The Post-Subprime Regulation Scramble

By Klaus C. Engelen

The regulators and market players pick up the pieces.

As U.S. President George W. Bush and his Treasury Secretary Henry Paulson were working on a wide-ranging relief package to help struggling homeowners refinance subprime adjustable-rate loans or freeze the current interest rates for five years, some European finance ministers, leading politicians, and top bankers seized on failings exposed by the credit crunch to call for more pan-European supervisory arrangements. Some of them are pursuing the ultimate goal of a super-regulator to oversee EU financial markets.

It was Tommaso Padoa-Schioppa, Italy's finance minister and a former board member of the European Central Bank, who stirred things up. He sent a letter to EU finance ministers calling for a "single rule book that will be enforced uniformly all over the European Union" and for "binding standards" in all EU member states. Having been in charge of prudential supervision at the ECB board, Padoa-Schioppa argued that "the Commission and the European Central Bank had come through the crisis with flying colors, but the supervisors had failed—chiefly because they are scattered across the European Union and answerable only to capitals." In his view, "the recent financial turmoil was a revealing test of the shortcomings of the present system" and "it is now necessary and urgent to act

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Alistair Darling

Peer Steinbrück

U.K. Chancellor of the Exchequer **Alistair Darling** *and German Finance Minister* **Peer Steinbrück** *rejected calls for pan-European regulation of financial markets.*

decisively to enhance the European supervisory system." And summing up the failures in EU financial market supervision, he wrote: "It is disappointing that no sharing of confidential information on potential systemic risks to the European financial system appears to have taken place among EU supervisors. In crisis situations, European supervisors can be expected to act based on a narrow national perspective."

Since almost simultaneously EU Economic and Monetary Affairs Commissioner Joaquín Almunia launched a broadside against the present nation-based supervisory system, there was talk at the December EU finance ministers' meeting of a well-coordinated campaign by EU insiders for more Commission authority in financial market supervision. According to Almunia, "Pressure is mounting for European supervisory arrangements. Financial institutions should be subject to essentially the same rules irrespective of where they operate in the Single Market."

As was to be expected, U.K. Chancellor of the Exchequer Alistair Darling and German Finance Minister Peer Steinbrück rejected calls for pan-European regulation of financial markets. The German side argued for improving the working of the prevailing "Lamfalussy Process" for regulation and supervision of EU markets, called after Alexandre Lamfalussy, the Belgian central banker who chaired the committee that devised it (see box). The British pointed out that the United Kingdom and Germany accounted for about 55 percent of total wholesale financial services volume in the European Union in 2006, while Italy and France, countries favoring a more centralized system of supervision, only accounted for 8 percent of the market during that period.

From a European point of view, Karel Lannoo, who has worked for years on financial market supervision issues and who manages the Centre for European Policy Studies (CEPS), sums up the situation: "The unfolding financial market crisis is presenting [also] the European Union's regulatory and supervisory system with its first big test." In his view, the crisis "has revealed worrying differences in responses to stress, flaws in the enforcement of rules, and gaps in the supervisory framework." And we share his warning that "central bankers, policymakers, and national banking supervisors urgently need to agree to a set of policy priorities and to prepare a more integrated response to crises. The international reputation of Europe's financial market is at stake."

Nicolas Véron, a research fellow at the Bruegel Institute, argues: "German supervisory setbacks and the Northern Rock debacle have shone a spotlight on crisis management and prevention, and highlighted how different regulatory settings either helped or hindered efficient public policy." According to Véron, in the view of the City of London as a financial hub, "the liquidity crisis has concentrated minds," and has shown how the United Kingdom's interests could be best served by ensuring Europe's financial regulation becomes more efficient and credible rather than, as until now, by "'keeping Brussels at bay' and making sure that none of the continental developments has a material effect on London's practices."

Taking the proper lessons from the recent failures, Europeans should reassess the Lamfalussy Process, says Véron. Thus, the City "should play a leading role in improving Europe-wide financial regulation." This means "to reorganize supervision at the national level, including most conduct-of-business regulation, and to devise adequate ad hoc solutions at the European level for those tasks for which financial integration has rendered the national approach insufficient."

