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Optimal Structures for Financial Regulation and Supervision

David G. Mayes*

Introduction

The present financial crisis has led to a rethink of optimal structures for regulation and supervision. It has not been simply that deficiencies in both supervision and regulation have contributed to the crisis but that the structure of how international financial institutions are regulated and supervised by various groups of national authorities makes it more difficult both to reduce the chance of financial problems and to handle them when they occur. None of this has come as a surprise, but until the recent difficulties the problem had to a large extent been theoretical and not, fortunately, demonstrated in practice. Now it has been. This article therefore explores how it might be possible to improve the framework, particularly in Europe. An opportunity now exists for changes to be implemented as there is a political will to take action to avoid getting into the same difficulties again.

The problem at the national level

As illustrated by the recent de Larosière Group Report (2009), current thinking is that two main activities are needed to try to ensure the continued maintenance of financial stability. The first is try to ensure that individual financial institutions are prudentially run and second to try to establish where the threats to the stability of the financial system lie and how they can best be addressed. The present crisis has shown that both activities had important deficiencies, such as inadequate attention to leverage, liquidity and the procyclicality of capital requirements but the concern here is whether the structure of how these activities were organised was a contributor to the problem.

However an integral part of the problem of effective supervision and regulation is the ability to handle problems when they occur. This has also been seen to be weak and, while acknowledging it, neither the de Larosière report nor the Turner Review (2009) has come up with clear proposals for action. If financial institutions can expect to be bailed out if they encounter severe difficulties – especially if they are large or many banks face the same problem at the same time, it will be more difficult to persuade them to manage their risks as carefully as they might if shareholders' funds and directors' jobs were fully exposed. Thus if what happens in problem times is not addressed, setting up new structures to handle normal ("good") times may not be very effective. The institutions responsible for resolving problems and for ensuring that the safety net operates swiftly and effectively need to have objectives, responsibilities and an incentive structure that is compatible with prudence practised by financial institutions in normal times, not one that runs in the opposite direction as is frequently the case at present (Eisenbeis 2004). Having just bailed out several banks, as in previous crises, it will be even more difficult for the authorities to establish a believable regime that will make it clear that next time will be different and those responsible for taking the risks must absorb them, not the taxpayer.

Macro- and micro-supervisory structures

Despite the massive size of the crisis it is not clear that major changes are required to the structure of national regulation and supervision in good times but rather to how the supervision is carried out. Mayes et al. (2009) contains a wide range of suggestions, for example. It is clear that in some countries supervisors were too weak compared to those that they supervised and that there was a degree of regulatory capture. There have been clear problems in the United States with inadequate supervision outside the realm of traditional banking, indicating that the range of supervision needs to be extended. However, the complexity of the US system has been largely a facet of

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history and is not repeated in most other OECD countries. It is a very clear lesson to the EU countries in their approach to a single financial market that they too should not create a complex structure as they move steadily towards a single financial market and the continuing removal of barriers to integration. This would be all too easy, as existing authorities quite naturally do not want to give up their powers, and hence new organisations will have inevitable overlap and opportunities for conflict.

Moreover, much of the difficulty has been a collective international one, with Basel Committee standards proving to be inadequate. Therefore, although the crisis may have been centred in the US, there is still a need for all countries to address the failings in supervisory and regulatory standards. It is not surprising therefore that the G-20 has decided to try to improve the international framework, strengthening the Financial Stability Forum to form the Financial Stability Board. Nevertheless it is still the responsibility of each country to improve its own institutions, even though international advice and assistance will be of considerable value.

While the existing national individual organisations can be improved and responsibilities realigned among them to reflect the recent experience, it will always be difficult to recruit the best staff because of the salary differential with those who are being supervised. Regulatory and supervisory structures therefore have to reflect the realities and not be based on the belief that the authorities can always be one step ahead of the financial system. They will tend to be one step behind and an attempt to change this is only likely to be successful if it clearly inhibits innovation and the growth of the industry. Hence there has to be a balance between trying to avoid problems and clearing up those that occur swiftly with little harm to financial stability.

