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.
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.
- 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

<table>
<thead>
<tr>
<th>Lines of Defense</th>
<th>Sources of Global Financial Systemic Risk</th>
<th>Unregulated Activities</th>
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<tr>
<td></td>
<td>Global Financial Institutions</td>
<td>Global Money and OTC Derivatives Markets</td>
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<td></td>
<td></td>
<td>Unregulated Activities</td>
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<tr>
<td>Pvt. Risk Mgt &amp; Market Discipline</td>
<td>Partial</td>
<td>Primarily</td>
</tr>
<tr>
<td>Market and Banking Regulation</td>
<td>National with cooperation</td>
<td>Not really; over-the-counter transactions</td>
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<td>Prudential Supervision</td>
<td>National and Home/Host Issues</td>
<td>n.a.</td>
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<tr>
<td>Market Surveillance</td>
<td>Indirect, as participant</td>
<td>Direct; National and International</td>
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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

(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.
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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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