Global Financial Regulatory Reform

Summary of Oliver Wyman perspectives for FSA discussion

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1 Introduction

We are caught up in a financial and economic crisis of historic proportions. It will like previous crises be characterised by several waves. From its start in US housing, we currently see a major credit crunch driven by uncertainty about bank balance sheets and major hedge fund redemptions, and expect corporate and sovereign credit crises to follow.

This paper outlines our views on the causes of the crisis, the failure of regulation to contain it and the actions that are now needed to reform regulation. It is intended as a discussion note to support meetings with bodies involved in regulatory reform. It is work-in-progress, not a final recommendation, so is intended to stimulate debate, not close it.

2 Causes of the crisis

The crisis is fundamentally the result of deep financial imbalances – especially in the monetary, exchange rate / reserve, and long-term capital supply policy arenas - that have created an unprecedented expansion of corporate stock and bond markets, and in particular of mortgage bonds. Thus the US housing bubble would not have reached this scale without the determination of Asian sovereign investors to sustain it for the sake of export promotion. Similarly, the unwinding of the global carry trades can be seen as a direct function of politically manipulated yield curves in many jurisdictions.

This fundamental cause does not excuse the failure of financial regulation to act as a brake on the macroeconomic accelerator. Its failure to do so greatly exacerbated the impact of the imbalances. Thus shadow banks, not controlled by leverage rules and willing to take big liquidity and interest rate risks, became the main drivers of capital demand. Lightly regulated jurisdictions competed with established financial centres and encouraged excessive growth of intermediaries – Iceland is just one of a dozen or so such centres worldwide. Regulatory arbitrage was also the main driver behind new products, and motivated new suppliers such as insurers to venture into banking. Public banking failed again, as the Landesbanken cases show. Despite the recency of the Enron case, the governance failures of financial firms – from short-term bonuses via toxic risk transfer to unsuspecting investors to executives sidelining internal risk management and misunderstanding primary markets – fuelled these trends.

In the face of these risks, regulators and their gatekeepers – accountants and rating agencies – failed to identify, control, monitor and mitigate risks, leading to the crisis we are now caught up in. They were not just overwhelmed by events. In some instances they also contributed to the failure of the regulatory system as a whole. The US inter-agency fights on regulating derivatives, or the correlation of fees paid by issuers to rating agencies with the toxicity of ABS products, are examples of how deeply short-term industry interests had penetrated the regulatory system as a whole.

3 Prevention through neutralising the wider causes of the crisis

The economic system that led to the crisis was based on the belief that markets could to a great extent regulate themselves due to the profit seeking self-preservation instincts of their participants. However, when prices (e.g. interest rates) send wrong signals and when design flaws lead to problems in market participants' coordination, profit seeking mechanisms tend to exacerbate market failures. The role of regulators should be to identify and act on these market failures. In particular:

- Debt fuelled capital demand
  - While Central Banks were mainly focused on controlling economies' monetary aggregates the development of bond markets became one of the main drivers of capital demand
  - Tied to monetary aggregates, interest rates were kept low and gave firms the ability to increase leverage and fuel demand in capital markets which created upward pressures on prices
  - Ultimately, this led to a self-reinforcing mechanism where firms' used bond markets to increase leverage and have taken big liquidity and interest rate risks for the sake of riding the upward trend in asset prices, driven by imbalances of supply and demand in the capital markets rather than by fundamentals
  - Central banks and regulatory agencies will be required to monitor a broader set of asset demand drivers in the economy in order to allow early detection and correction of demand/ supply imbalances and prevent unsustainable investment patterns that are often in the origin of asset bubbles

- Shadow banks, non-banks
  - All types of shadow banks should be folded into one of three formal financial charters: banks, insurers, investment funds.
  - The bank definition should strictly be defined by credit, and not as often in the past by funding. Finance company charters should be abolished.
  - Non-banks should follow not just transparency, but also suitable leverage and risk-based capital standards as banks. Regulatory competition options between charters concerning asset quality, risk profiles should be directly related to leverage. All non-bank charters should be forced to offer a capital preservation guarantee for investors as a basic alternative to other strategies.
  - Pension reform strategies ought to ensure that asset composition remains balanced and diversification sufficient to reduce the pressure on public bailouts of particular markets.

