholesale finance – the big players in OTC derivatives market
  - National/Local supervision for domestic/retail finance
- Regional/Global pre-committed financing for recapitalizing global/systemic institutions when deemed appropriate and necessary
- Uniform market regulation (one rule book) – designed/coordinated across major international financial centres.

Other essential reforms

- Bank capital requirements on off-balance-sheet and structured-product credit exposures
- Regulatory limits on bank leverage
- ‘Intelligent’ disclosure and market transparency
- Re-align compensation incentives with long-term stakeholder interests
- Hold bank executives, prudential supervisors, market regulators, and market monitors accountable for performance

Global Governance Issues

- What is the appropriate political level of leadership versus enforcement and implementation: Heads of State; Finance Ministers and Central Bank Governors; other authorities?
- What is appropriate geographic representation: can’t have 185 countries making global financial risk assessments?
- How to communicate risk assessment without triggering market disturbances?

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