



JACQUES DE LAROSIÈRE

Comment

There is a meeting of minds around the world on how best to reform the financial system, but enforcing these principles in a consistent way will still be difficult.

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There has been, over the past year, an intense reflection on how to reform the regulatory system. The Volcker Report (December 2008), the European de Larosière Report (February 2009), and the UK's Financial Services Authority Report (March 2009) have proposed a number of recommendations. On June 19, 2009, the European Council approved the main thrust of the European Report. At the same time, the Geithner proposals came out.

Many of these recommendations are similar or marked by a common inspiration. A few examples can be given:

First, there is a tendency, on both sides of the Atlantic, towards more regulation and higher capital requirements. Not for the sake of regulation, but for a better and safer functioning of the markets. The notion that regulation is fundamentally misconceived or dangerous and that self regulation is the right solution is now a thing of the past: the crisis has shown that most financial institutions were not able to moderate their short-term appetite for profit and to develop a true culture of risk management.

Second, the importance of detecting systemic risks early on is also recognised. The European Council has probably set out the most elaborate solution in this respect: the creation of a 'European Systemic Risk Council' under the aegis of the European Central Bank with the active participation of EU central bankers and supervisors, is a bold concept. The council will be responsible not only for analysing systemic risks, but also for issuing precise recommendations. Those who would be asked to act will have to do so or 'explain'. The EU Council would be called upon as a last resort. The US concept ('Financial Oversight Council') is to some extent different: it focuses on the detection of risks that could appear in "systemically important" institutions more than on the overall macroeconomic dangers. This, in my view, is a weakness.

Third, the procyclical nature of regulation should be reduced. Here also, minds meet. Bank capital requirements as determined by the Basel Committee have contributed to procyclicality. The reliance of regulation on rating agencies and on banks' internal risk models has been misplaced and has led to excessively optimistic results. There is also agreement, in principle, on the need to impose on banks higher provisions or capital requirements in 'good times' to be used in downturns. And one can equally note some convergence of views on the procyclical impact of accounting rules. Imposing the 'market-to-market' principle to banking books, including assets held on a long-term basis, leads to unjustified volatility and procyclicality. The International Accounting Standards Board should start working with regulators.

One could add to these convergent trends:

- The idea that the 'parallel banking system' should be brought into the regulatory net (hedge funds, dark pools of capital, etc...) in order to avoid regulatory arbitrage.
- The notion that over-the-counter transactions on derivatives (especially credit default swaps) should be standardised and conducted on regulated exchanges or, at least, cleared in sufficiently organised and well-capitalised systems.

■ The concern that compensation systems in financial institutions should be better aligned on their long-term interests and not be a source of short-term deviations.

But, all this being said, a major issue remains to be addressed: how to enforce these principles in a global and consistent way, so that all actors operate under the same obligations and that a common playing field is ensured?

FRAGMENTATION DANGER

It is indeed essential to resist fragmentation of the global financial system and the emerging threats of 'national' or 'regional' measures being taken by regulators in different parts of the world. This danger is real. We already observe some diverging concepts. For instance, the US notion that 'harder' regulation should be imposed on 'systemically important' or 'too big to fail' institutions is far from being an obvious solution. Experience has shown that medium-sized 'non-systemic' banks (IKB, Northern Rock) can create havoc. The truth is that regulators should calibrate capital and liquidity requirements according to the nature of the risks incurred by an institution, to the concentration of its activities and portfolio, to its liquidity vulnerability – independently from its size. It is clear that what is urgently needed is one consistent set of rules on capital requirements (especially regarding trading books and proprietary trading).

The G-20 has called on the Financial Stability Board (now enlarged) to oversee regulatory co-ordination in close collaboration with the Basel Committee. Will this prove sufficient? Time will tell. But we do not have much time. Are co-ordinating committees the most swift and efficient way to go? Let us not forget that Basel II is not yet applied by the US. I believe that if we



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really want to avoid national fragmentation, the best way would be to agree on an international treaty. That would provide clarity, enforcement procedures and sanctions on a global plane.

In absence of a treaty, at least one should use the IMF to supervise, at a national level, the enforcement of international prudential rules. The IMF/World Bank Financial Assessment Programmes (FSAP) should, as a minimum, be compulsory for all IMF members and fully integrated in the Article IV process. The FSAP results should be published and countries obliged to explain, if that is the case, why they are deviating from IMF recommendations.

Now that agreement has been reached on broad principles, this global enforcement process is the most important and urgent issue for the G-20 policy-makers. ¹⁸

JACQUES DE LAROSIÈRE CO-PRESIDENT OF EUROFI