Lorenzo Bini Smaghi: The role of regulators when markets fail

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the conference on the Squam Lake Report "Fixing the Financial System", New York City, 16 June 2010.

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Introduction

Ladies and Gentlemen,

It is a pleasure to be here to discuss the Squam Lake Report in front of such a distinguished audience. The report offers valuable insights into how to improve the financial regulatory and supervisory architecture, with the aim of achieving a more resilient financial system.

In my comments today, I would like to highlight three important points in this area: i) the reform of capital requirements, ii) the role of proper supervision and regulation, with a focus on the changes needed to achieve greater effectiveness, and iii) the regulation of executive compensation in financial services.

1. Capital requirements and the role of supervision

Let me start with the main pillar of banking regulation, i.e. capital requirements. The Squam Lake Report makes three recommendations. Capital requirements should: i) be higher for larger banks; ii) depend on the liquidity of the assets held by a bank; and iii) increase in proportion to a bank's short-term debt. The recommendations examine three of the most prominent elements that have characterised the crisis: the build-up of systemic risk, which has been exacerbated by the behaviour of large and complex financial institutions; the price spirals triggered by the fire sale of illiquid assets under distressed market conditions; and the fragility of a business model based on widespread recourse to short-term financing.

The main thrust of these recommendations has been high on the post-crisis regulatory agenda. Allow me to briefly recount the most relevant features of the ongoing reform of the financial sector at the international level.

First, the Financial Stability Board (FSB) is investigating the options for introducing regulations covering the specific risks related to large and complex systemic financial institutions. Systemic institutions, by definition, entail higher interconnectedness. They increase the complexity and fragility of the system; they end up amplifying the inherent pro-cyclicality of the financial system and lead to the materialisation of systemic risk. In a downswing, the intensity of deleveraging, liquidity hoarding and asset fire sales is proportional to the size of an institution's balance sheet, as the Squam Lake Report notes, but also to its interconnectedness and opacity. Against this background, regulators are working to devise measures of systemic importance based on a combination of factors such as size, substitutability and interconnectedness, which could be drawn on to calibrate additional prudential requirements, for instance a surcharge.

Turning to the core of prudential regulation, in December 2009, the Basel Committee of Banking Supervision (BCBS), under the aegis of the G20, proposed a major overhaul[1] of the micro-prudential framework. There is a consensus that in the years prior to the crisis financial institutions were operating with too little capital, with excessive leverage and with insufficient recognition of the risks undertaken – including liquidity risk.

The Basel Committee's proposals envisage: raising the quality and quantity of capital[2], strengthening risk coverage[3], and introducing a non-risk-based leverage ratio[4] as well as a regime of countercyclical capital buffers. Importantly, the new rules will comprise a novel, harmonised treatment for liquidity risk. Rather than imposing capital requirements based on the liquidity of assets, the Committee has opted for specific quantitative provisions (outright liquidity ratios) for directly promoting stronger liquidity buffers. In particular, banks will be required to hold sufficient high-quality liquid assets to withstand episodes of financial stress as well as to shift towards more stable sources of funds on the liability side.

A substantive advantage of the liquidity framework proposed by the Basel Committee is its ability to improve the management of liquidity risk, which is inherently a cash flow risk and cannot be fully addressed via liquidity-based capital requirements only. The chosen option directly gears both the assets and liability mix towards, respectively, higher liquidity and more structural (longer-term) composition, also providing observable and verifiable metrics for the purposes of rigorous monitoring. By doing so, it explicitly promotes prudent liquidity risk management, thus minimising the likelihood of unexpected liquidity shortages, which may be covered only at prohibitively high cost at times of distress.

Agreement has been reached at G20 level that the new standards will be phased in as financial conditions improve and the economic recovery firms up, with implementation envisaged by end-2012. The Basel Committee will also consider appropriate transition and grandfathering arrangements.

Given the scope of the reform, I wish to emphasise that regulators and central bankers are fully aware of the importance of a thorough assessment of its overall impact, including the interaction between different rules and the potential consequences for financial intermediation and for the real economy. In this context, the Basel Committee and the FSB are carrying out both a bottom-up (focused on the impact on the institutions' balance sheets) and a top-down macroeconomic impact assessment[5]. The first results of these exercises are expected to be available next month. The BCBS will issue by the end of this year a fully calibrated, comprehensive set of measures based on the outcome of this work .