There has been a general tendency towards two structures for supervision and regulation, one being a responsibility for overall financial stability assigned to the central bank and the other a unifying of responsibility for supervision of the financial sector. Both trends are a reflection of experience and a reaction to developments in the market, where the main financial institutions are involved in most sectors. These trends make the organisations for both macro-prudential and micro-prudential supervision stronger and more expert. However, there is no universal recipe and it is clear that the size of the country matters. Small countries in particular find it difficult to support a number of organisations and it is argued that separating supervision from the central bank in Iceland was one of the contributory factors to their problems (Jännäri 2009).

There is a long-standing argument about whether central banks should be involved in supervision but it is clear from the present crisis that central banks need to be well informed about the health and activities of the individual institutions that comprise the financial system. Solutions such as those applied in Finland and Estonia, for example, involving a very close relationship between the two organisations and with extensive common facilities may well prove satisfactory if full integration is rejected.

Two main arguments are advanced for separation at the operational level. The first is that the needs of monetary policy aimed at price stability and financial stability may not coincide. The second is that it is not clear that the central bank is likely to be the obvious repository for skills in conduct of business regulation. Countries therefore have in general chosen either to set up an independent supervisor that combines prudential and conduct of business regulation or to concentrate prudential supervision in the central bank (Masciandaro and Quintyn 2007)

In some respects neither of these arguments remains very persuasive. The crisis has emphasised that price stability and financial stability are closely intertwined. A major failing in the previous arrangement has been that those responsible for overall financial stability have lacked much in the way of powers to do anything about it. The various Financial Stability Reviews (Cihak 2006), while well constructed, had largely an advisory role. Many of the problems of risk in the system had been identified but neither the responsibilities nor the powers for tackling them had been properly assigned. If macro-prudential regulation is to mean anything, those responsible need tools to achieve it. It is not clear for example how far implementing the de Larosière report would go beyond seeing that the European authorities were better informed. The Eurosystem would need new powers to act on this information.

The drawback to each country addressing the problems as it thinks fit and developing its choice of organisational structures for supervision and regulation is that the different bodies may not fit together well internationally. The three level 3 committees (CEBS,

CESR and CEIOPS) are already large in order to cope with responsibilities spread across a number of national agencies.

Structures for the resolution of problems

The major structural deficiencies, however, have been shown to lie in the field of problem correction. Once problems have struck, countries have found it difficult to respond in the way they wanted. The UK has probably illustrated both the problem and its solution most vividly with respect to large banks. But problems with resolving small banks, such as Custodia in Sweden (Riksbank 2006), have revealed that having a smooth process that allows an institution to close before losses mount is much more difficult than was expected. After the financial crisis of the early 1990s Sweden carried out a thorough review of its legislation and institutions and in 2000 produced proposals to tackle this deficiency. It has taken the present crisis to take action and implement these proposals. This is an important lesson in present circumstances: authorities can readily conclude that because they were able to get through a crisis, albeit with difficulty, they are adequately set up for the future – aided no doubt by the feeling that they have learnt the lessons and will not make the same mistakes again.

For such a regime to work well it must be possible for the authorities to act early at the first sign of difficulty and have a strictly time-bound approach that forces them to implement a resolution before shareholder value is totally eroded. The US, Canada and Mexico inter alia have such a regime, labelled SEIR (Structured Early Intervention and Resolution), whereby it is the duty of the resolution authority to achieve a resolution at minimum cost to itself. Since in each case the resolution authority is the deposit insurer, which will be among the first to be exposed to loss once shareholder capital has been exhausted, this provides a clear incentive structure for Prompt Corrective Action. In the US case a series of increasingly tough measures are mandated with the FDIC ultimately having to intervene once the leverage ratio falls to 2 percent.

The UK Banking Act 2009 has identified what it must be possible to do with a troubled bank (sect 1(3)):

- Transfer to a private sector purchaser
- Transfer to a bridge bank
- Transfer to temporary public ownership.

