Swallowing the National Toad

Germany's top regulator says it's time the industrialized world swallow its pride and implement some aggressive regulatory reforms.

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For some time now a strange phenomenon has been observable: People who used to employ convenient euphemisms such as "turbulence" and "turmoil" can no longer avoid using the word "crisis." Even so, I would still regard this term as rather temperate language, because a crisis, as a famous German-speaking writer once remarked, is very often a productive state of affairs: By calling for immediate remedial action, it can erode established patterns of behavior and disrupt the ingrained ways of conventional thinking. As German regulators are irrepressible optimists, living by the motto "think positive," I wouldn't argue with the use of the word "crisis"—if we could only convince the markets to panic constructively.

Instead, they have been panicking in the old self-defeating way, driven by herd behavior, which has created a financial inferno worthy of portrayal by a modern-day Dante. There have been heavy casualties along this ride to disaster. The traumatic events that have unfolded over the last few months are forcing financial regulators to re-examine their current maxims. It is clear that the preconceptions that made sense in the past do not fit the present. Maybe the regulatory framework has been erected on insufficient or even false premises, and we have relied on a fair-weather construction that works only as long as cold winds are

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not blowing. Maybe disaster myopia had inflicted us and blinded us to the true risks of the financial sector. Nothing is what it seemed any more, and we might be forced now to pop a few balloons of self-delusion.

For years national supervisors have been arguing over what is the best system of supervision—and in so doing we have wasted valuable time. Now that the old order is crumbling and we are under terrible pressure, all of a sudden fraternization is breaking out all over. What unites us now is the urgent need to reshape banking regulation so as to prevent crises like the present one ever happening again—or at least not with this destructive force. So one or two countries are just going to have to swallow a national toad—that is, swallow their pride and bite the bullet—of Basel II, for example. I take the liberty of saying this on U.S. soil.

The subprime crisis has provided dramatic evidence of the dangerous loopholes and inadequacies that were inherent in the international regulatory system—and still are. The rigid intellectual approaches of Basel I, the fatal loopholes in the quantitative standards, the culpable neglect of risk management systems—the list of mistakes in the old Basel rulebook is a long one. Thanks to Basel I, banks were able to engage in regulatory arbitrage on a hitherto unknown scale and pump themselves full of risk unchecked.

A short-term band-aid approach will not suffice.

Many of the catastrophes of the recent past would not have happened at all under Basel II. It is a tragedy that it has taken ten years to get the new rulebook adopted. Basel II must be implemented worldwide with all speed—and in full. Those who fail to understand this are doing a great disservice to the stability of financial markets all around the world. Basel II is not a catalogue that each country can leaf through to pick out the bits that suit it best.

Basel II plugs some of the fatal loopholes in the quantitative regulatory standards. And with its Supervisory Review Process, the new capital standard also introduces a concept that drives banks to improve their risk management systems. It is our task as supervisors to force banks to make a great leap forward in this area.

The subprime crisis has shown that whether a bank sinks or swims depends heavily on the quality of its risk management. Banks whose risk management worked properly escaped relatively lightly—with the emphasis on "lightly." Others collapsed with a resounding crash—or were spared this fate only by spectacular rescue operations.

Dangerous Loopholes

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With Basel II we have only remedied the worst shortcomings in the old regulatory system. That is not enough. In the glaring light of the subprime crisis, what has become obvious is that we have to tighten up some of the rules—especially those relating to capital adequacy. Capital requirements have to be driven up—not overnight during the crisis, but over a lengthy period once we are back to normal.

We are still as far away as ever from a convincing reconstruction of the rule book. But at least we know the direction that we have to take. The Financial Stability Forum points us in that direction in its pioneering "Report

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[…] on Enhancing Market and Institutional Resilience" of 7 April of this year. The Basel Committee for Banking Supervision has already taken the Financial Stability Forum's recommendations on banking supervision on board.

Under the first Pillar of Basel II—which deals with capital requirements—we are tightening up the rules on re-securitization. We will be widening the incremental default risk charge for largely illiquid trading book positions, which has already been enshrined in the new Basel rulebook, to include migration. And we will be increasing the capital requirements applied to short-term liquidity facilities for asset-backed commercial paper to the level that also applies to longer-term credit lines.

The most important solutions must be worked up and set in train before the press reports the problems.

The requirements of Pillar 2, the Supervisory Review Process, will change considerably. Institutions will have to structure their risk measurement and control processes so as to cover their whole business—or even re-structure them altogether. They will also have to include off-balance-sheet and securitized products. Banks will in addition have to critically examine the valuations of all their products. They will in the future need to employ stress tests to check whether their risk management serves its purpose.

We shall also be imposing new requirements in future on the management of liquidity risk, which is not covered by capital requirements under the first Basel pillar. For far too long a time, the Basel Committee was blind in this eye. Member countries wanted to be masters of their own liquidity rules, which made it impossible to define international liquidity standards—an omission that has had devastating consequences. Last month the International Conference of Banking Supervisors adopted the Basel Committee's new Principles for Sound Liquidity Risk Management and Supervision.