The bottom-up impact assessment will provide policy-makers with guidance on the proper calibration of the proposed measures as well as form a basis for establishing a credible minimum after cumulating the effects of the changes, taking into account their interactions.

The top-down assessment will inform the decision on the overall level of minimum capital requirements the system should hold, while also gauging the long-term benefits of a safer financial system. It will also deliver insights into the impact of the new capital standards on

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1 The reform package comprises two consultative documents entitled: "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring".

2 The new rules recognise common equity as the highest quality component of capital.

3 The introduction of capital requirements for counterparty risk exposures arising from derivatives and securities financing activities is being proposed, as are incentives for the central clearing of over-the-counter derivatives. These measures complement the higher capital charges for trading book exposures and securitisations that were adopted in July 2009.

4 The leverage ratio, covering also off-balance sheets items, is envisaged to act as a backstop measure to curb excessive balance sheet growth.

5 The ECB is a key contributor to the top-down macroeconomic impact, focusing on the euro area.

credit availability, ensuring that the introduction of the proposed measures will not hamper credit extension or affect economic growth. Estimates of the macroeconomic impact are still in progress and thus it is too early to draw solid conclusions. But – I should add – it has recently been suggested[6] that the impact of the Basel Committee reforms on growth may be limited, especially when compared with figures circulated by the industry, which tend to be based on somewhat extreme assumptions. In particular, it has been observed that there are reasons to expect a relatively smooth balance sheet adjustment by the banking system and therefore a less pronounced macroeconomic impact. First, the impact of the new liquidity rules may be significantly mitigated by adjustments to both the composition and the maturity of the balance sheet: for instance, lengthening the maturity of the liabilities to better match that of the assets would likely result in lower riskiness overall and thus lower funding costs. Second, the investors' required rate of return on banks' equity and other sources of funding, such as long-term bonds, can be expected to decline, reflecting a lower risk for share and bondholders resulting from the enhanced resilience and safety of banks, hence decreasing the cost to banks.

Nevertheless, macroeconomic conditions and the health of banks' balance sheets would still be relevant factors when deciding on proper implementation arrangements. With regard to the latter, I would also like to comment on the crucial role of international coordination and cooperation for the success of the regulatory efforts to shape a better prudential framework. Large and complex financial institutions are global players and thus require a global response. In this context, international collaboration between the authorities and a strong commitment to enforce a timely and harmonised implementation will be of the essence to promote a level playing field and prevent international regulatory arbitrage.

Strengthened cooperation has already taken place at the level of policy-making bodies such as the Financial Stability Board and the Basel Committee on Banking Supervision in the context of the implementation of the G20 regulatory reform agenda. This has fostered convergence, on both sides of the Atlantic, in the approaches to bolstering the national frameworks. In this respect, it is worth mentioning that at the outset of the crisis, while the EU legislation already reflected the amendments referred to in the Basel accord, the US committed to do so by 2011. I am confident that the US authorities will live up to their commitment and will take the necessary steps to further enrich their national framework so as to take into account the latest proposals formulated by the Basel Committee. I would also point out that Europe is currently working on strengthening its legislative framework in respect of issues such as a bank levy or broadening the scope of regulation to hedge funds and credit ratings agencies. Although similar initiatives are under way in the US, I would like to point out that, by contrast, our approach does not aim to limit the size of systemically important financial institutions, but rather to strengthen their supervisory framework through the implementation of internationally agreed principles.

2. Effective and comprehensive supervision and regulation

The final result of the reform of the international regulatory architecture will be a financial system with more and better-quality capital, enforced by appropriate micro-prudential standards. Yet there's a question we cannot avoid: would a stronger micro-prudential framework be enough to prevent a repetition of the events we experienced during the financial crisis?

I don't think so. Higher and better capital and liquidity requirements are an essential condition to improve the stability of the financial sector. But they are not a sufficient condition *per se*, if not accompanied by a sweeping change in the orientation and practice of micro-prudential

[6] See "Bankers' 'doomsday scenarios' under fire", Financial Times, 30 May 2010.

oversight. I believe that one of the most crucial lessons to be drawn from the crisis concerns the twin failures of: i) light-touch regulation, and ii) the narrow perimeter of regulation and supervision, excessively focused on the banking system and on the legal status of the supervised entities.

