FINANCIAL REGULATION AFTER THE CRISIS

MAIA VASILESCU
UNIVERSITATEA "CONSTANTIN BRANCUSI", STRADA VICTORIEI, NR. 24, TIRGU-JIU
maria_vasilescu1983@yahoo.com

Abstract:
The current crisis has revealed the consensual perception of banking risks, contagion and their implications for financial regulation. Mispriced risks, amplified by the instability and fragility of financial institutions determined a downturn of the financial system lacking strong, well-defined supervision rules and procedures. In the future regulation has to change, but it is not clear if it will change in the right direction, given the important influence the public opinion and political groups can have on regulatory authorities.

Key words: *financial crisis, regulation, supervision*

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The global financial crisis has underlined in a painful way that the globalized economy is a fact. As we all felt it, problems arising in a narrow segment of the U.S. market became the most serious global downturn since the Great Depression.

Though crisis eruption was shocking, the response scenario was unprecedented because, although different countries from all over the world could have turned inwards as a reaction to the present crisis, they instead intensified their collaboration, as we noticed whilst the innovative G-20 Leaders Summits, by providing multilateral institutions like the International Monetary Fund with new, significant resources and tools. The result did not forget to appear as a coherent and powerful policy that set the stage for the recovery. Policymakers face new challenges because they have to take action to reduce the probability and severity of any future crises, making some financial institutions subject to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system.

In the future regulation has to change, but it is not clear that it will change in the right direction because regulatory authorities may have a wrong view of crisis prevention and management induced by the influence of political groups of interests or public opinion.

Although the crisis was an extraordinarily complex event with multiple causes, weaknesses in the risk-management practices of many financial firms, together with insufficient buffers of capital and liquidity, were clearly an important factor. Unfortunately, regulators and supervisors did not identify and remedy many of those weaknesses in a timely way.

The crisis highlighted weaknesses in liquidity management by major firms. Short-term secured funding of long-term, potentially illiquid assets--through repurchase agreements and asset-backed commercial paper conduits, for example--became unavailable or prohibitively costly during the worst phases of the crisis, both here and abroad.

The events of the past two years revealed serious failures in risk management at regulated financial firms that, in turn, underscored the need for supervisors to identify weaknesses in a more timely way and to more effectively ensure financial institutions remedy the problems. The nature and causes of these failures have been outlined in reports issued by a variety of domestic and international groups in which we participate.

Two important themes have emerged from these efforts. First, they have reaffirmed the importance of effective consolidated supervision, particularly at large, complex organizations, so that supervisors can properly understand risks and exposures that cross legal entities and business lines. Second, we must combine a systemwide, or macroprudential, perspective with firm-specific risk analysis to better anticipate problems that may arise from the interactions of firms and markets. To support these approaches, we are strengthening our supervisory processes to include analyses that draw on multiple disciplines, updated surveillance tools, and more timely information so that supervisors can identify emerging risks sooner and respond more effectively.

First, recent experience confirms the value of supervision of financial holding companies--especially the largest, most complex, and systemically critical institutions--on a consolidated basis, supplementing the supervision that takes place at the level of the holding company's subsidiaries. Large financial institutions manage their businesses in an integrated manner with little regard for the corporate or national boundaries that define the jurisdictions of functional supervisors in the United States and abroad.

Second, our supervisory approach should better reflect the mission of a central bank to promote financial stability. The extraordinary pressure on financial firms last fall underscored how profoundly interconnected firms and markets are in our complex, global financial system. Thus, any effort to address systemic risks will require a more systemwide, or macroprudential, approach to the supervision of systemically critical firms. More generally, supervisors must go beyond their traditional focus on individual firms and markets to try to identify possible channels of financial contagion and other risks to the system as a whole.

Those lessons notwithstanding, the formulation of credible and coherent exit plans would give a needed boost to confidence and enhance the effectiveness of the current stimulus. Here as well, the Japanese experience provides an important lesson. Clear communication on exit policies by the Bank of Japan beginning in 2003 supported a relatively smooth exit from quantitative easing and a downsizing of its balance sheet. In contrast, exiting from fiscal stimulus proved more challenging, limiting the effectiveness of fiscal stimulus over time.

Thus, designing credible plans for fiscal consolidation once the recovery is underway should be a top priority, especially in advanced economies. The fiscal challenges ahead are formidable. IMF projections indicate that government debt in advanced economies will reach nearly 120 percent of GDP by 2014. In these circumstances, whittling advanced economies' government debt down to levels consistent with strong and sustainable long-term growth would require large structural fiscal improvements—by perhaps as much as 8 percentage points of GDP.

To restore confidence, taxpayers will need to be convinced that stimulus measures are temporary. At the same time, any adjustment in fiscal policies must contend with the demographic forces that are adding further spending pressure. As is obvious, the implied changes in taxes and spending will represent an ongoing challenge, and none of it will be simple either to design or to implement.

Monetary policy typically can adapt more readily than discretionary budget policy to changing circumstances. With generalized inflationary pressures absent in most advanced economies at this time, monetary policy most likely can remain accommodative for some time, especially in many advanced economies.

Exit strategies will also need to encompass the various measures put in place to support the financial system, including asset purchases, capital injections, and various types of guarantees. Given the fungibility of financial flows, international cooperation in this area will be especially important to avoid unintended cross-border distortions.

A fundamental element of effective financial regulation is protecting consumers from unfair and deceptive practices. The recent crisis clearly illustrated the links between consumer protection and the safety and soundness of financial institutions. We have seen that flawed financial instruments can both harm families and impair financial stability. Strong consumer protection helps to preserve household savings and to provide families access to credit on terms that are fair and well matched with their financial needs and resources. At the same time, effective consumer protection promotes healthy competition in the financial marketplace, supports sound lending practices, and increases confidence in the financial system as a whole.

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