Re-Regulating the Financial System

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Fundamentals of Current Regulation

- Laissez-faire approach to risk-taking
  - This has been the mayor financial innovation of the last twenty years

- Maniacal focus on capitalisation
  - Disregard of the traditional tenets of banking, i.e. liquidity and provisioning

- Ability to **fine**-measure risks (firms) and **fine**-assess them (supervisors)
  - However, rules of thumbs when we come to fix capitalisation at 8% and decide on additional buffers

- A market-friendly approach by supervisors
  - Recent proposals converge on giving even more discretionary powers to supervisors without changing the rules of the game

A Radical Change of Perspective

- **We have to:**
  - Completely abandon the Basel construction
  - Over-regulate for at least the next 10-15 years
  - Simplify regulation, lower its costs and reduce supervisors' discretionary powers
  - Given a common international regulatory base, increase autonomy and responsibility of local jurisdictions

A New Approach

- **General lines:**
  - Oppose a *rentier*-approach to wealth accumulation. This is possible with a financial structure that does not allow for highly risky financial instruments and institutions
  - Regulation must not evaluate fat tails, but must slim them down
  - Shift from a risk-measurement to a risk-control approach to regulation

- **We propose to:**
  - Introduce **structural measures** for avoiding hard-to-value risks, limiting paper-value financial deepening and the size of intermediaries
  - Regain focus on **margins of safety**, particularly on liquidity and provisioning
  - Re-direct incentives towards a sustainable financing of the real economy

Main Features of Our Proposal
Structural Measures

- Regulators agree on "a positive list of financial instruments and institutions. Anything that is not explicitly allowed is forbidden" (Buiter, 2009). Among "institutions" we include organised markets
- Hard-to-value and hard–to-manage instruments and intermediaries are not permitted
- Common rules extend to **all leveraged financial firms**
- Regulated institutions are not permitted to have direct or indirect relations with countries not adopting a basic regulation homogeneous to their own
- Foreign banks are allowed to operate only as subsidiaries

Main Features of Our Proposal
Structural Measures

- Leveraged institutions are not allowed to enter into securities and derivative contracts not traded in organised secondary markets
- Supervisors are obliged to set up clear and binding crisis resolution procedures for all leveraged institutions
- False information to the supervisory authorities and attempts to skim off value from the institution are considered as corporate fraud and are subject to criminal prosecution. They thus include all significant misstatements not only of allowances for credit and portfolio losses, but also of provisions
- Separation of leveraged financial firms from Collective Investment Schemes (CIS), insurance companies, pension funds and commerce

Main Features of Our Proposal
Prudential Measures

- All regulatory requirements must be observed both on a stand alone and consolidated basis

- Foreign subsidiaries have to met regulatory requirements on a local basis

- Fair value accounting is applied neither to the banking nor to the trading book
  - The banking book is evaluated at amortised cost
  - The trading book is marked to market
  - A specific Reserve Fund for Trading Losses is set up to smooth the effects of potential gains or losses on the income account

Main Features of Our Proposal
Prudential Measures

<u>Capitalisation</u>

- Maximum limits to un-weighted leverage ratios are imposed, distinguishing between banking and trading books

- The maximum leverage for the trading book is lower than the one allowed for the banking book. The trading book is defined in terms of its gross value, at market prices

- Maximum leverage requirements are established in relation to categories of intermediaries defined in terms of size intervals. Larger the size, significantly lower is the maximum permitted leverage ratio. The size refers to consolidated balance-sheets, distinguishing between the banking and the trading books

Main Features of Our Proposal
Prudential Measures

<u>Liquidity</u>

- Coefficients to limit maturity mismatches are introduced
- Liquidity requirements must be met with cash and/or risk-free assets
- Different liquidity requirements for the banking and the trading book
- For the banking book the liquidity requirement is an increasing function both of the value of the book and of the customer funding gap
- For the trading book the liquidity requirement is an increasing function of portfolio's market value

Main Features of Our Proposal
Prudential Measures

- Dynamic provisions are introduced as a direct function of interest income. Fiscal treatment of provisions must follow supervisory rules, and not vice versa

- Savings in regulatory requirements coming from risk transfer is admitted only when risks are integrally shifted to unconnected subjects and no new obligations are linked to them