Tommaso Padoa-Schioppa, *Italy's finance minister and a former board member of the European Central Bank, stirred things up.*

AN AMBITIOUS WASHINGTON REFORM AGENDA

Looking back at annual meetings of the Bretton Woods institutions, financial market regulators and supervisors historically have played a marginal role. But not this time around as the International Monetary Fund and the World Bank held their annual meetings in October in Washington. Under the shadow of the subprime crisis and its global implications, they launched an ambitious reform agenda.

For many observers and market participants the failings in financial supervision—as they became apparent in the U.S. subprime mortgage sector, in the problems of German banks with their off-balance sheet conduits, and with the bank run at the United Kingdom's Northern Rock—have contributed to the costly financial crisis, as did too-low interest rates. Therefore, not only market participants—with major financial institutions and their shareholders losing billions of dollars—but also supervisors and regulators are licking their wounds while central banks, reacting decisively in the crisis by providing huge amounts of liquidity, have generally increased their importance and reputation. In some EU countries—such as Germany and the United Kingdom—horrendous shortcomings have led market participants and the broader public to question present financial market supervisory arrangements and institutions.

There are indications that Italy's bank supervisors applied hefty doses of "principles based" regulation instead of caring much about the outgoing Basel I rules.

Thus, financial market supervisors and regulators moved to center stage not only in the official discussions of the G7 nations, but also at numerous financial industry gatherings where regulators and supervisors discussed the lessons of the current financial turmoil with top representatives of the private sector.

At the Washington meetings, regulators and supervisors were asked by the G7 finance ministers and central bank governors to work with other authorities to come up with proposals to limit turmoil on global financial markets in times of stress. The appropriate forum to meet this new challenge is the Basel-based Financial Stability Forum.

The Financial Stability Forum was established in 1999 to promote international financial stability through better information exchange and closer international cooperation in financial supervision and surveillance. At its roots were financial turbulences—the Asian debt crisis, the Russian ruble disaster, and the near-failure of Long-Term Capital Management.

The Basel-based forum brings together on a regular basis national authorities responsible for financial stability in important international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. Under the G7's mandate, the Financial Stability Forum set out "to examine the underlying causes of recent financial market turmoil and to make appropriate recommendations." To address these issues, the Forum has set up a Working Group on Market and Institutional Resilience. The group will "develop a diagnosis of the causes of recent events, identify the weaknesses that merit attention from policymakers, and recommend actions needed to enhance market discipline and institutional resilience."

Highlights at this year's gathering of world financial leaders were the discussions on regulation and supervision at the Institute of International Finance, and at the "Breakfast Dialogue With Government Officials," for many the most important inside discussion among top regulators and supervisors, organized towards the end of the IMF meeting by the Institute of International Bankers.

In his speech at the twenty-fifth anniversary dinner of the Institute of International Finance, ECB President Jean-Claude Trichet came up with a message that the private sector wanted to hear. Banks should take steps to fix weaknesses uncovered in the recent global financial market turmoil. Any move for quick new laws might cause more harm than good, argued the ECB's president before eight hundred executives of the global association of financial service firms. Trichet wanted to give "the right of first refusal to the private sector" to work out appropriate principles for restoring confidence and liquidity in financial markets. The banks should consider "voluntary" disclosure of their holdings of complex securities. This would include disclosure of vehicles banks arranged to stay off their balance sheets.

Increased voluntary disclosure "could work as an important signalling mechanism that would allow investors to reassess positions and gradually help the market for structured finance to start functioning again," Trichet said.

By announcing a major initiative "to refine best practices for market participants," IIF's chairman, Deutsche Bank CEO Josef Ackermann, spelled out what the private sector plans to do. Through a committee that is co-chaired by Cees Maas, former CFO of ING Group, top experts of some of the largest financial institutions from across the globe will produce recommendations by spring 2008 that reflect the views of leaders of the financial services industry and that can enjoy strong support from financial service firms and complement efforts underway by the official sector.

