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The Finance Market Watch Program @ Re-Define

Lessons from the Financial Crisis

The ongoing crisis has highlighted several key deficiencies in the current financial system, which would need to be addressed. Some of these are

1. There was an excessive focus on the stability of individual institutions and too little focus on the stability of the system as a whole.

   - The issue of systemic stability needs to be at the heart of the regulatory agenda.

2. The scope of regulation was too narrow with several institutions such as hedge funds, private equity firms and special investment vehicles falling outside the scope of most bank regulation even as they performed bank like functions. Others such as investment banks and money market funds were too lightly regulated. Markets such as those in derivatives and securitized bonds were also left largely unregulated. In a number of jurisdictions, especially tax havens, the overall regulatory regime ranged from non-existent to unsatisfactory.

   - The scope of regulation needs to be comprehensive and it should extend to all jurisdictions, all institutions, all markets and all instruments.

3. The regulatory regime was too procyclical with capital adequacy, loan loss reserve rules, credit ratings, marked to market accounting rules all adding to the already inherently procyclical nature of financial markets and thus amplifying business cycles.

   - The new regulatory regime needs to be explicitly counter cyclical.

4. Many financial institutions were allowed to become too big, too complex or too interconnected to fail where their failure would have had catastrophic consequences on financial markets as was highlighted after the collapse of Lehman Brothers. Far from such institutions having to have an extra safety margin of capital and liquidity protections as would have made sense, many had less than for comparable smaller, simpler and less

connected institutions partly as a result of arbitrage opportunities and the flexibility provided to them under the Basel II capital accord.

- The moral hazard problem where these institutions enjoy an implicit subsidy from the possibility of public rescue made matters worse. That is why the new regulatory regime has to find a satisfactory way to deal with such systemically significant institutions either by downsizing them or by introducing extra safety margins that makes them internalize the systemic risks they pose.

5. The long bull market and low interest environment led to regulatory complacence where the availability of liquidity across several markets was taken as a given and the 'just in time' liquidity regime where short term borrowing was used increasingly to fund longer term assets contributed in a large way to the vulnerability of the financial system.

- The new regulatory regime must put the need to maintain adequate and robust liquidity, which has been long ignored in regulation, at the heart of regulation this point forward.

6. The fact that there were no proper and sufficient legal and financial mechanisms to allow an orderly winding down of financial institutions added significantly to the uncertainty that surrounded the viability of financial institutions. While mechanisms were designed on the go in most major OECD economies, these were ad hoc and inefficient from the perspective of both the taxpayer and market confidence.

- That is why one of the priorities for the new regulatory regime needs to be to formulate a legal and fiscal regime that allows the orderly, flexible and quick winding down or takeover of large, complex and interconnected financial institutions both at a national as well as an international level.

7. The lack of proper international supervisory and regulatory oversight stood out in the crisis where regulatory and oversight gaps in the supervision of internationally active financial institutions helped because the crisis and the lack of proper co-ordination or supranational authority helped prolong it.

- One of the key requirements for regulatory and supervisory reforms is to introduce mechanisms and institutions that facilitate an effective international supervision program, help co-ordinate regulatory regimes and enable internationally co-coordinated crisis management.

8. The pre crisis financial system was characterized by 1) too little capital 2) of insufficient quality and 3) excessive borrowing and embedded leverage. This low quantity and quality of capital eroded the shock absorption capacity of the system and the leverage helped amplify losses and contagion.

- The new financial regulatory regime needs to have much stricter provisions for the quality and quantity of capital as well as limit total leverage in the system.

9. The financial system is rife with misaligned incentives and conflicts of interest in the compensation of financial market participants which encourage short-termism, excessive risk taking and allow them to ignore due diligence all of which compromise systemic stability and market integrity. This was particularly evident in the case of the origination of securitization, trading by investment banks and the issue of credit ratings.

- A proper alignment of incentives needs to be at the heart of the new financial regulatory system. At a minimum, the lack of due diligence in the origination and issue of securitized bonds, the conflicts of interests

that prevail in credit rating agencies and the risk enhancing bonus schemes that are widespread in the financial sector all need to be addressed urgently.

10. The crisis also highlighted the inadequacies of consumer and investor protection in current regulations which were highlighted by the Madoff scandal, the lack of transparency of financial institution exposures and losses and the sale of complex ill suited securities such as certificates to retail customers.

- o The ongoing regulatory reform needs to increase transparency in the system, improve investor protection and institute enhanced consumer safeguards. The ongoing crisis has highlighted several key deficiencies in the current financial system, which would need to be addressed. Some of these are

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