We have observed many instances of supervisory failure in which supervisors did not fully understand the business models of the institutions they were overseeing or the nature, scope and location of the underlying risks. This has largely been due to the light-touch model of regulation and supervision, which has been proven ineffective because it failed to keep pace with financial innovation and with the financial sector's capacity to dynamically alter the profile and the location of its risk exposures. I am convinced that the main failing of light-touch regulation and supervision lies in its overwhelming reliance on rules. Too much emphasis is placed on monitoring a mostly formal compliance with the rules. In other words, the light-touch approach to supervision is ineffective because it failed to recognise the powerful incentives of financial institutions to game what on the surface appeared to be well-intentioned and granular requirements.

Historical experience has demonstrated that supervisory emphasis on mechanical rules such as capital requirements may encourage perverse behaviour that ultimately leads to excessive risk-taking. Why is this? In the absence of adequate supervision, banks have incentives and opportunities to game the rules by developing financial innovations that allow a shifting of risk beyond the perimeter of the regulated sector and by devising novel strategies which increase their exposure to risks but which, on the surface, appear compliant with the rules.

Since the introduction of the Basel Accord in 1988, supervisory authorities have been equipped with the tools of risk-based supervision, as underpinned by capital rules. Over time, and in many respects as an attempt to arbitrage away prudential requirements and gain capital relief, financial institutions began packaging their exposures, shifting them to off-balance sheet entities and distributing them across the financial system. As a consequence, aided by the development of financial derivatives and structured products, a seamless transition to the "originate and distribute" business model took place, alongside the growth of the shadow banking system.

It would not be correct to say that such a fundamental shift went ignored by supervisors. In fact, it was even regarded[7] – often with the approval of academics and central bankers – as a highly positive improvement in the risk-transfer capacity of the system, while the system-wide effects it was producing on risk-taking, lending standards and risk management went unheeded. Overall, the dangers associated with the migration of risks to less regulated and thus less capitalised parts of the financial sector – the shadow banking system – were largely neglected. The received wisdom mistakenly saw the shadow banking system as a club of sophisticated market participants, in principle detached from the core of the traditional banking system and free to operate without appropriate rules and oversight. Now we know that this perception was not only incorrect, in that the shadow banking system turned out to trigger far-reaching systemic effects, but also that it fostered, through herding pressure behaviour, the widespread adoption of dangerous financial strategies and activities. Indeed, even traditionally regulated financial institutions took advantage of the regulators' passivity, perhaps best exemplified by the lack of regulation for the burgeoning credit derivatives market, by taking on risks that the regulators were only dimly aware of. The recourse to leveraged trading exposures[8], already incentivised by the preferential regulatory treatment of

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[7] For a prescient contrarian view, see Rajan, R. (2005), "Has Financial Development Made the World Riskier?", keynote address to the 2005 European Financial Management Association (EFMA) Meetings, Milan, Italy, 1 July 2005.

[8] Called the leverage "game", in Acharya V. and M. Richardson (2009), editors, "Restoring Financial Stability: How to Repair a Failed System", New York University Stern School of Business, John Wiley & Sons, March.

the trading book as compared with the banking book, ultimately fostered the retention of larger and larger senior tranches of asset-backed securities and CDOs and to the proliferation of vehicles such as ABCP conduits and SIVs. In this respect, the failings of light-touch regulation and the short-sighted focus on the banking system appear overwhelmingly clear. On the one hand, the tail risks hidden in the payoff profiles of highly rated securitisations were not understood by financial supervisors. On the other hand, the migration of risks outside the traditional banking sector into a thinly capitalised shadow banking system lacked appropriate oversight.

This process resulted in a weakening of the prudential rules, a sharp deterioration in bank capital, an overall decline in lending standards, an unsustainable growth of leverage, a persistent under-appreciation of risks and, ultimately, in an unprecedented degree of fragility and interdependence in the financial system. Looking ahead, supervision will have to move towards taking a proactive and forward-looking approach. Likewise, the regulatory net needs to be cast wide enough to encompass all financial institutions and activities capable of generating systemic effects.

