

Global Financial Crisis Bulletin

Another Response to the Financial Crisis: Regulatory Reform

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Most people would agree that one of the factors that contributed to the current economic crisis was an inadequate regulatory regime for financial services activities. Many reports and sets of recommendations have already been issued about the root causes of the problem and how regulatory regimes should be revamped to better protect the stability of the financial system. More reports and recommendations are forthcoming – among them the regulatory reform plan of the new Obama administration, a report being prepared by the U.K. Financial Services Authority and its chairman, Lord Turner, and a report expected to be issued in February by a European Commission working group operating under the direction of Jacques de Larosière, a luminary in the international financial services community. Also on tap is another G-20 meeting, scheduled for early April, in which the global economy and regulatory reform no doubt will be key agenda items.

In January 2009, *Financial Reform, A Framework for Financial Stability* was published.¹ This report has received a fair amount of attention. Its notoriety stems at least in part from the fact that it is the product of the Group of Thirty, a prestigious Washington D.C.-based international organization sponsored by major central, commercial and investment banks. Chaired by Paul Volcker, former Chairman of the Federal Reserve Board and current chair of the President's Economic Recovery Advisory Board, the members of the Group of Thirty (at the time this publication was released) include Timothy Geithner, the new U.S. Secretary of the Treasury, and an extensive list of well-known central and private sector bankers as well as former high-ranking supervisors and government officials. Mr. de Larosière serves as an Emeritus Member. Given this membership, it is not unreasonable to speculate that other studies underway and legislative initiatives may draw on some of the Group of Thirty's findings and recommendations and help shape a consensus among the key players who will drive global regulatory reform.

Root Causes of the Problem

There have been a variety of reasons offered for why the regulatory infrastructure failed to prevent what can only be called a collapse of the global financial services industry. Some of these reasons were outside of the regulators' control, such as the following:

- Segments of the financial services industry, such as mortgage brokers in the United States, were unregulated or under-regulated.
- Market innovation led to the development of products such as credit default swaps, which were unregulated.
- Regulatory infrastructures designed in much different (and simpler) times did not allow for effective oversight of some large, complex financial services organizations.
- Financial institution compensation schemes, heretofore not considered within the regulators' purview, encouraged irresponsible behavior in many companies.

¹ "Financial Reform, A Framework for Financial Stability," published by the Group of Thirty Working Group on Financial Reform, January 15, 2009. Excerpts from the report as well as information on how to order a copy are available at <http://www.group30.org>.

These issues aside, the extent of the industry meltdown suggests that regulators failed to see and react quickly enough to signs that many financial institutions were growing risky businesses aggressively without proper risk management. The challenge now becomes how to reform the regulatory infrastructure to prevent future disasters of the magnitude we are experiencing today.

Guiding Principles for Reform

Emphasizing that the regulatory infrastructure must strike an appropriate balance between imposing restrictions and not being flexible and efficient enough to support ongoing innovation and advancement that are critical to the process of financial intermediation and, therefore, economic progress, the Group of Thirty has set forth five guiding principles for fixing the broken regulatory infrastructure. These are:

- The role of the public sector in safeguarding financial stability should be predicated on maintaining the health of the system and containing systemic risk.
- To effect fair and effective competition, financial services activities should be regulated uniformly regardless of what type of company offers them.
- Official oversight and crisis response require a professionally managed structure of public agencies that are insulated from political and private interests.
- Effective, consistent application of regulatory principles requires a high degree of international cooperation.
- The need for high standards of institutional governance and risk management must be recognized.

Recommendations for Effecting Reform

In response to these guiding principles, the Group of Thirty offers four core recommendations which on their face seem indisputable, given the root causes of the crisis:

1. Gaps and weaknesses in the coverage of financial regulation and supervision must be eliminated.
2. The quality and effectiveness of prudential regulations and supervision must be improved.
3. Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital and liquidity.
4. Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives, such that the system is more resistant to the failure of even very large financial institutions.

Underlying these four core recommendations are 18 detailed recommendations. Among some of the more noteworthy ideas discussed in the Group of Thirty report are: the designation and regulation of “systemically significant” financial institutions, a migration to some variant of a “twin-peaks” or integrated approach to supervision in lieu of institutional or functional regulation, a move toward more practical and less pro-cyclical capital standards, proposed regulation of the over-the-counter (OTC) market, and the need to establish an effective failure resolution scheme for large nonbank financial institutions.

