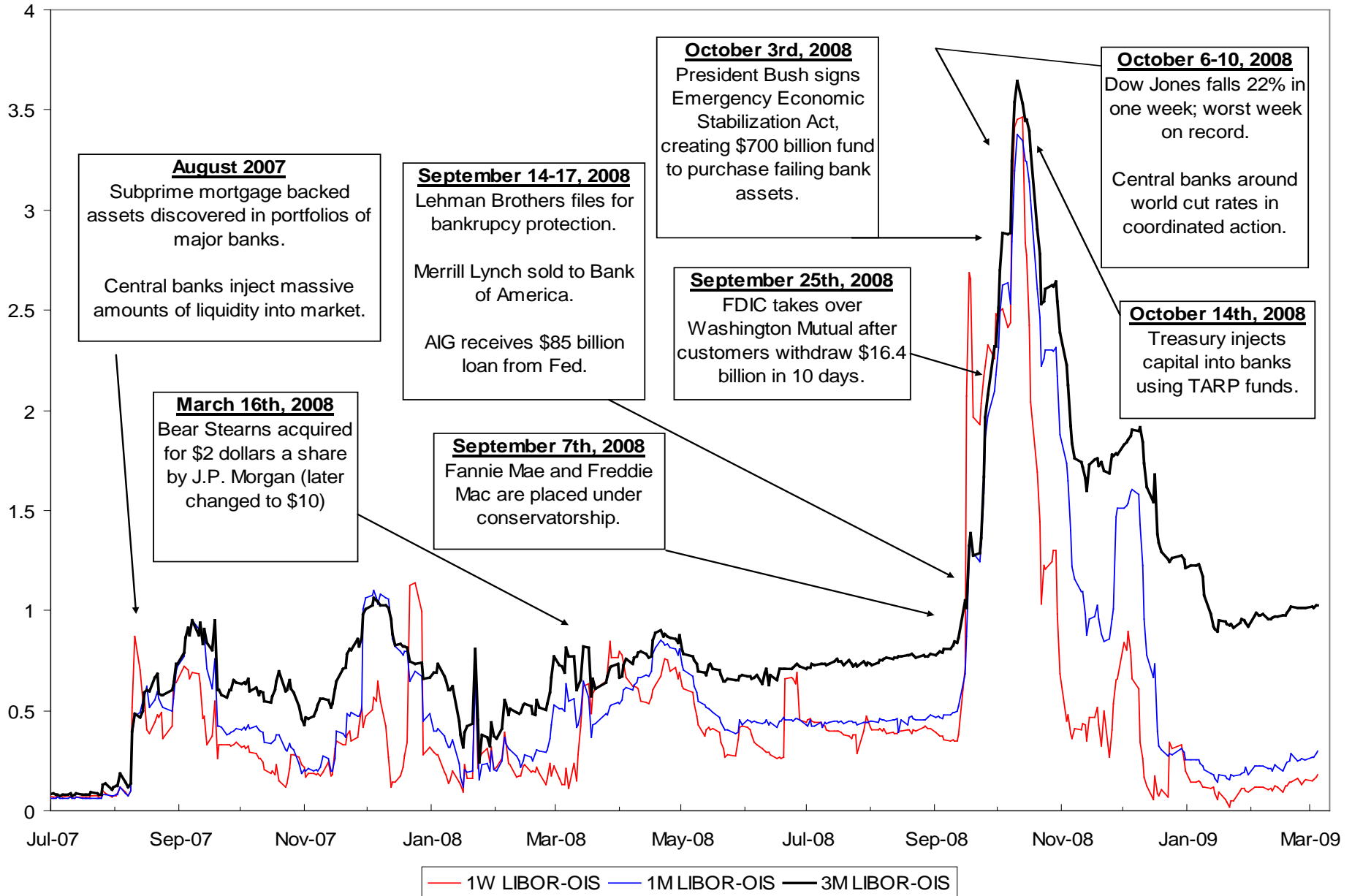


# Rebuilding the Global Architecture of Financial Regulation

**Malcolm Knight**  
**Vice Chairman, Deutsche Bank**  
**Visiting Professor, London School of Economics and Political Science**