Finally, an assessment must be made of how the supervisory authorities applied the tools available to them and whether their decisions were taken on the basis of an independent judgement or were somehow influenced by external factors. Historical experience offers ample evidence that inadequate arrangements as regards the independence of the supervisory authorities contributed to the emergence of financial instability. The East Asian crisis of 1997–1998 is a frequently quoted example of weak regulations and forbearance, resulting from political interference in supervisory activity and leading to a financial crisis.

Institutional arrangements should ensure that supervisors are independent from the political authorities and not at risk of regulatory capture by the supervised institutions. In some cases the desire to enhance the competitiveness of domestic financial institutions may have influenced decisions that allowed such institutions to behave in a less prudent manner. These are important issues, and should be part of the international debate on how to enforce effective supervision so as to strengthen the capacity to mitigate future financial crises.

3. Compensation of top executives

Let me now turn to the topic of executive compensation. Remuneration of top executives has recently attracted special attention, notably in the financial sector, where the distribution of sizeable severance payments, entirely disconnected from the institutions' performance, has caused a public outcry. Moreover, the financial crisis has revealed that inappropriately designed compensation mechanisms could lead to excessive risk-taking and should therefore be subject to policy intervention. The Principles for Sound Compensation Practices elaborated by the FSB has been a crucial step forward in this regard. Input from academia will be essential to refine this framework. In this respect, the emphasis in the Squam Lake Report on executive compensation is of interest, especially as it concerns an area which has not yet been fully addressed at the international level[9].

I broadly agree with the report's first idea, namely that governments should not regulate the absolute levels of executive compensation in financial institutions. On that point, I would like to make the following remarks.

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[9] At the present juncture, the principles and standards for sound compensation practices have mainly been designed to apply to a relatively large range of employees, i.e. those "categories of staff whose professional activities have a material impact on the bank's risk profile" (see "Compensation Principles and Standards – Assessment Methodology", January 2010, BCBS). These categories include senior managers and others; material risk-takers (e.g. traders) and staff performing important risk management and control functions are also targeted by the framework.

First, as a matter of fact, the average level of executive remuneration has substantially increased[10] in recent years. While this trend is perceived by some stakeholders to be a problem, it is not necessarily evidence of economic inefficiency. However, the financial and economic crisis has highlighted not only the high level of executive pay, but also a mismatch between executive pay and performance. The payment of very high salaries, bonuses and severance payments to executives while companies are underperforming and banks are being bailed out by taxpayers' money could be seen as evidence of inadequately designed compensation schemes.

Second, I would like to comment on the idea in the report that "market prices are typically the best way to allocate resources". In my view, the precise scope of such a statement should be carefully specified. Indeed, it has been recently pointed out that the importance of factors other than the ones usually associated with "free" market conditions (productivity, competition, initiative, talent), such as executives' bargaining power and tactics to influence their pay levels, should not be overlooked. This seems to be particularly true in the case of large lump-sum payments such as the "golden parachutes".

In this context, although I believe that direct intervention by governments in the absolute levels of executive compensation is not desirable, national authorities and policy-makers *should* monitor their evolution. Furthermore, an indirect public intervention may, in some cases, be justified. The setting of limits on severance pay with respect to the fixed component of the remuneration and the banning of severance pay in case of failure are two examples in this respect. The European Commission[11] took this approach in its recommendation issued in April 2009[12]. Overall, the boundary between the change in the structure and the level of executive pay is rather blurred.

The Squam Lake Report also argues that the structure – and form – of executive compensation should not only aim to eliminate excessive risk-taking but also to reduce the possibility of taxpayers' bailouts. In short, it should address the anomaly of gains being privatised and losses being socialised during the financial crisis. Withholding a fraction of an executive's compensation for a number of years and not paying it if the firm goes bankrupt or receives significant government support should help to align the incentives of managers with those of taxpayers and reduce excessive risk-taking. Such an approach is relatively new in comparison with the measures developed so far at the international level (e.g. deferral arrangements, clawback/malus provisions), which essentially seek to align individual incentives with those of the institutions' shareholders. The BCBS proposal[13] will introduce a framework that will give supervisors stronger tools to promote capital conservation in the banking sector with payout restrictions.