According to Ackermann, "the weaknesses in business practices and market dynamics that have been revealed have highlighted the areas where industry practices need to improve." Therefore, the committee's agenda will concern a variety of key issues, including those relating to structured products, including risk management, credit underwriting practices, and the pricing of risks; conduits and the contingent liquidity risks that firms have been exposed to by using off-balance sheet instruments; valuation questions, especially where markets are thin or absent; the interpretation and evaluation of ratings; and transparency, disclosure, and communications to define appropriate standards.

Spelling out the IIF's private-sector initiative, Ackermann pointed to the IIF's report "Principles of Liquidity Risk Management," published in March, that made recommendations for good industry standards. "For example, the report urged that executives responsible for liquidity risk should have a detailed understanding of the contingent liquidity risk to which their firms are exposed by off-balance sheet vehicles—so as to ensure that effective contingency measures are in place in the event that liquidity problems arise that could cause a draw on back-up commitments."

Although the problems of some leading financial institutions—with Citigroup and Merrill Lynch on top of the list—have worsened since the Washington meeting in October, the IIF's move to come up with a set of "best practices" is appreciated among supervisors and regulators working in the Financial Stability Forum. "It is very important that the private sector examine these events and draw lessons from the turmoil and its underlying causes," says a top official on the basis of anonymity. "There were clearly good and bad practices out there; some firms have done very well and others badly; some countries' arrangements worked well, others did not." The official continued: "I think the official sector should welcome private-sector efforts to flag 'best' practices. If the IIF's work in these other areas is as good as the liquidity risk management paper, we should be very happy." But he makes some qualifications: "Clearly, the official sector must undertake its

A Lamfalussy Primer

The "Lamfalussy Process" is an approach to financial service industry regulations used by the European Union. It is named after Alexandre Lamfalussy, the former Belgian central banker and director-general of the Bank for International Settlements who chaired the EU advisory committee that in 2001 worked out a process of four "levels," each focusing on a specific stage of the implementation of legislation. It was first created for EU securities legislation and later extended to banking supervision, insurance, and pensions.

At the first level, the European Parliament and Council of the European Union adopt a piece of legislation, establishing the core values of a law and building guidelines on its implementation. The law then progresses to the second level, where sector-specific committees and regulators advise on technical details, then bring it to a vote in front of member-state representatives. At the third level, national regulators work on coordinating new regulations with other nations. The fourth level involves compliance and enforcement of the new rules and laws.

The Lamfalussy Process is considered to provide benefits over traditional lawmaking, including more consistent interpretation, convergence in national supervisory practices, and a general boost in the quality of legislation on financial services.

—K. Engelen

The German Scramble for Regulatory Relevance

Will German politicians and bureaucrats succeed in dismantling key elements of the integrated financial market supervision agency that was established only five years ago? Will they seriously weaken the management and leadership structure of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) by taking away most powers of the agency's president, outspoken and strong-willed Jochen Sanio?

These are questions raised by large segments of Germany's financial community since the German government put forward plans to revamp its financial market supervision agency. "Putting the cart before the horse!" That is how a leading banking expert characterizes the moves of German Finance Minister Peer Steinbrück, first to change BaFin's leadership structure, then to take time to come up with solutions to improve the banking supervision structure and processes, and in particular to find out how to better define the respective operational responsibilities of BaFin and the Bundesbank under the "dual supervision" regime.

As things stand, by early next year, BaFin will be run by a five-person board of directors instead of a president. Four executive directors will be responsible for their particular divisions—supervision of banking, securities, insurance, and a new division dealing with "administration and policy development."

Under the new law, the four executive directors "shall be able to decide independently about all financial and organizational questions."

Consequently, come the next banking crisis, Germany will be sending a not-so-reassuring signal to the global markets: All major decisions by BaFin's board of directors "shall be reached by majority vote." Gone may be the days of a firm hand in supervision and resolute crisis management at the top, when BaFin's President Sanio could show rogue bankers and financiers that a financial watch dog won't only bark but also bite—as he did this summer:

- When the intervention of BaFin forced WestLB Chief Executive Thomas Fischer and risk officer Matthijs van den Adel out of their positions.

- When BaFin played a key role in putting together a rescue package to save IKB Deutsche Industriebank from insolvency due to huge exposures in subprime mortgages in the United States.

