How to Bring in Systemic Risk Considerations into Financial Regulation and Supervision?

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Main issues in regulatory reform

- Effective regulation of individual systemic institutions.

- Limiting contagion between institutions.

- Limiting adverse impacts of financial regulation on macro-economic performance.

- Enhancing co-operation and co-ordination between different authorities.

Overall approach

"Elimination of systemic risks"

- size and business restrictions
- separation of banking business
- "narrow/public utility" banking
- higher capital ratios/leverage caps for large banks
- "solo"/host-country supervision
- moving OTC instruments on exchanges
  - ***high efficiency costs***
  - ***very difficult to enforce***

"Management of systemic risks"

- stronger risk management and governance standards
- leverage limits through modified capital regulation
- greater transparency
- clearing-house solutions
- non-cyclical financial regulation
- effective group supervision/ home-host cooperation
- enhanced macro-prudential surveillance
- regulation of systemic "non-banks"

Main principles for the "risk management" approach

- Make improvements in the present risk-based framework.
- Broad approach to regulating all systemically relevant institutions and their all material risks.
- Neutral regulation = limited distortions and incentives for circumventing behaviour.
- Set strong incentives for effective risk management.
- Boundaries between authorities should not matter for effective overall supervision of groups and surveillance of financial stability.

Strengthen risk management in systemic institutions

- Underline management responsibility.
- But need for stronger principles in regulation; enforcement by stricter supervision:
  - independent risk controls, reporting and model validation;
  - management by risk limits, risk-based performance measures rather than by “profit units”;
  - effective central risk monitoring in financial groups.
- More demanding standards and greater supervision intensity regarding systemic institutions; while not stricter capital requirements.
- Remuneration by long-term performance:
  - bonuses to funds, claw-backs.

Changes in the prudential requirements for systemic institutions

- Leverage limits via higher capital charges on trading book exposures and off-balance sheet exposures; not via simple leverage ratios.
- Prevention of life-threatening risk positions in any circumstances through limit setting ("reverse stress-testing").
- Adequate supervisory powers to enforce Pillar 2: i.e. the requirement to identify and manage all material risks.
  - Currently inadequate powers in many EU countries.
- Conservative stance towards allowing diversification benefits.
- Limits to business model and other types of concentration risks (e.g. funding).

Managing interconnectedness between institutions

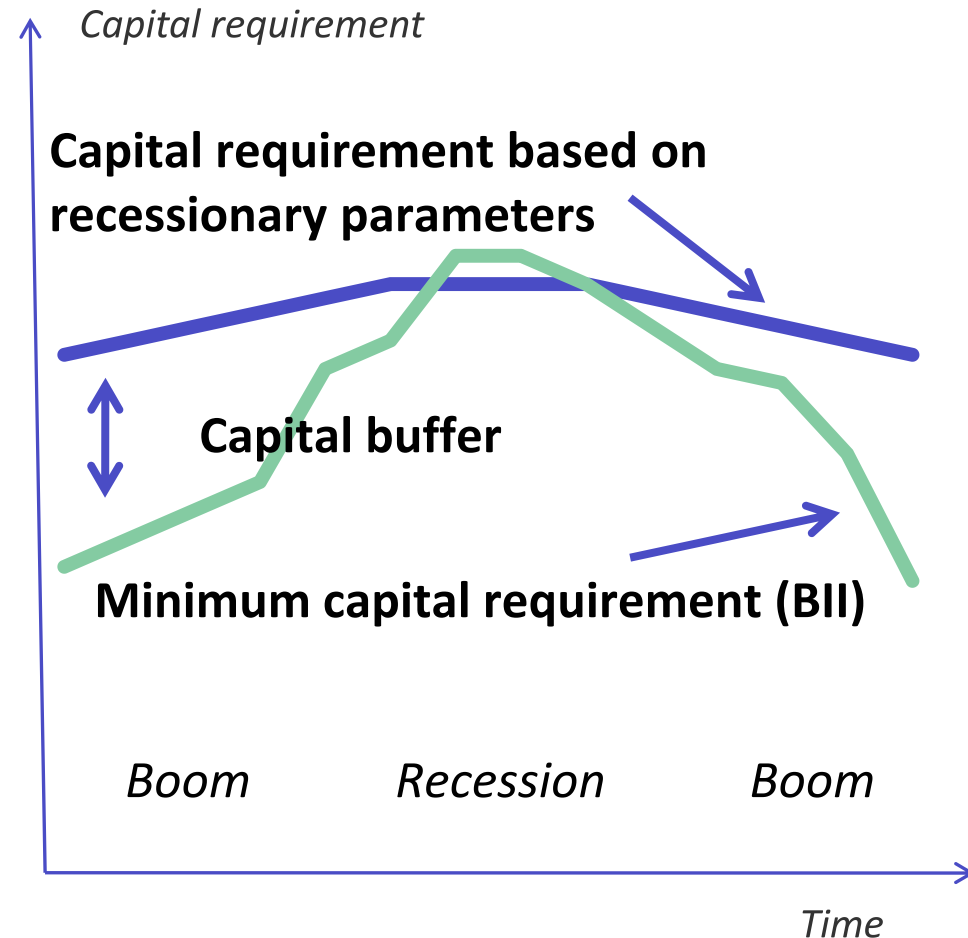
- Diversification requirements for interbank exposures, but not to obstruct liquidity management in cross-border groups.
- Enhanced consolidated supervision and home-host cooperation to allow benefits from centralised risk management in groups.
- Develop further co-operation and centralised EU-level steering in the supervision of major cross-border groups.
- Introduce adequate safeguards in regulation to let supervisors intervene early-enough when risk management fails.