“Systemically significant” financial institutions are defined as those which, regardless of the type of charter or license they hold, are of significant size (as measured by both on- and off-balance-sheet activities), employ leverage to large scale such that their potential contraction of liquidity would affect the market, are highly interconnected with other players in the financial market, and/or provide infrastructure services such as clearing and settlement that are critical to the operations of the financial market. The Group of Thirty recommends that institutions meeting these criteria be restricted in undertaking proprietary activities that present particularly high risk and serious conflicts of interest. For example, companies in this category that are involved in the packaging and sale of assets would be required to keep a meaningful part of the credit risk. The Group of Thirty further recommends that “systemically significant” financial institutions be subject to national-level prudential supervision. Though not specifically recommended in the Group of Thirty report, some have suggested that there should be a single, national regulatory body created and charged with supervision of these institutions, regardless of their charter or license type or the nature of financial activities they perform.

To date, conventional wisdom has recognized four different approaches to the organization of financial regulation and supervision:

- The **institutional approach**, where a company's legal status (e.g., bank, broker-dealer, insurance company) determines its regulator
- The **functional approach**, in which the applicable regulator is determined by the nature of activities conducted
- The **integrated approach**, in which a single universal regulator provides safety and soundness and market conduct regulation
- A **twin-peaks** approach, where there is separation between safety and soundness and market conduct regulation

The institutional and functional approaches, both of which have become somewhat blurred in recent times, have been largely discredited by current events. Although some may also challenge the efficacy of the integrated and twin-peaks approaches – countries employing these approaches have not fared appreciably better than those where the institutional or functional approach prevailed – the Group of Thirty believes there is a growing consensus around the need to consolidate and simplify regulatory structures, stressing principles rather than rules, the importance of international coordination and cooperation, and the need to ensure the regulatory infrastructure is free from political and private pressures.

As noted in the Group of Thirty report, one of the most surprising and disturbing facts of the current crisis is the speed at which financial institutions moved from being well-capitalized under existing regulations to requiring government bailouts just to survive. This fact points to shortcomings – e.g., the inability to estimate risk levels accurately – in the current capital standards and, according to the Group of Thirty, the need to raise the requirements for being considered well-capitalized to provide a better cushion on the downside.

Credit default swaps (CDS), which are traded on the OTC market, are widely believed to have been a significant contributor to the industry's problems. The Group of Thirty outlines five key points related to the proposed regulation of the OTC derivative market:

- An appropriate national regulator should be able to promulgate rules to govern market participation.
- Parties subject to regulation should include those engaged in making two-sided markets, those engaged in providing credit protection, and those whose activities reach a level of systemic importance.
- A professional intermediary in OTC derivatives must be regulated as a bank or must register with the regulator as a professional intermediary.
- The regulator should promulgate rules regarding the reporting of large positions.
- In order to protect the stability and integrity of the financial market, the regulator should promulgate rules governing the multilateral clearing organizations that clear OTC derivatives.

Another striking outcome of the financial crisis, particularly in the United States, has been the proliferation of new bank holding companies. Large nonbank financial services companies sought and received approval to become bank holding companies to participate more freely in TARP programs and to access Federal Reserve funding along with the retail deposit market. While there may not have been any other option to deal with the problems of these institutions, commercial banks that have paid – both in terms of the degree of regulatory oversight and in deposit insurance – for their right to access government funding and the retail deposit market now find themselves competing with institutions that some would argue have been provided access unfairly to the same benefits. The current crisis argues for the development and implementation of a legal framework that allows for the orderly resolution of nonbank financial institutions apart from the *ad hoc* modification of existing rules to address “exigent circumstances.”

The issues discussed above are just a very few of the topics addressed in the Group of Thirty report. Interested parties are encouraged to read the entire report.

What is Missing from the Group of Thirty Report?

One aspect of regulatory reform not discussed in the Group of Thirty report – nor in many of the other reports on regulatory reform – is what changes need to be made to regulatory organizations to enable

them to supervise the many larger, more complex financial institutions that have been created as a result of the crisis. Comprehensive regulatory reform must address the need for recruiting, training and retaining regulatory professionals and arming them with the tools they need to go head-to-head with industry management. At a minimum, this requires revisiting the funding for regulatory agencies and agency compensation schemes to ensure regulatory agencies are able to attract the right talent for the challenges ahead.

The Debate Has Just Begun

We will see many more plans and ideas for fixing the regulatory structure. A meaningful fix will require thought and time to develop, but the impetus for making sweeping changes has never been so compelling. A patchwork fix will only guarantee that we will have the same discussion about the need for reform when the next crisis occurs – and we had all better hope it is not as bad as this one.

In future issues of the Global Financial Crisis Bulletin, we plan to compare and contrast regulatory reform plans offered by other organizations and governments.

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