- When BaFin also saved Sachsen LB, a landesbank with huge exposures in the U.S. subprime mortgage market, from bankruptcy by urging another landesbank, that of Baden-Württemberg, to buy Sachsen LB and provide the needed liquidity.

The new "Gang of Four" leadership may be running the BaFin operation—with a staff of more than 1,600—not in the direction of more integration among the pillars of banking, securities, and insurance in order to match the market needs of more and more integrated financial products. They may instead revert to the old days of fencing between these pillars.

BaFin President
Jochen Sanio

Steinbrück's first reform stage is shaping up as a political *fait accompli* due to the large Grand Coalition support of Christian and Social Democrats. Berlin's politicians and bureaucrats justify these steps "to broaden BaFin's management structure" after a fraud scandal involving an IT manager that pointed to weak internal controls in an agency that is suppose to supervise internal controls in banks and other financial institutions.

Less certain are two things: First, what power will be left under the new structure to Sanio, who recently turned sixty, and who fought hard to get the integrated financial supervision agency established? Sanio's reputation as a world-class supervisor and regulator has become an asset for Germany as other national supervisors are struggling to regain or retain trust and credibility.

Second, will Sanio will stay on after losing most of his operational responsibilities as "president" and after having been set up by his political enemies as a whipping boy of the German financial system?

"If Steinbrück, in a first step, only wants to install a new top management at BaFin, he is putting the cart before the horse," says Stephan Paul, a leading banking expert from Bochum University. Together with his colleague, Stefan Stein, he recently presented a highly critical study on the reform needs in German banking supervision and how the new draft legislation will fall short of what should be done.

"It is incomprehensible that Berlin politicians push aside all the well-reasoned objections and proposals by German banks and academic experts regarding the man-

agement structure and other core elements of BaFin reform," says Paul. "Instead, there is consensus to take away, as fast as possible, Sanio's power. Berlin politicians act as if the fallout from the turmoil that has swept markets in the wake of the U.S. housing industry crisis and that nearly brought down two mid-sized German banks didn't happen."

According to Paul and his colleagues, any meaningful modernization in Germany's financial supervision "has to start with strengthening integrated supervision and providing the funds for hiring more qualified staff in order to be able to cope with ever more complex financial products and ever more interconnected market segments." Second, banking supervision has to be concentrated at its core with much more cooperation and information sharing among the main actors: BaFin, the central bank, and major accounting firms.

Some spokesmen of the different banking sectors are keeping their powder dry. They are particularly angry that so far there have been no parliamentary hearings on the first stage of reform.

But they understand that Steinbrück uses the contagion effects of the subprime mortgage woes in the United States on German banks and the weaknesses that were revealed in the country's financial market supervision to postpone the bulk of the reform on the ground that the finance ministry would need more time to study the implications of the failures in the recent financial crisis and to work on a better sharing of supervision responsibilities between BaFin and the Deutsche Bundesbank.

The political blame game among the two banking supervisors and those in government is still causing irritations.

Meanwhile, the political blame game among the two banking supervisors and those in government is still causing irritations. Steinbrück's ministry tried to shift the blame to BaFin and the Bundesbank "because they never bothered to clarify how potential liabilities from special purpose vehicles or conduits should be treated in balance sheet examinations."

Is this an attempt to hide the Finance Ministry's own blunders? Most embarrassing remains the fact that Steinbrück's department head and key BaFin supervisor, Jörg Asmussen, also didn't push for clarification of how to treat the huge special vehicles and corresponding off-balance-sheet credit lines.

Gerhard Schick, a member of the Bundestag's finance committee from the Green party and an expert on banking, reminded the ministry that they raised the issue already in 2003 and got nowhere. They wanted to know from the ministry why it was possible to transfer huge credit lines outside the balance sheet and thus avoid putting up equity capital as it is needed in on-balance-sheet short-term lending.

As the present crisis has shown, what the financial market supervision system lacks most is high quality personnel.

There also is a lot of shifting blame between the Bundesbank and BaFin. In the case of IKB, the Bundesbank still takes the position that in the dual system of banking supervision, BaFin shared responsibility. This is disputed by BaFin and the Finance Ministry, since IKB was not on the list of banks "with systemic risks." For "systemic relevant banks," both BaFin and the Bundesbank share responsibility as supervisors.