Reducing pro-cyclicality of capital regulation

- FSF 20099: *Build-up a buffer above regulatory minimum during a boom; use the buffer to absorb higher losses in stressful environments.*
- Need a rule-based, transparent approach to allow for a build-up and release of the buffer:
  - Weak market pressure to have higher level of capital in good times; while questions of adequate capitalisation in bad times.
- Determination of the size of the buffer:
  - Use the risk-based Basel II framework as the only capital yardstick.
  - Draw on banks internal models to recognise modelling differences and specificity of individual portfolios.
  - Not possible to have public authorities determining the size of the buffer and setting the triggering events for its build-up/release based on macro-economic variables.

Automatic capital buffer based on internal models with recessionary parameters

- Required buffer = difference between the capital charge using recessionary parameters (PD, LGD) and the minimum capital requirement under Basel II.
- Set the buffer mechanism in hard regulation (not in Pillar 2 dialogue).
- Greater data requirements, but no public intervention required on the size/build-up/release of the buffer.
- Captures bank-specificities.
- Effective increase in the capital requirement (generation of a buffer) in favourable environments for bad times.



Changes also required in accounting rules

•IFRS accounting provisions should require provisions for expected losses (over economic cycles); not only for already incurred losses.

– Rely on internal models also when determining provisions; not on publicly determined formulas or triggers.

• Marked-to-market or fair value principles should be maintained for the benefit of early determination of losses.

• Need for much more international harmonisation of supervisory approaches to valuation.

Micro- and macro-prudential activities should not be separated

- Institutional setting is still based on a separation of micro- and macro-prudential supervision:
  - maintained also in the proposed new EU setting;
  - hard separation endangers successful conduct of both functions.
- Turning analysis into responses in micro-supervision is the key:
  - there are no macro-prudential instruments;
  - authorities will have to “lean against the wind”.
- Contagion links and common exposures of systemic institutions possible to see only from a global/EU perspective:
- Strict rule-based co-ordination of crisis management action is necessary due to conflicts of interest.

Conclusion

• Keep-up momentum, but resist responding to the financial crisis by intrusive regulation (trying to "eliminate" systemic risks).

• Build effectively on the current risk-based framework.

• Intensive supervision of systemic institutions rather than non-neutral regulatory requirements.

• Public authorities cannot engineer capital requirements to limit pro-cyclicality and build-up/release capital buffers.

  – Capital buffers ("automatic stabilizers") could be determined using the internal models approach with parameters estimated for recession periods.

• Capital adequacy regulation cannot "do it all"; we need to strengthen substantially internal risk management and governance.