Stanisław Kluza, Ph.D.
Chairman of the Polish Financial Supervision Authority

The way out of crisis: towards efficient regulatory reform

The expanding destabilization in the global financial market during the last two years has exposed critical gaps and deficiencies in our financial regulatory system. Supervisory failures and excessive overreliance on the alleged corporate wisdom of systemically important institutions resulted in catastrophic losses. This caused a dramatic decrease of confidence in our financial system and contributed significantly to the current recession. Today we must challenge errors of the past and propose a comprehensive reform- not gold-plating of the current regulatory framework, but new principles, a new philosophy of supervision. These new rules must provide more stability for the whole system and more protection for consumers and investors.

Therefore, debate over the future architecture for financial market shall start with addressing systemically important issues. Then we should focus on restructuring the current framework aiming at elimination of overlaps and restoring confidence in the financial system.

1. Priorities for comprehensive regulatory reform

Regulation of OTC Derivatives

The crisis has revealed a strong need to undertake a full-fledged analysis of the functioning of Over-the-Counter derivatives market. There have been several doubts in the recent years as to whether settlement as well as operational infrastructure of OTC market is sound. Volume and complexity of transactions on the OTC market combined with insufficient transparency create a considerable risk that failure of few significant institutional investors may shake the foundations of the whole market. Hence, regulators shall act promptly to deliver solutions providing for more transparency, simplification and standardisation of OTC derivatives. This includes also the development of appropriate risk-mitigation techniques. Most of the regulators agree that one of the next steps on this way would be development of central counterparty for credit default swaps. Bearing in mind that counterparty risk in CDS contract is reflected by appropriate rating, the changes, especially downgrade of the rating can cause disruptive procyclical effects.

Regulation of Hedge Funds

Hedge funds themselves are currently out of the scope of prudential regulations affecting their capital adequacy or liquidity. As it has been truly pointed out by Lord Turner from the British FSA, hedge funds' activity may have an important procyclical systemic impact. In regard to this, many shortcomings could be tackled through application of appropriate prudential regulation (e.g. capital and liquidity rules) to hedge funds as well as to other category of investment intermediary. Taking into account current trends in the market it is likely that hedge funds may evolve into systematically important institutions in the years to come, as it was the case with development of investment banks in the last twenty years. Therefore, we need a regulatory response to this phenomenon and thus a response which is well designed in advance.

Procyclicality of banks' capital requirements

For the last few years we notice the tendency of the financial institutions to focus on the problem of procyclicality. The solutions which are currently intensively discussed aim at limiting the effect of increasing the capital requirements in the good times and lowering during the downturn. One can not query the necessity of avoiding tools which additionally deepen the amplitudes of cycles (a very interesting problem of consequences of the market assets and liabilities valuation is an example). However we should be aware that it is almost impossible to decide in which point of cycle we are and the anticyclical effect should be the output of the scrupulous supervision especially in the crisis time. The lowering of financial requirements gives the illusory feeling of security.

Regulation of credit rating agencies (CRAs)
A combination of investors' excessive over-reliance on credit ratings and their failure to understand the intrinsic limitation of ratings resulted in miscalculation of potential downside risk of the securitization and structured credit market. On the other hand, CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data, flawed methodology or due to a software error (Moody's). There is no doubt that CRAs should improve the quality of the rating process and manage conflicts of interest rooted in the issuer-pays model. Appropriate measures must be taken to improve internal governance and provide transparency about rating process and its methodology. Besides, CRAs should clearly differentiate ratings on structured finance from those on bonds. To achieve or enforce all those goals supervisors shall review their use of ratings in the regulatory framework. Authorities should review as to whether the role that they have assigned to ratings in their legislation is consistent with the objectives of encouraging investors to make independent judgment of risks and perform their own due diligence when making decisions about investing their capital in a specific financial instrument. Thus, a review is specifically needed with regard to the reliance of Basel II on external ratings. Successfully, at the EU level, a strengthened oversight regime for rating agencies has been passed two weeks ago by the European Parliament. Hopefully, the new regulation will come into force in July this year.

The originate-to-distribute model
Underwrites, distributors and managers involved in the OTD chain have insufficient incentives to provide reliable information on the quality and performance of underlying assets. The intrinsically embedded failure of the OTD model has magnified in the years preceding the outburst of the turmoil. Apart from poor underwriting standards, in many cases, some assets went into off-balance sheet conduits or SPVs with significant leverage and liquidity risk, making them vulnerable to a classic type of volatility. The information asymmetries in the OTD market lead to moral hazard problems on the part of lenders. Financial institutions ended up with substantial exposures to many of these conduits to which risk had been transferred, through contingent credit lines, revenue risks and counterparty credit exposures.