Measures to defer compensation are important, but they have at least one major drawback. It is very difficult to compute the "right" time span between the peaks and troughs of a cycle. For instance, the report proposes to defer (a part of the) compensation for five years. Although such a period is longer than the minimum deferral period of three years targeted by

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[10] For evidence on remuneration in the financial sector, see Philippon T. and A. Reshef (2009), "Wages and Human Capital in the U.S. Financial Industry: 1909–2006", NBER Working Paper No. 14644, January.

[11] Note that the underlying logic of the European Commission approach is aligned with the FSB's Implementation Standard 12, according to which "Existing contractual payments related to a termination of employment should be re-examined […]; prospectively, any such payments should be related to performance achieved over time and designed in a way that does not reward failure".

[12] See Commission Recommendation of 30 April 2009, complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies. According to the Recommendation, termination payments should be limited to a certain amount or duration beforehand, which, in general, should not be more than two years' annual remuneration (on the basis of only the non-variable component of the annual remuneration).

[13] "Strengthening the resilience of the banking sector", December 2009, BCBS.

the FSB Implementation Standards, some of the groups responsible for packaging structured products which caused billions of losses for the financial system have earned substantial fees for more than five years. It is therefore essential that such deferral arrangements, which function as the first risk adjustment mechanism, incorporate measures linking the deferral payment to future performance within a reasonable time horizon.

From a more general perspective, it is important to recall that agency costs and excessive risk-taking behaviours can be traced back to unsatisfactory corporate governance and regulatory frameworks as well as to shortcomings in the design of compensation plans. In this regard, the use of stocks and stock options in the remuneration packages did not alleviate the agency costs imposed on the shareholders during the market turmoil. This circumstance highlights the need for policy-makers to promote longer stock holding periods and stricter forfeiture rules so as to make these instruments more capable of providing incentives for long-term value creation. In addition, rather than maximising the return on equity, the compensation structure should encourage the maximisation of the return on assets, i.e. the total value of the firm, as this would help to curb excessive risk-taking and leverage.

Profit centres should also be provided with long-term incentives in order to avoid creating “fake alpha”. To this end[14], financial institutions should have in place independent risk management functions with sufficient authority to lean on the decision-making process. It is essential that risk managers are not isolated from the business lines they oversee and that they have access to the necessary information. Their analyses should be communicated to the Board and top executives in a comprehensive and comprehensible manner (with a forward-looking view of the risks taken). Shareholders and Board members should also have sufficient knowledge and expertise relevant to the financial activities the institution is pursuing to permit effective governance. Transparency in compensation packages should perhaps also be encouraged.

Conclusion

The financial crisis has exposed major shortcomings in micro-prudential regulation and supervision. A sweeping reform of the rules, in particular of capital adequacy and liquidity requirements, is in the making. It’s needed, but it’s not enough. The supervisory orientation has to shift from a light-touch approach to one that is more proactive, forward-looking and at times necessarily intrusive, as an indispensable complement to the rules. Supervisors need to look more closely at the business and strategic risks of systemic institutions, gaining full knowledge of the strategies pursued and the sources of excess returns. Supervisors should also be able to gain access to all the parts of the group, regardless of the legal status of the supervised entity. Furthermore, regulators and supervisors have to be alert to the fact that financial innovation, by adding layers of leverage, complexity and opacity, can transform the risk profile of even traditionally safe assets.

At the same time, the regulatory net must be extended to the whole range of leveraged institutions which can trigger systemic risk, including the shadow banking system and other firms that pose potential systemic risks such as hedge funds. Any changes in the regulatory framework must be carefully scrutinised so as to minimise the risks of regulatory arbitrage and not provide incentives to transfer certain types of systemically relevant risk beyond the perimeter of the regulated sector. Higher prudential requirements, whether inside or outside the banking system, should be imposed on riskier activities, regardless of their location.

[14] The following developments are in line with the BCBS “Principles for enhancing corporate governance”, issued in March 2010.

Furthermore, changes to the prevailing practices in executive compensation are needed. An effective – and stringent – executive compensation framework should be designed to ensure that managers, who play a key role in defining their institutions' risk strategies, are not rewarded for artificial excess returns, such as those stemming from positions whose risks have not yet materialised. In addition, enhanced supervisory cooperation, especially between major financial centres, as well as an extension of the coverage of the international framework, to all the financial services institutions, notwithstanding their legal status, is essential.