But thanks to the high reputation that the Bundesbank still commands, the blame was put on BaFin and Sanio. Sachsen LB is another matter. From its beginning, this public-sector bank was considered "systemic relevant."

As the internal memo of a major German banking association points out, "In the case of Sachsen LB, those responsible in the State of Saxony were sleeping at the wheel." The law under which the state bank was set up gave far-reaching responsibilities for supervision and operations to key state officials.

As the present crisis has shown, what the financial market supervision system lacks most is high quality personnel to match the expertise in banks and other financial service firms. But this would be costly.

The way the Berlin government and Steinbrück have handled the issue is "a case study in ignorance and arrogance of those politically responsible toward the market actors at a time of still-smouldering financial crisis," laments a top German banker, on condition of anonymity because he has enough troubles with Berlin politicians.

—K. Engelen

own review of events and take steps it sees necessary, including but not limited to reinforcing recommendations coming out of the private sector. That will be happening. But in the process of arriving at conclusions about what reinforcement and additional steps are needed, the Financial Stability Forum and all its member bodies will have dialogue with the IIF and other private-sector groups working on these issues in the next few months."

What McCarthy didn't address openly but confided to some of his peers was that he is very disappointed with his FSA staff for not alerting him earlier to the Northern Rock disaster.

There was another important message coming from Ackermann in his role as finance industry spokesman: That it doesn't make sense to blame supervisors or regulators for the recent weaknesses in business practices, but that the finance industry is strong enough and has the financial resources to recover.

But listening to key regulators and supervisors in October in Washington, one got the impression that market regulators were still hedging their bets.

Callum McCarthy, head of the United Kingdom's Financial Services Authority, admitted that "what has happened is very sobering both for market participants and for regulators, and both have needed to learn the appropriate lessons." He warned that regulators must not succumb to political pressures and adopt what he called "mad dog" responses that could make matters worse. As the top supervisor of a country that—in the case of Northern Rock—was faced with the first bank run in one hundred years, McCarthy conceded that for the Financial Services Authority and other U.K. policymakers, "working to improve depositor insurance programs" has the highest priority.

In McCarthy's view, "the recent troubles, whatever their causes, have manifested themselves as an acute liquidity problem." This means "we need to make progress on liquidity standards. Given that global firms aspire—justifiably—to manage their liquidity on a group-wide basis, it is clearly preferable that we agree on new internationally agreed standards rather than develop separate national regimes." Regulators have been wrestling with the liquidity issue since 2000, but have made little progress.

At the Institute of International Bankers panel, McCarthy got down to the nitty-gritty: "The recent troubles have thrown into sharp relief issues which need greater attention than they have sometimes been given. I think, for example, that the wish of global entities to reduce the scope of separate liquidity regimes of subsidiaries implies stronger and more effective guarantees of those subsidiaries by the group. The freezing of the foreign exchange swaps market which occurred must make both treasurers and supervisors look again at currency liquidity."

With respect to the present valuation problems of structured products, McCarthy takes a hands-off approach: "Regulators shouldn't substitute their judgment of the value of the securities for the bank's assessment." The banks should see the beneficial effect of transparency. The market has reacted kindly to those banks that have "set out what they have done and explained it." What McCarthy didn't address openly but confided to some of his peers was that he is very disappointed with his FSA staff for not alerting him earlier to the Northern Rock disaster.

U.S. Federal Reserve Governor Randall S. Kroszner, who at the spring meeting of the Financial Stability Forum had told his fellow supervisors that they shouldn't worry about the U.S. subprime and structured products markets, must have been struck by sudden enlightenment. Now he argues that the problems in the subprime mortgage sector could "get worse before they get better" for two reasons. First, all indications are that housing activity is continuing to weaken and house prices in general will be sluggish for some time, and second, because mortgage delinquencies and foreclosures will probably continue to rise for a number of quarters as the bulk of resets to higher rates and payments have yet to come.

Talking before the IIB panel, the former economics professor from the University of Chicago sees two reasons for what he calls a "breakdown" of the price discovery process in the markets for structured credit products such as collateralized loan obligations and collateralized debt obligations.