Putting a regulatory framework in place shall establish policies which require originators to reduce the moral hazard problem. One of the rules to be implemented would be making information on what loans the originator and the securitizer hold available to market participants. This is one of the tools regulators need to consider as they draft improved OTD-related disclosure regulations.

2. The points of contention in good regulatory reform

In Europe we face the problem of pressure from industry (especially large financial groups acting on the cross border basis) on the legislative bodies to focus on the supervision of a group and a parent undertaking and at the same time relaxing the requirement for subsidiaries. The consequence is shifting the supervisory powers to group/home supervisors from local/host ones.

It is clear that the market structure has huge impact on the supervisor's point of view, which depends on the fact whether they play the role of a group supervisor or not. The most controversial suggestions in scope of the transfer of powers has been rejected after the long disputes and under the influence of the crisis experiences. As regard insurance sector the problem is not limited to Europe area only. Some IAIS papers also introduced such ideas and, even though they did not gain the recognition so far, the tendency is clear.

The second fundamental question which must be answered is how much capital the financial institutions should hold to be able to meet their liabilities in unfavorable market conditions and what degree of free capital transfer between entities belonging to the same group should be permitted. The situation is similar as in the area of supervisory powers: the group approach is presented as the most suitable one.

Taking into account the group perspective the issues of the capital requirements calculation as well as transferability are based on consideration of a group as one company. This is theoretical situation whereas in practice the capital (which is "somewhere" but nobody, and particularly local supervisor does not know where) cannot be acknowledged as an available one. There are also legal transfer barriers as well as mental ones. Every government knows the next election term.

During the last 2 years we could have also observed that cases which were previously assessed as tail events (so almost impossible to take place at the same time) had happened simultaneously and the diversification effect turned out to be overestimated. Therefore the lower capital requirements increase the probability of situation in which parent companies face insolvency problems and will not be able to support their subsidiaries. The consequences will be borne by policyholders, bank depositors as well as global economy.

Here we come across the third issue which is under the Polish FSA's anxiety, namely the ex post measures, for example the financial resources to cover all liabilities. The example of Icelandic banks operating in the UK in form of branches has shown that a lack of adequate supervision in a host member state as well as an inefficient deposit guarantee scheme cause serious problems for both home and host member states. Impracticality and weakness of the principle that home member state is responsible for activities of braches set up abroad has been brought to light by the case of Landsbanki, in which funds gathered by the Icelandic deposit guarantee scheme occurred to be insufficient. Therefore, as long as sound and robust guarantee scheme of branches is not introduced the local supervisor should be able to undertake any supervisory actions necessary to ensure stability of a local market, such as ability to limit activity of a foreign branch or ability to require to carry on activity in form of a subsidiary instead of a branch.

3. How do we make global regulation work?

There is a fundamental rule which says that the supervisory powers must be distributed between different bodies according to their responsibilities. As long as we do not solve the problem of shifting the responsibilities, which encompasses for example one deposit guarantee scheme, prudent assessment of diversification effect taking into account all group specific risks or equity and justice in the asset transferability in case of insolvency, one may not claim that the group perspective is the right one. The issue of pan European deposit guarantee scheme causes a lot of problems even in such an integrated area as European Union.

Polish FSA calls for the balanced powers of group and local supervision based on the responsibility principle. The scope of powers in a situation where a demand of one party depends on the willingness of the another one and does not have any legal basis, creates problems of the jurisdictional nature and does not enhance the field of cooperation, which is an inherent characteristic of proper cross-border supervision. The collaboration becomes easier since increasing number of countries apply the risk based supervision. Such a framework gives possibilities to identify the scope and the potential severity of the exposures. The supervision authorities possess information which enables them to take anticipating decisions like identifying financial bubbles. Therefore we welcome the de Larosière report proposition about the necessity of macro-supervision, but in order to enhance effectiveness of the new structure it should be in our opinion strongly connected with micro supervision on the country level as well as cross border one. It will limit creation of gaps which would be immediately abused. A good example are financial institutions which were not supervised, but had the large impact on the financial system. It is impossible and impractical to supervise all financial institutions but an analysis of possible systemic risk in the micro scale will allow to identify unfavorable trends. The institutional solution of macro supervision is an European idea, however we see a lot of benefits in adjusting it to the global level.

The example of Icelandic banks justify the opinion that host supervision should be given more power as regards oversight of branches of banks located in other member states. It is because host member states are responsible and bear the costs of losses of their consumers when funds held by a home deposit guarantee scheme prove to be insufficient.

In the present situation it is justified to claim that only effective national supervision ensures that sufficient amount of capital is held at the local level. It is very important since solvency of local financial institutions constitutes the best protection for consumers.