Financial Regulation Going Forward

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Market failures and distortions

- Information failures
- Externalities—systemic risk
- Limited liability of shareholders & managers
- Subsidies to bank debt: deposit insurance, TBTF, tax treatment
- Short-sighted accounting & risk measurement
- Regulatory distortions

Misaligned incentives

- Agency problems: opaque risk shifting
- Collective action problems: herd behavior in booms and panics
- Short-term profits at the expense of long-term stability
- Excessive and procyclical leverage, maturity mismatch, & other risk-taking

Unstable system

- **Dynamically**
  - Procyclicality: boom-bust cycles
  - Asset price bubbles-bursts
  - Amplification of economic cycles

- **Structurally**
  - Non-resolvable entities
  - Interconnectedness
  - Complexity
  - Opacity
  - Larger system-wide LGD
Capital Flows to Debt-Like Instruments Increasing

Source: IMF staff calculations based on data from IMF, IFS and WEO.
Assets Under Management of Institutional Investors

(In trillions of U.S. dollars)

Investment companies
Pension funds
Insurance companies

Sources: International Financial Services, London; OECD; and IMF staff estimates.
The cycle - the upswing

Contributing factors to crisis:
- Global imbalances
- Loose monetary policy
- Growth in AUM—search for yield
- Insufficient supervision
- Regulations
- Accounting standards for asset valuation

Asset prices rise

Exuberant optimism

The economy booms

Leverage, lending and risk-taking expand

Volatile wholesale funding expands

Bank profits and equity rise

Measured risk falls: less capital required

Short-sighted provisions fall

Latent systemic instability
The cycle - the downswing

- Credit crunch
- Asset prices collapse
- Open instability, Uncertainty
- Measured risks soar: more capital required
- Systemic losses, Recession
- Provisions belatedly rise
- Bank profits and equity fall
- Liquidity crunch in wholesale funding
- Asset fire sales
- shock as trigger

Open instability, Uncertainty
Systemic losses, Recession
Macro-prudential responses

- Dampening cyclical swings
- Monetary policy responsive to bubbles and financial imbalances
- Dealing with global imbalances

Structural measures

Macroeconomic measures

Counter-cyclical prudential measures

SIFI surcharges, Levies & taxes, Living wills, Resolution, Limits on activities
Countercyclical prudential measures

**More forward-looking expected loss buffers**
- **Provisions** on amortized cost assets
- **Valuation reserve** on marked-to-market assets
- **Prudent collateral valuation** (limits on LTV, minimum haircuts)

**Less leverage**
- Better quality of capital
- Higher risk-weighted minimum CAR (calibration?)
- Non-risk-weighted cap on leverage (Pillar 2?)
- Limits/levies on volatile funding
- Minimum liquid assets buffer

**More countercyclical capital (unexpected loss) buffers**
- Reduce procyclicality of Basel II risk weights
- Capital conservation rules
- Dampen excessive credit growth through additional buffers (Pillar 2?)

Prudent calibration to avoid excessive negative impact
More reliance on proactive supervisory discretion to limit risk taking?
Reducing probability/cost of failure

Structural
- Limiting size/scope (e.g., “Volcker rule”)
- Subsidiarization
- CCPs

Regulation
- Capital and liquidity surcharges based on systemic riskiness/non-resolvability
- More intensive supervision
- Contingent capital requirements
- Going-concern bail-in of creditors

Taxation
- Levy based on systemic riskiness
- Initially based, e.g., on uninsured debt
- Refined over time for better capture of risks

Resolution
- Living wills
- Cross-border resolution framework
- Burden-sharing arrangements

Many options:
Pros and cons depend on specific national circumstances

Cross-border consistency
Implementing Regulations

The will to act

The ability to act

High Quality Supervision
Thank you