Editorial

Responses to the financial crisis

A STRANGE WORLD

It is a strange world. The financial system virtually collapsed in spite of the enforcement of regulations that were aimed at avoiding precisely that. Then again, regulators and standard setters do not seem to have coordinated their efforts very successfully. While Basel was looking for ways to allow banks to eventually reduce their capital base, albeit subject to the quality of their portfolios, accounting standards evolved and made the system highly procyclical, on top of some Basel rules that actually helped magnify the adverse cycle. Quite why those responsible for Basel and the accounting standards did not coordinate their efforts better remains an unanswered question. The Basel regulators have always targeted systemic risk, the risk that extends to all classes of financial firms, and its effect on capital markets. But their regulations targeted individual firms, at the microeconomic level, and did not focus sufficiently on systemic risk. The system became highly leveraged and mismatch risk became the norm for many financial firms or vehicles trying to capture the positive spread between short and long-term rates. Not many people cared, except for those senior risk managers and managing directors who knew the severity of the dangers involved. And their worries do not seem to have attracted much attention from top managements looking for development and profit, ensuring their practices complied with rules that were, in spite of regulations, designed to prevent such a crisis.

With trillions of dollars' worth of credit risk being offloaded onto the financial markets, high mismatch risk for financial firms and vehicles, and accounting rules that pleased all those profiting from a booming industry, but which are now seen to have worked adversely in a downturn, it is perhaps not surprising that the worries of some enlightened bank officers and executives did not draw more attention.

Now that we have experienced the system-wide crisis there is much debate regarding ways to avoid a repeat of the crisis. There is also much comment on the unfairness and asymmetrical treatment whereby huge losses are suffered by the public but gains remain with those working in financial firms. Yet, where firms are 'too big and too interconnected' to fail, this turn of events is unavoidable, however unfair it may seem.

But while regulators are looking for more stringent regulations, banks are resisting and still considering using previous practices. How, ask the banks, can we finance the economy again if the expected stronger capital constraints reduce the amount of credit we extend? The banks have a point. Without adequate financing, the economic recovery is going to be slow and subject to doubts by investors and others who still do not understand how regulators and standard setters will resolve the system-wide dilemma they face.

But can we revert to past practices associated with the same sort of governance that failed so spectacularly because the economy needs banks to finance the economy? While regulators say 'no', bankers say 'yes', on the grounds that techniques that worked well for so many years should work well again, provided that deviations from sound practices remain restricted within reasonable bounds.

It is indeed a strange world, with so many implications of the financial crisis still unknown, with so many players advocating that reverting to past practices is necessary and with too stringent regulations that will create the risk that regulators and policy makers miss their goals.

Joel Bessis, Co-Editor, Journal of Risk Management in Financial Institutions

Joel Bessis is Professor of Finance at HEC Paris. In addition, he undertakes consultancy assignments in banks and conducts executive training in risk management in Europe, USA and Asia.

REGULATORY RESPONSES

The regulatory response to the financial crisis has been along the lines of two main concerns — the capital and liquidity shortfalls found in the market and the realisation that global systemic risk is here and it is real. The world has now committed to have compensation, capital, liquidity and intensive supervision rules in place by the end of next year and to adopt an upgraded Basel II rulebook by 2011.

There is no doubt that significantly higher capital requirements for the risks on banks' trading books will be implemented, with the revamped Financial Stability Board (FSB) reporting to the G20 leaders in Pittsburgh that the average capital requirements for the largest banks' trading books at least doubling by the end of 2010. Whether these levels of capital are sustainable remains to be seen, but by the end of the year, the Basel Committee will issue a new minimum global liquidity standard.

This new regulatory framework introduces a liquidity coverage ratio that can be applied in a cross-border setting. It establishes a harmonised framework to ensure that global banks have sufficient high-quality liquid assets to withstand a stressed funding scenario specified by supervisors.

However, the crisis has highlighted the moral hazard risks posed by institutions that have become too big to fail or that, by their interconnected nature, are too complex to resolve. Over the next 12 months, the FSB will develop measures that can be taken to reduce the systemic risks these institutions pose in the belief that more intense and internationally coordinated regulation and supervision of firms presenting greater risks can help to reduce the probability of their failure. Possible measures include specific additional capital, liquidity and other prudential requirements, but, in almost a direct reference to the failure of AIG, the FSB will look at other measures to reduce the complexity of group structures and, where appropriate, encourage standalone subsidiaries.

Likewise, the European Commission too is forging ahead with ambitious reforms to the current architecture of financial services committees, with the creation of a new European Systemic Risk Council (ESRC) in a bid to oversee and manage the risk brought by firms operating cross-border, along with the creation of colleges of supervisors.

The ESRC, expected to be up and running next year, will monitor and assess risks to the stability of the financial system, assessing potential threats to financial stability that might arise from macro-economic developments, providing analysis, issuing early warnings of system-wide risks and, where necessary, recommendations to deal with these risks. Liaising closely with the FSB, the new body would for the first time equip the EU with a pan-European macro-prudential supervision system.

On founding the ESRC, the European Commission stresses that national supervision will not be affected and that this is adding an extra layer of supervision. As a result, it is expected that the ESRC will collect its data from existing supervisory bodies and national regulators, with no extra reporting requirements from banks needed.

But according to P. J. Di Giammarino, CEO of JWG, a think-tank for EU-driven IT change in financial services (http://www.jwg-it.eu/), there is no 'silver bullet' for building a macro view of systemic risk. He says: 'Nobody owns the entire picture of a market, counterparty, customer or instrument today, so why do the G20 think we can just hit a button and get a meaningful set of systemic risk results?'

Di Giammarino believes that banks need to be more involved so that practical solutions are found. He says:

> 'There are trillions of pieces of data flying about without any mechanism to bring them together. Creating quality data sets across different segments of the industry, markets they participate in and customers they serve, while developing technology to integrate the information within a time frame this short is impossible with the current focus.'

It is an ambitious task, but, politically, the attainment of robust macro prudential oversight of the world's global financial markets cannot be seen to fail.

Frances Maguire, Co-Editor, Journal of Risk Management in Financial Institutions

Frances Maguire is a freelance journalist with almost 20 years' experience. Formerly Editor of *Banking Technology* magazine and Associate Editor of *Futures & Options World* magazine, she is currently Contributing Editor for *The Banker* and *FX&MM* magazine.