What will we be demanding? I'll mention just a few examples: better liquidity risk management, stress tests, contingency funding plans, and a liquidity cushion that is big enough to see a bank through a survival period. We supervisors will monitor how the banks are implementing the new standards and whether their liquidity cushion is appropriate. In so doing, we shall cooperate with our colleagues in other countries.

The rules of Pillar 3—which deal with disclosure—will also be tightened up, for example, by introducing detailed requirements for securitizations held on the trading book and sponsorship of structured investment vehicles in particular. Banks will have to disclose their Internal Assessment Approach (applied to securitized products held on the trading book) for asset-backed commercial paper as well as the valuation principles applied to securitized products. And if these products involve pipeline and warehousing risks, they will have to disclose this too.

The subprime crisis has showed us more clearly than ever that we regulators have a fundamental problem in identifying risks that escape our direct analytical grasp. These include in particular risks that are packaged into securities—and are also located in other countries. Even our colleagues in the United States obviously didn't know that the giant mortgage institutions had thrown the rules for sound lending overboard in recent years by granting the now-notorious subprime loans and had even been creating portfolios especially for sale overseas. Oh, if only we had known. Then we might have realized that the ratings for the securitizations of these loans were an illusion. This identification problem is hitting Germans particularly hard: since competition is particularly fierce in my country, many German banks are seeking their salvation especially in foreign business. This is one explanation of why we have suffered a few hits.

This brings me to the last point that I would like to address: cooperation with colleagues across national borders. Cooperation between supervisors of groups of institutions has a long tradition. It is based on bilateral Memoranda of Understanding, which generically govern cooperation between two regulatory authorities. Fine documents, full of

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Fine documents, full of fine words—and not worth the paper they are written on in times of crisis. In the European Union we have the Banking Directive, which governs the respective roles of the home country and host country supervisors. Well, that's better than nothing, I suppose.

fine words—and not worth the paper they are written on in times of crisis. In the European Union we have the Banking Directive, which governs the respective roles of the home country and host country supervisors. Well, that's better than nothing, I suppose. But we need new structures. At the moment it looks as though in the European Union the supervisory authorities and central banks responsible for groups of institution will shortly be obliged to cooperate. The already existing colleges of supervisors would then constitute the institutional framework of this cooperation and they would probably—and this would be an innovation—also include the regulators responsible for systemically relevant branches.

Politically, there is at present no alternative to the colleges. For that reason we should structure them in such a way that they help us to make decisions during the crisis. The colleges must subject the business models of groups of institutions to regular and thorough examination in order to build up a comprehensive picture of all risks together. They must be involved in crisis management and support the national regulators in their difficult work. The most intimate details should be discussed in a closed circle—of high-ranking supervisors. Every member of this small circle must know how problems of systemically relevant banks impact on their jurisdiction. In this illustrious little group—let us call it a core college—supervisors must be able to exchange the most important information and coordinate decisions. That calls for honesty and trust.

Core colleges for times of crisis—it remains to be seen whether this model also finds favor outside the European Union. From my own painful experience I know that we must urgently tackle the subject of cross-border crisis management at the global level—possibly by granting the supervisor of a bank in extreme difficulties a period of time in which to organize a rescue or to ensure that it is wound up in an orderly fashion. That would of course presuppose that, as mentioned, all the regulators involved know the group's risk structures. If under such an approach a regulator rescues a bank or ensures that it is wound up in an orderly fashion, all the regulators dealing with subsidiaries and/or branches of this institution should be informed, ideally at the same time and continuously, but at least immediately after the end of the rescue attempts. And for the sake of fairness, under this procedure the affiliates should not be self-service shops for assets. Last but not least: the most important solutions must be worked up and set in train before the press reports the problems. That is a major prerequisite for effective crisis management—both within institutions and between institutions and their regulators.

Time is out of joint for all the players in the financial market, regulators included. No one will come out of this episode well. As in Greek tragedy, we cannot escape the feeling that catastrophes are inevitable. Unfortunately, solutions are not. Today we are struggling with the depressing fact that this crisis has exposed serious shortcomings in the regulatory regime that need urgent correction. The credibility of financial regulators is being severely tested. A short-term band-aid approach of the type that we have seen on so many occasions before will not suffice. The offer of another round of self-regulation will have to be rejected. Governments have to take bold comprehensive action. From today there is a new game in town called, "He who pays the piper calls the tune."

The answer lies not in ditching the present regulatory framework, but in making major and fundamental changes to tighten regulation in a way that financial firms will not like but will have to accept. Don't call this over-reaction. It's just the pendulum swinging back to the middle, where it belongs.

At the same time—and that is our main task for the time being—we have to devote ourselves with ferocious energy to saving the international financial system from the wild gyrations of a maelstrom, the sickening sweep of whose descent we have never seen like before. If not stopped, it will plunge the financial world with horrible rapidity into an abyss and devour it. In this situation, what we need on all sides is courage which dispels the fear that has gripped our hearts. *Audentes fortuna iuvat*—fortune favors the bold. ◆