- Derivatives
  - Casino markets that transfer risks not matched by underlying real credit exposures should be banned for all three financial charters.
  - The regulator should drive standardisation of derivatives, through capital and regulatory incentives to use standardized and centrally cleared instruments

- Standardization occurs at the final stages of a derivative life cycle. The origin of derivatives is almost always driven by some market participants demand for risk transfer or hedging mechanisms and this natural mechanism should be permitted
- Problems arise when the misalignment of incentives leads to co-ordination problems. More concretely, when the elements of an asset bubble are present in the market brokers will tend to fuel the process as a result of:
    - increased prices often coming with increased volumes, which makes it easier for brokers to profit as prices go most times in one direction driven by a higher volume of transactions
    - Even if brokers were at some point convinced that the price of an asset had no real support, competition with other brokers prevents them from halting the rising trend as this would require them to waive business and profits
- The key to solving this problem is really regulating brokers' activity in a way that restrains their market power when it becomes perverse. Standardisation is a possible solution as it encourages capital into the market.

- Primary market transparency and protections
    - Consumer protection measures should be adopted, and extended to certain corporate credit markets (e.g. SME). Financial education and redress mechanisms should be strengthened. Risk-based capital and consumer protection rules should be realigned, material protections added to transparency (e.g. in case of objectively risky financial products);
    - Bank-internal improvements of underwriting standards should be matched by external transparency efforts with regard to primary market, e.g. improved access to collateral registers (esp. pan-European), improved valuation methods of collateral and price and instrument (e.g. rent level) databases, credit bureau standards.

- Restructure banks
    - Specialist institutions – benefits should be given to simple, safe business models with diversified funding structures; special (wholesale) banks should be operated only with explicit liquidity facility schemes;
    - Define bank insolvency regime: with predetermined degrees of protection for other creditors, predetermined creditor representatives (deposit insurer, senior bondholder, other) to be convened in emergencies

- Governance standards:
    - Banks should have an 'Appointed Technical Risk Manager' – Life companies have appointed actuaries who owe a duty to the regulator (personally) that the company is solvent.
    - Banks should be forced to strengthen sector and loan underwriting expertise by a re-licensing procedure by business area (mortgage, consumer, SME, corporate, public etc.).
    - 'Chairman's Board' minus 1 – at least one meeting per year should not have the CEO present. Many organisations that failed (Lehman, RBS, Northern Rock,

BayernLB) had overbearing CEO. Other whistleblower mechanisms should be considered.
- ➢ The duration of bonus pools should approximately match the risk mismatch of the assets. If you sell off all the risk, you can get paid today, if the institution holds it for 20 years, as a group the duration of the bonus pool should be 10 years.

4 Prevention through correct regulation of banks

The regulatory agenda of the last two decades has been crowded by initiatives aimed at reinforcing firms' controls and risk management and capital adequacy.

Recent events show that these initiatives failed. The reasons for this failure are linked to a backward looking regulatory process, in which decisions are made with a limited set of information. The result was that existing regulation failed to address significant risks (e.g. liquidity) and addressed others through a lens of complexity that prevented it from acting on the real sources of risk. We propose changes along the three pillars of Basel II.

- Minimum capital (pillar 1):
  - ➢ Leverage limits need to be based on all sources of risk including liquidity and interest rate / currency (ALM) which has been 'forgotten' in Basel II in addition to the current credit, market and operational risk framework;
  - ➢ In that vein, incentives for matched-funded lending and securitizations with credit risk retained but liquidity and interest rate risk passed to investors should be given; this addresses many problems seen in mortgage finance;
  - ➢ Liquidity diversification should be stimulated and liquidity coverage be required for at least 90 days, moreover liquidity gaps should be limited relative to capital;
  - ➢ Cross-border and cross-collateral credit diversification should be stimulated rather than ignored, as under the current Basel II framework; excess concentration especially damaged the UK banking industry;
  - ➢ Excessive credit growth should be penalized, e.g. by adopting the dynamic provisioning approach that Spain successfully implemented;
  - ➢ Excessive borrower leverage should be penalized, both in the case of consumers and corporate credit; the improvement of collateral valuation techniques is key in that regard (e.g. move away from open market house valuation to discounted cash-flow techniques);
  - ➢ Similarly, the use of risky financial products should be penalized, and here regulations be integrated with a stronger material consumer protection framework;
  - ➢ Models used to determine capital requirements should cut back on volatility-based concepts (e.g. VAR) in favour of integration with full economic (i.e. cyclical) models describing the primary markets;
  - ➢ In a 2-3 year horizon across the board higher minimum capital should be imposed, e.g. tier 1: 5%, tier 2: 10%, here the new interest rate and possibly liquidity risk capital charges can be used as a vehicle.

