Regulatory Issues in Respect of the Credit Crisis

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Executive Summary

1. There are two separate aspects of the crisis:
   - a liquidity and credit event in the finance industry, accelerated by enormous leverage in the financial sector;
   - unwinding of global imbalances, triggered by the fallout of the financial crisis. However, these imbalances have not been caused by the crisis.

The downturn of the real economy is a separate problem and cannot be solved by the rescue of the finance industry alone.

2. The crisis has clearly brought to light the limits of soft law regulation. We have a global finance system with globally active institutions, whereas supervisors and lenders of last resort are national. But supervisory cooperation is still reliant on voluntary fora lacking a base in international public law. There is no treaty-based organisation with authority to regulate the finance industry. Regional organizations such as monetary unions can achieve a clear legal base more easily.

There is urgent need for a clear base in public international law with the authority to issue regulation on large cross-border institutions, comprising:
- minimum harmonisation of supervision to achieve consistency and a level playing field;
- co-operation of supervisors including mandatory intervention in specified cases.

In the case of bail outs of large cross-border institutions which are subject to the above-mentioned regulatory minimum harmonisation, supervisory cooperation and burden-sharing should be mandatory, as well as application of stringent conditions on the institutions concerned. This should reduce incentives for moral hazard.

3. The liquidity crunch was widely triggered by the de-leveraging of maturity transformation and by intransparent re-aggregation of securitised and distributed credit risks. Macro supervision of systemic risks is necessary, as a supplement to the regulation and supervision of individual institutions.

4. Regulation on and supervision of maturity transformation and liquidity has to be included in international cooperation and convergence as closely as is the case with capital requirements.

5. The existence of an undisclosed and unregulated shadow banking system can directly affect liquidity and solvency of the entire financial system. Agreements on minimum principles in respect of supervision on non-banks are necessary.

6. The crisis has clearly evidenced weaknesses of model-based approaches and specific model elements in particular.