

DIAGNOSIS OF REGULATORY FAILURES; CRITERIA FOR EFFECTIVE REGULATION

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I. PROBLEM: “The shadow financial system”

- a. Regulation been incomplete.
- b. Certain actors (hedge funds, rating agencies), mechanisms (banks SIVs) or instruments (derivatives) are totally unregulated or regulated too lightly. Offshore centres: far lighter regulation.
- c. The example of Spanish SIVs.
- d. Regulatory arbitrage implies “ shadow financial system” grows faster and often generates more problems.
- e. Unregulated parts depend on systematically important banks via provision of credit or guaranteed liquidity (e.g. counter-parties to hedge funds, ex-post liquidity to SIVs).

I. SOLUTION: COMPREHENSIVE FINANCIAL REGULATION

- a. Regulation has to be total for all institutions and instruments.
- b. To discourage regulatory arbitrage and prevent build up of systemic risk.
- c. Regulation should be equivalent across board, for solvency and liquidity on all risk weighted assets.
- d. Key criteria: equivalent leverage (e.g. capital for all banks and all their transactions, margin for hedge funds)
- e. Some actors (e.g. rating agencies) should be regulated in other ways to improve their methodology and overcome conflicts of interest.

II. Key pre-condition for good regulation is increased transparency.

- The Problem.
 - a. Information very poor or non-existent on actors like hedge funds or on derivatives, especially OTC.
 - b. Problem for other market actors, investors, as well as regulators and economic authorities.
- The solution.
 - a. Hedge funds. Minimum requirements: total aggregate positions, both long and short positions, market, liquidity and credit risk, level of leverage.
 - b. The U.K. FSA recent disclosure requirement.
 - c. Derivatives. Could OTC be standardized and channelled through clearing house exchanges?

III. Regulation tends to add to pro-cyclicality

- The problem: markets and regulations are pro-cyclical.
 - a. Main market failure in financial and banking markets: pro-cyclicality
 - b. Regulation (e.g. Basle II) accentuates pro-cyclicality, e.g. The use of own models to calculate capital, role of rating agencies.

III. Regulation tends to add to pro-cyclicality contd.

- The solution: regulation has to be explicitly counter-cyclical.
 - a. Banks: Goodhart-Persaud proposal of counter-cyclical capital
 - b. Criteria: total assets, or also weighting for rapidly growing assets?
 - c. Capital adequacy vs. Provisioning
 - d. Timing of introduction
 - e. Hedge funds and derivatives, could there also be counter-cyclicality in their regulation? If derivatives positions grow excessively, can collateral be increased?

IV. Can compensation mechanism be self-regulated or should they be regulated?

- The problem: incentive issues at the heart of excessive risk-taking.
 - a. Remunerations high and one-sided; linked to short-term profits.
 - b. Asymmetries stronger for actors like hedge funds.
- The solution: compensation self-regulated by financial industry or regulated?
 - a. Bonuses to be accumulated in escrow accounts.
 - b. Cashed only after a long period (ideally, full cycle).
 - c. Would encourage more focus on long-term.
 - d. Problems of implementation.
 - e. Who would regulate?