Regulatory Reform

Every mystery or crime story is based on suspects, means, a motive, and an opportunity. Often the story ends when the suspect is apprehended. The root causes for the global financial crisis followed a similar script, but hopefully it will end with meaningful reform to address the means, motive, and opportunity that helped cause it.

The lead actors in the financial crisis mentioned often include banks, investment banks, hedge funds, monoline insurers, households, regulators, central banks, rating agencies, government-sponsored enterprises, and yes, even the tax code by favoring debt financing.

What were the means? As argued by the IMF's Chief Economist, Olivier Blanchard in a recent article in *Finance and Development*, there were four main causes of the financial crisis.

First, assets were created, bought, and traded that appeared much less risky than they truly were. Second, securitization led to complex and hard-to-value assets on and off the balance sheets of financial institutions. To be clear, securitization is an important form of financial innovation to distribute risks and improve liquidity. Complexity causes opacity, however, which can offset these benefits by concentrating large risks in pockets of the financial system, in turn posing risks to the system as a whole. Third, securitization and globalization led to increasing interconnections between financial institutions both within and across countries. Finally, leverage increased markedly.

Regarding the motive, remuneration packages, particularly bonuses, that reward short-term results led to insufficient attention being paid to risk. In addition, assets were moved into structured investment vehicles, allowing higher leverage without commensurate provisioning, supporting a firm's bottom line, at least as long as the risk was not exposed.

The main players in the financial crisis were provided with an opportunity stemming from an inadequate regulatory and supervision framework and a benign economic environment with abundant liquidity available at low interest rates, in the context of wide and rising global imbalances—the large current account deficit in the United States financed by the surpluses in Asia and in commodity-exporting countries.

As Mr. Blanchard notes, once the crisis hit, it was propelled by a modern version of a bank run. Institutions that were perceived to be at risk, were no longer able to finance themselves on the money market, not least because their assets were so hard to value, and instead had to resort to selling assets at "fire-sale prices," in turn depressing the book value of assets in other institutions. This was amplified by the regulatory framework, which called for restoring the capital ratio regardless of whether economic times are good or bad. Specifically, existing regulations require banks to hold more capital during downturns as risk measures increase, when capital is already depleted. This required outside investment or a further round of deleveraging through asset sales.

The rest is history. Access to financing by financial institutions, corporations, and households dried up, housing prices fell further, unemployment increased, and global trade collapsed leading to the worst global recession since the Great Depression.

As noted in the October 2009 IMF *World Economic Outlook* and *Regional Economic Outlook for Asia and the Pacific*, the situation has since much improved, in large part thanks to the unprecedented, global, financial, monetary, and fiscal stimulus. Optimism has made a comeback, but we should not lose sight of the causes of the crisis and the channels through which it was propelled, lest we risk a sequel.

Restoring financial sector health and strengthening financial sector regulation and oversight therefore remain the key priority. This is not an easy task. Reform needs to balance the benefits from financial innovation with preventing the buildup of excessive risks, and it requires international cooperation to maintain a level playing field. As illustrated above, introducing the wrong kind of regulation could make things worse, particularly if a future crisis looks very different from the current one. What are some of the reforms being considered?

Regarding the means, measures to reduce leverage, particularly during upswings, are high on the agenda and could include numerical limits to accompany risk-weighted capital requirements. Also, countercyclical loan-to-value limits could reduce the volatility of property lending. A separate capital-adequacy requirement for assets in the trading book of institutions is also being discussed. The role of rating agencies is being reviewed.

Regarding the motive, there has been much discussion of reforming the salary structure in financial institutions and the need for stronger disclosure of off-balance sheet exposures and securitization.

Regarding the opportunity, measures to strengthen the regulatory framework that are currently being discussed include introducing countercyclical capital adequacy requirements and loan-loss provisioning. The idea is that financial institutions would buildup bigger buffers during good economic times, to reduce the need for capital raising and deleveraging during adverse economic teams. Risk taking could also be limited through differentiated capital requirements. Unwinding global imbalances in an orderly manner will take time and international cooperation.

Proposals have also emerged to make banks pay insurance fees to fund any future rescues in the sector. Such proposals for an insurance fee should reflect systemic risk and could be one way to deal with "too-large-too-fail" institutions—because of their size, interconnectedness with the financial system at large, or because their activities cannot be readily substituted by other institutions.

At the request of the G20, the IMF is actively engaged in all the areas above, together with the Financial Stability Board and the Bank for International Settlements, and will present a range of options to ensure financial stability next spring. As always, maintaining political

momentum will be key. Too often in the past lessons from, albeit smaller, crises were quickly forgotten once the economy turned the corner, including the collapse of Long-Term Capital Management in 1998, and the 2002 default of Enron and WorldCom, which already pointed at the risks from leverage and opacity.