This entails having powers to transfer shares and to transfer property, rights and liabilities, by acting early while the bank still has positive value but is not viable without resolution.[1] All these can be achieved without triggering close out clauses or other ex ante ring fencing provisions. This requirement is key to a viable system. Ordinary insolvency will result in the interruption of many of the troubled bank's vital functions, which will of itself prevent a smooth resolution. US law specifically precludes any triggering during the day that the reorganisation takes place so there is no break in services. Furthermore, as the Custodia and Fortis examples show, it must not be possible for the shareholders to challenge the authorities' actions or the new arrangements will not work and counterparties will withdraw. Proper independently assessed compensation is obviously needed to ensure there is no expropriation.

What is more contentious is the institutional structure to achieve this. If the supervisor is responsible for resolution there is a danger of a conflict of interest. If a supervisor is not responsible then there is a problem of ensuring that the resolution agency is properly informed. In the US, the resolution agency, the FDIC, is also a supervisor. In Canada, the equivalent organisation, the CDIC, is not a supervisor but has a close relationship with the Office of the Superintendent of Financial Institutions from whom it can demand heightened supervision. In the UK, the Bank of England is the resolution agency, with its intervention triggered by the supervisor, the FSA. Nevertheless it is clear that the resolution agency needs to be involved at the outset of the process as soon as there is any concern that the subject bank may have a problem. The Bank of England has found that it takes around two months to get a smooth resolution in place. Finding possible buyers takes time even if due diligence processes are truncated with the aid of guarantees against hidden problems.

There are multiple objectives for the Special Resolution Regime in the UK:

- To protect and enhance the stability of the financial system of the UK
- To protect and enhance public confidence in the stability of the banking systems in the UK
- To protect depositors
- To protect public funds

[1] The UK FSA's phrase is that the bank does not meet the "threshold conditions" for continuing registration.

- To avoid interfering with property rights in contravention of the European Convention of Human Rights.

These objectives have no ordering and hence no requirement simply to maximise the value of the insolvency estate or minimise the direct or indirect cost to the taxpayer. This makes the prior assessment of what will be done in any future case much less predictable. While some argue that such ambiguity is constructive, the less people believe there will be a taxpayer bailout the lower the moral hazard.

The nature of the cross-border problem

The same two issues have to be addressed for cross-border financial institutions:

- First, to establish how national authorities in different jurisdictions can work together to ensure that large international financial organisations can be regulated and supervised efficiently and effectively in order to reduce the chance of financial problems
- Second, to improve how these national authorities can work together to resolve any problems that do occur.

A third issue is to ask how such joint work can be organised.

Most attention has been placed on the first of these issues and there have been a number of proposals already on how to proceed, the foremost of which in Europe is the report of the de Larosière Group (2009), which suggests a strengthening of the existing arrangements at two levels: first the creation of clear arrangements for improved macro-prudential supervision led by the ECB (a European Systemic Risk Council) and second improved co-ordination of micro-prudential supervision through each of the three "level 3" committees, CEBS, CESR and CEIOPS, which would be turned into authorities with increased powers:

- Legally binding mediation between national supervisors
- Adoption of binding supervisory standards
- Adoption of binding technical decisions applicable to individual institutions
- Oversight and co-ordination of colleges of supervisors
- Licensing and supervision of specific EU-wide institutions (e.g., credit rating agencies and post-trading infrastructure)
- Binding co-operation with the European Systemic Risk Council over macro-prudential supervision
- Strong co-ordinating role in crisis situations.

Enhancing macro-prudential oversight is likely to be non-contentious as it improves information for all those involved. The ESCB is the obvious route for such co-ordination since the principal players are the central banks although at the national level the effectiveness of the arrangements will depend on the powers assigned.

However, at the micro-prudential level there is some dispute (Turner 2009, for example) over whether it is best to treat the three sectors of banks, securities markets and insurance separately, when the trend in many countries has been to amalgamate financial supervision into a single authority. Turner (2009) also has a much milder view of the powers that should be assigned to a European level authority, making it an advisory rather than an executive agency.