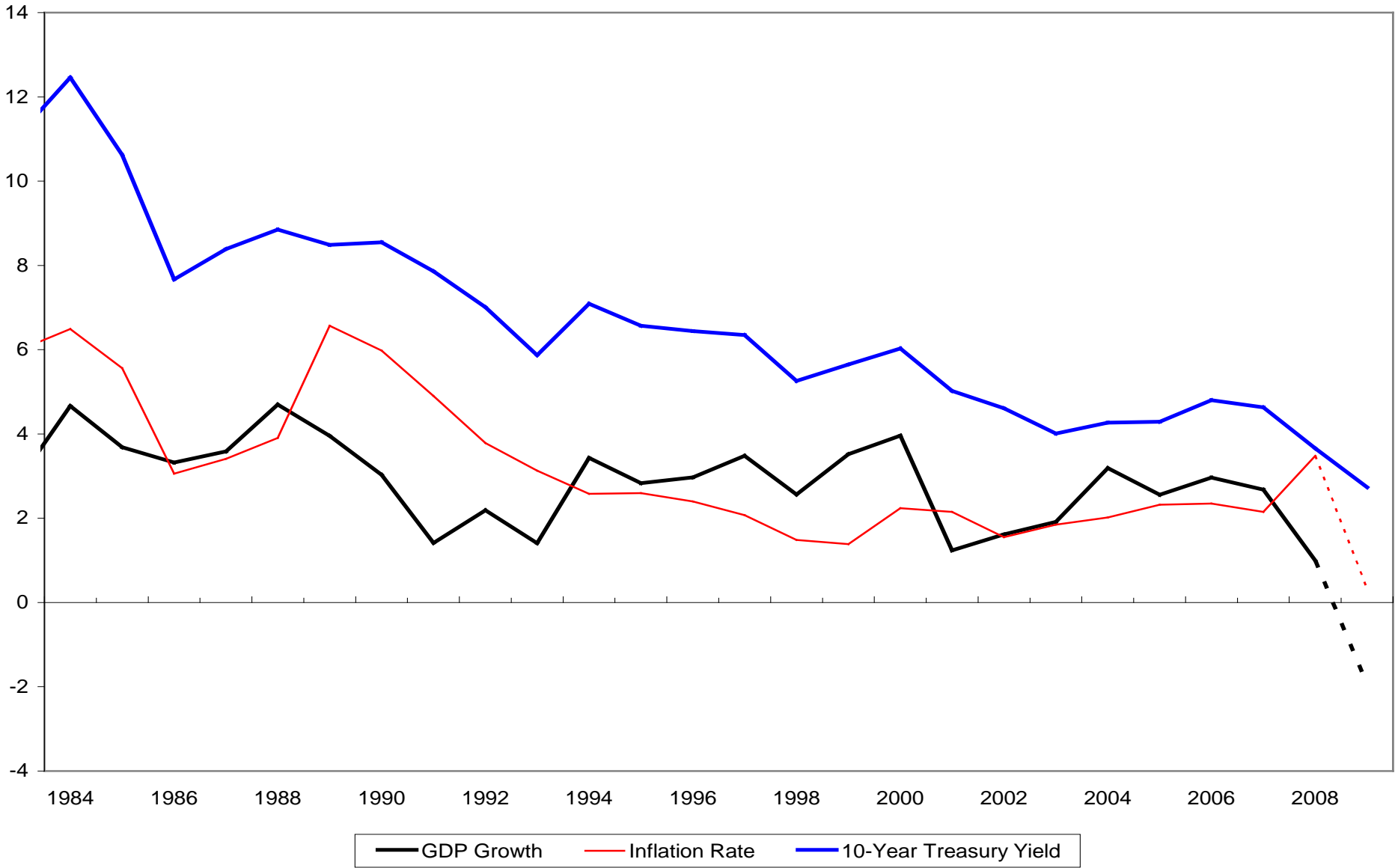


## US Dollar LIBOR-OIS Spreads





# Advanced Economies





## Three Key Weaknesses of the Global Financial System:

- 1) **Neither private market participants nor regulators took full account of the build-up of systemic risks in the credit cycle upswing during 2002-07.**
  - The ‘marketized’ financial system that developed over the past decade led to *much larger* increases in credit, leverage, and the prices of certain credit instruments and commodities than had been typical of past cyclical upswings.
  - There were no market price signals that directed market participants to build up capital and liquidity buffers to protect themselves against the increased level of risk in the financial system as a whole.
  - Aggregate financial system risk is an “externality”. This means there is a “market failure” – regulators should step in to induce more prudent risk-taking as they judge that overall financial system risk is rising.