> "First, some investors may not have done sufficient due diligence with regard to complex structured products. Prior to the recent market disruptions, many buyers and

> sellers of complex structured products appear not to have demanded sufficient information from sellers, and simply accepted investment-grade ratings of these securities as a substitute for their own risk analysis. When the problems in the subprime mortgage market began to emerge and delinquencies on subprime mortgages in pools backing these securities exceeded rating agency estimates, subsequently resulting in a number of downgrades, investors lost confidence in the quality of these ratings, and hence the quality of the information they had about these instruments, and pulled back from markets for structured products across the board."
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> "Second, a related factor contributing to the breakdown in price discovery is the recognition by investors of complexity and lack of transparency, both in the instruments themselves and in the markets more broadly. The complex structures of the innovative instruments, and the lack of transparency with regard to the underlying assets backing these instruments, made them more difficult and costly to value than many investors originally thought. At the same time, many investors realized that it was difficult to identify where the risks were lodged. This uncertainty, of course, is one of the trade-offs of a more market-intermediated finance system in which risks are more widely dispersed rather than concentrated in the banking system. As problems in the subprime mortgage market became more apparent, investors became unwilling to purchase products that could have any exposure not only to subprime mortgages, but to housing-related assets and other structured products more generally."

Kroszner continues:

> "Put simply, investors suddenly realized that they were much less informed than they originally thought. In these circumstances, it is not necessarily surprising that investors pulled back from purchasing certain instruments at any price."

On the IIB panel, Fabrizio Saccomanni, director general of the Bank of Italy, came up with a European perspective. He pointed to the successful struggle of Italy's supervisors in recent years to keep its major banks from getting exposed to large liquidity commitments for off-balance-sheet "conduits" and structured investment vehicles that had invested in the U.S. mortgage market.

What became clear was that European banking supervisors have been dealing very differently with liquidity commitments for off-balance-sheet conduits and structured investment vehicles. For instance, German banking supervisors have tried to explain the near-failures of IKB Deutsche Industriebank and Sachsen LB using the lack of any legal basis to stop those banks from taking on huge liquidity commitments for conduits and structured investment vehicles that had invested in structured products in the U.S. mortgage market. "Had Basel II been in force, both banks would have had to come up with a capital charge of 8 percent covering the credit line for off-balance-sheet conduits or structured investment vehicles, while under Basel I no such capital charge was required," argues a German regulator. There are indications that Italy's bank supervisors applied hefty doses of "principles based" regulation instead of caring much about the outgoing Basel I rules.

"The subprime lending crisis is only the most recent proof that vulnerability spreads rapidly all around the world. Almost every problem today becomes everybody's problem, regardless of its origins. And globalization acts as a multiplier. It leverages good policies as well as bad ones."

This is how Angel Gurría, Secretary-General of the Organization for Economic Cooperation and Development, summed up the fallout from the U.S. subprime crisis in his speech to the European Banking Congress in Frankfurt in November. Addressing this European audience, he observed that global crises happened elsewhere and Europe seemed little effected. "When we tried to anticipate where crises would arise next, we thought of the emerging world. After Tequila in Mexico, Vodka in Russia and Samba in Brazil—where would the next source of financial crisis and economic turmoil be? Wherever it was, chances were high that it would largely spare Europe. But this has changed."

Among those who now are heading major international institutions, Gurría, a former top Mexican official, brings to his position a decades-long experience in dealing with financial crisis. After all, he developed close ties with bankers and financial officials all over the world from the days when he was Mexico's chief debt negotiator after that country defaulted on its international debt in the summer of 1982, bringing about the Latin American debt crisis.

Gurría was repeating the points he made at the IMF/World Bank meetings that the recent crisis showed "that the explosion of different financial instruments outside the core segment of the banking sector was underestimated and a large part of the transactions took place out of the reach of traditional banking and monetary regulation."

Concludes Gurría: "Of course, in some cases supervisors should have been more aware; and in others authorities did signal concerns about the conduits used to securitize loans and some of the underlying lending practices. But today we do need to look again at the set of tools that we have—and that we don't have—to influence financial market developments." ◆