While greater harmonisation of regulation and greater co-ordination among national supervisors will obviously help in improved cross-border arrangements it is not clear that this is tackling the problem head on and may be requiring substantial convergence of regulation where it is not essential. The large majority of banks round the world are national and likely to remain so. They can therefore be adequately dealt with by national arrangements reformed in the manner described in the earlier sections of this article. The number of cross-border banks that are of systemic importance outside their home country in Europe is quite small: 30-50 depending upon the definition used (Schoenmaker and Oosterloo 2007). Their supervision and regulation could indeed be dealt with through enhanced co-operation on an individual basis through supervisory colleges led by the home country. Although this will not cover the international banks that are not primarily European in character – wider international arrangements will still be needed.

An alternative solution, which has considerable attractions, is to have a European level approach. One approach is to have a European regulatory standard that would be applied directly (Cihak and Decressin 2007), thus avoiding the need for national authorities to change their own regulation. Nevertheless, having such a European standard might lead to extensive

convergence of national regulation as has been observed in the US.

However, co-operation and co-ordination in good times is the easier problem. Acting swiftly in a crisis has proved much more difficult. The experience with the three main Icelandic banks exposes some of the problems. First of all, the home authority must have both the power and the resources to address problems in the parent group and its branches. The Icelandic authorities simply could not manage to pay-out all insured depositors. This does not require a change in structures of supervision and regulation but a firmer decision on what structures of financial institutions are acceptable across Europe. Within individual countries more thought should be given to the monopoly (anti-trust) concerns to ensure that all financial institutions are capable of being resolved in a crisis (Stern and Feldman 2004).

Second the lead authority must be able to compel rapid action among the authorities in the group. Here, however there is a clear problem of mismatch between authorities. It is resolution authorities that are involved in resolving problems, and they may not be the same as the supervisors. For a structure to work well in a hurry it must be simple. Thus if one wanted a European level or international body, one responsible for resolution might be the best place to start rather than one for supervision.

The BIS (2008) is making a good start on identifying the main problems amd what needs to be done. National authorities would not simply need similar powers so that prompt corrective action and early resolution could be applied to a group but they would have to be able to act in the interests of the group as a whole, taking account of the systemic consequences of disorderly action, particularly in small countries dominated by foreign-owned banks. The objectives under the new UK Banking Act 2009 relate entirely to the UK and would therefore be at variance if another country in the group had a greater problem. The relationship between New Zealand and Australia illustrates how a workable system can be designed. All the main banks in New Zealand are Australian owned, but to enable New Zealand to act to maintain financial stability in a crisis they do not merely have to have the appropriate legal structure – to be properly capitalised subsidiaries – they also have to be capable of operating on their own, within a day, in the event of a problem. Thus if national authorities have a structure where they can each act to safeguard their financial stability, the cross-border system will work, as has been illustrated in the crisis by the case of Fortis. Operating a genuinely cross-border system without a division of responsibilities on national lines presents much greater problems.

The European Commission has recognised that the best way to tackle problems in financial institutions is to detect them early and act rapidly, and is preparing a White Paper on the topic to be published in the middle of 2009. However, the initial lists of differences in powers and tools collected by CEBS (2009) is daunting. To this must be added the further differences in a wider international context, including accounting rules and major aspects of insolvency such as the application of territoriality rather than universality that is applied to groups in the EU.

In a national environment it is possible to specify quite simply what the objective should be in organising a resolution and how conflicts should be resolved. This is no longer true in a cross-border context as those with countries with greater problems deserve a greater focus. It is thus difficult to provide an ex ante agreement but agreements at the time may be too difficult to organise in the limited time available.

It would be nice to be optimistic but history is not promising. It is well worth noting the remarks of the sceptics and seeking to make sure that their views prove mistaken. Kay (2009) provides an excellent example: "The likely outcome of present discussions is that everyone will agree they will regulate better and that there should be more co-operation between national regulators. This might prevent anything like the Icelandic problem occurring again. It is more likely that the tooth fairy will agree to provide compensation for future bank failures."

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