- Supervisory review (pillar 2):

- Supervisory capacity ought to be strengthened: goals are political independence (comparable to central banks), market-based salary levels, greater barriers to post-career at supervised institutions;
- Supervision authorities should be given a lender of last resort and insurance function, e.g. via conversion into capitalized deposit insurance agency or as backup of a private deposit insurance system. The US FDIC has been one of the few regulatory agencies that consistently outperformed other regulators.
- Private sector (banking group) supervision should be strengthened, e.g. by introducing formal private deposit insurance (mezzanine level, after lenders taking first hit, with public deposit insurer taking the catastrophic hit and doing oversight) and enforcing member liquidity facilities in proportion to deposit insurer capital (e.g. 5:1). Similar private sector group protection can be arranged for secured bondholders, e.g. in the case of covered bonds. This structure provides for an implicit extension of supervisory review.
- Gatekeeper reforms (accountants, rating agencies) should focus on payment structure (investors, and/or government), establishing external control mechanisms (e.g. model policing of rating agencies), and credible penalties for misconduct. Outsourced functions should partially be reintegrated into regulatory agencies.

- Market discipline (pillar 3):
  - Separation and trading of risks remains essential, i.e. reforming the securitization market. Huge universal banks threaten to become the mega-black box; trading allows for risk pricing data and reducing excessive concentration and correlation risks. Preference should be given to products that are explicitly guaranteed, backed by capital. Structuring without such guarantees should be discouraged.
  - Deposit (as well as money market and other public guarantee premiums) should be risk-based, and disclosed.
  - All banks should be required to have traded debt just junior to deposits with a 10yr plus maturity. Intervention set on spread of this debt. Additional monitoring instruments such as CDS should be considered.

5 Actions when preventative measures fail

- Early intervention can avoid significant destruction of value:
  - Banks' business is based on the value of trust that allows them to run their asset book without being called upon their liabilities.
  - The only exception to this is when bankruptcy becomes imminent. At that stage deposit runs and covenant breaches impose on banks an immediate, significant and expensive repayment of liabilities
  - When governments and regulators believed that a bank is too big to fail or that it would remain solvent if there was no immediate call on their liabilities, early re-capitalization can avoid significant value destruction by halting the chain of events and preserving the value of trust

- Mitigating actions should send clear signals about the value of securities:
  - At times when uncertainty is causing severe downward pressures on market prices, rescuing actions can add to that uncertainty.
  - Even when there is consensus that (as long as default is avoided) securities are undervalued, the prospect of a government rescue scares demand from the market since the only known fact is that the value of securities will be north of zero.
  - As rescuing actions are normally aimed at keeping businesses running, clear messages about how rescuing will occur and its impact on the value of securities can actually bring demand to the market which in turn will provide support to prices and reduce the need for recapitalization.

- Avoid moral hazard in the way rescue plans are implemented:
  - The problem of being clear about when and how governments and regulators will intervene to rescue institutions is the moral hazard this creates, since investors may rely on this safety net and act less responsibly when making investment decisions
  - However, moral hazard can also occur if rescue plans are implemented in a way that does not allocate the losses resulting from a default event in a fair way
  - Institutions are only rescued/ re-capitalized when the alternative to this would necessarily be their default.
  - As such, it makes little sense that equity holders loose significant (if not full) rights to future profits, whilst debt holders keep their full rights only because a third party intervened to avoid the occurrence of the event they were receiving a yield for

6 Conclusion

This paper covers a lot of ground. In the interests of brevity, we have excluded many other relevant concepts such as creating a source of contingent capital. Across all these issues, we believe that the three which really need fixing are a simpler, more pragmatic pillar 1, a regime that embraces the shadow-banking system and the appropriate regulation of derivatives.

We will continue to develop our thinking and will produce a public version of this paper in due course, and with allowance for input received from our discussions with different stakeholders.