## Three Key Weaknesses of the Global Financial System:

- 2) There are large regulatory gaps among financial jurisdictions and across different categories of financial institutions and markets.**
- Until the crisis, many regulators held the view that the market should generally be allowed to function unfettered, since market discipline could control weak risk management or market abuse of retail customers.
  - Financial activity tended increasingly to gravitate to jurisdictions that prided themselves on “light-touch” regulation.
  - The scope of regulation across financial institutions that are active in similar transactions has been too narrow and uneven.
  - During the upswing of the credit cycle this created a powerful incentive for private sector financial institutions to engage in regulatory arbitrage by transferring risks either to their own unconsolidated vehicles or to hedge-funds and other entities in the “shadow-banking system”.



## Three Key Weaknesses of the Global Financial System:

### **3) Interactions between financial institutions and markets make the financial system fragile in times of stress.**

- Prior to the 2007 crisis, banks had become dependent on continuous liquidity in financial markets to allow them to quickly adjust the risks on their balance sheets.
- Liquidity in financial markets was assured by proprietary trading (including the proprietary trading desks within the supermarket banks, stand-alone investment banks and hedge funds).
- To complete this circle, banks, as “prime broker dealers” were the key lenders to these leveraged and lightly regulated financial institutions.
- These interactions have created new and as yet little understood interconnections between funding liquidity and market liquidity that can cause both types of liquidity to disappear simultaneously in stressed market conditions.



## Five Lessons from the Crisis:

### 1) Financial regulation must be harmonized internationally.

- Key regulatory measures to control risk-taking should all be consistent across national financial jurisdictions.
- These include such safety and soundness standards as:
  - minimum risk-weighted regulatory capital requirements,
  - the definition of what constitutes a firm's reserve of capital,
  - the capital buffers that financial institutions should hold relative to minimum legal requirements,
  - management of liquidity risks,
  - loss recognition,
  - provisioning.
- Bold steps will be needed in the future to integrate financial regulation and supervision and make them consistent internationally.



## Five Lessons from the Crisis:

- 2) **Regulators must monitor financial system-wide risks and require financial institutions that engage in 'bank-like' credit activities to build up capital buffers, liquidity, and provisions as these risks rise.**
- There should be a 'macro-prudential risk regulator' that is responsible for identifying and mitigating changes in the level of financial system-wide risk in both the upswing and the downswing of the credit cycle.
  - Although central banks are not the only candidates for this role, I believe that this responsibility is consistent with flexible inflation targeting.
  - Authorities might want to consider implementing a surcharge on the risk-weighted capital-asset ratio of each large financial institution that would rise as the size of the institution rose relative to the financial system as a whole.



## Five Lessons from the Crisis:

- 3) Several regulatory rules that resulted in distortions in competition and risk management must be rectified as soon as possible.**
- The failure to adopt Basel II in the United States led to regulatory arbitrage incentives.
  - Basel I biased banks' portfolio choice towards holdings of residential mortgages rather than corporate loans because it accorded a 100% risk weight to the latter but only a 50% risk weight to the former.
  - The lower capital charge on risks in the trading book relative to the banking book gave banks an incentive to place large amounts of illiquid assets, including complex structured products, into their trading books.



## Five Lessons from the Crisis:

- 4) **The scope of regulation needs to be extended to include all financial institutions that undertake activities similar to those of banks, hold similar risks, and thus have consequences for the stability of the financial system.**
  - Regulation must be extended to ensure that leveraged “bank-like” activities – whether they are in hedge funds, private equity, or even insurance companies – are regulated so that other financial institutions compete with banks on roughly equal terms in these quasi-banking activities.
  - As long as these ‘shadow-banks’ remain unregulated, their behavior creates competitive pressures that undermine risk management in large banking institutions.
  - Even if most hedge funds, private equity firms and similar entities are not large enough or interconnected enough individually to give rise to major systemic risks, the aggregate positions they take can potentially create stability risks for the financial system.



## Five Lessons from the Crisis:

- 5) Regulatory guidelines should achieve greater transparency and disclosure of the valuation of financial instruments and firms' financial performance.**
- All jurisdictions should, as soon as feasible, adopt a single universally-accepted set of high-quality accounting standards, combined with consistent guidance on accounting valuations and auditing standards.
  - Greater transparency would have reduced the uncertainties about counterparty risk that caused the enormous distortions in the interbank markets that undermined the core of the global financial system.



## Conclusion:

- These proposed changes to the global financial architecture will give greater incentives for the private sector to strengthen its risk management, thereby making the financial system much more resilient to shocks and less prone to crises.
- The key will be international cooperation to reach reasonable agreements on the measures needed to achieve all of these principles.
- We must embark on reform starting right now in order to redress the worst weaknesses of the current system.