BANKARCHIV

ZEITSCHRIFT FÜR DAS GESAMTE
BANK- UND BÖRSENWESEN

SEPTEMBER 2009
57. Jahrgang

Sonderdruck

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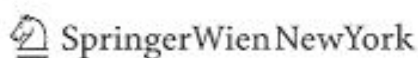
HERAUSGEGEBEN VON DER
ÖSTERREICHISCHEN BANKWISSENSCHAFTLICHEN GESELLSCHAFT



Update on Regulatory Issues in Respect of the Credit Crisis

Klaus Peter Follak

There is an urgent need for a clear base in public international law with the authority to issue regulation on considerable cross-border institutions. This paper analyses the state of discussions on regulatory responses as at mid-year 2009. It is concluded with some thoughts on the performance of Islamic banking during the crisis.

Keywords: Accounting standards, Basel Committee, Basel II, cross-border bankruptcy and liquidation, CRD, cross-border supervision, financial intermediaries, financial market regulation, IAS, IOSCO, Islamic banking, large exposures, liquidity management, macro / micro supervision, maturity transformation, marking to market, monetary policy, rating agencies, regulatory arbitrage, reporting standards, risk models, structured credit, subprime mortgages, systemic risk, valuation standards.
JEL-Classification: G 01, G 15, G 18, G 21, G 24, K 23.

1. Financial Turmoil and Global Recession

Last year, we saw a credit event in the finance industry – the realisation of subprime mortgage risks – evolve into a liquidity event and then into a solvency event. Now we are heading towards global recession. Crisis resolution plans everywhere – but are we really going anywhere? We won't be, if we don't clearly distinguish between separate problems and their driving factors.

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.

The shortening of banks' funding profiles, causing severe stress in interbank and other lending markets – ie the credit crisis – is continuing. The fallout of the credit crisis has triggered the unwinding of global imbalances which Fed Chairman *Ben S. Bernanke* in a recent speech puts this way: "In the simplest terms, these imbalances reflected a chronic lack of saving relative to investment in the United States and some other industrial countries, combined with an extraordinary increase in saving relative to investment in many emerging market nations." These problems cannot be solved by regulating the finance industry. Nor can rescue and recovery actions for financial institutions in distress replace preventive prudential regulation. At the moment the focus is on cleaning up, whereas the regulatory stage has to be set carefully, avoiding hasty patchwork and over-reaction born out of day-to-day crisis management – although the regulators have to be established with powers of early intervention urgently in case of any legal loopholes. This is why, basically, we are still confronted with the same regulatory needs as last year and why progress can be only gradual. Just putting more capital into the system can strengthen banks' balance sheets in respect of future write-offs during the downturn of the real economy. But it will not solve the regulatory problems – the *focus* has to be on *avoiding wrong and providing for the right incentives* for financial institutions.

2. Driving Factors and Possible Responses

2.1. Supervisory Style; Macro versus Micro Supervision

So far, the supervisory focus worldwide was on individual institutions ("micro supervision"). Although supervisors have regularly taken into consideration that the failure of an individual institution can have an adverse impact on the financial system as a whole, macro-systemic risks [1] have been neglected – ie situations when the financial system becomes overly exposed to aggregate risks, in particular correlation risks or unhealthy leverage within the financial system. The current liquidity crunch was widely triggered by the de-leveraging of maturity transformation and by intransparent re-aggregation of securitised and distributed credit risks. The supervisory focus including Basel II had been on selling risk off-balance sheets, which had produced efficient risk reductions in the first round. However, no one assessed where in the financial system such risks might resurface. Supervisors

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worldwide are unanimous on the *need for a systemic approach* of banking regulation and supervision as a complement to assessing individual institutions [2]. As far as the responsibilities are concerned, there are two models under discussion: a single integrated regulator model, where an integrated regulator operates alongside the central bank [3], and a so-called twin-peak model where the central bank is the prudential and systemic risk regulator operating alongside a conduct of business regulator [4].

Another issue of supervisory style deserves critical attention: "A shift in supervisory style from focusing on systems and processes, to focusing on key business outcomes and risks and on the sustainability of business models and strategies." [5] This tendency can be observed worldwide, and is certainly justified as long as rescue packages funded by taxpayers are being implemented. If this becomes a permanent supervisory focus, it

[1] *Nier*, IMF WP/09/70, pp 24. See also *Xin Huang / Hao Zhou / Haibin Zhu*, BIS Working Paper No 281 (April 2009).
[2] See for example *FSA*, Turner Review, pp 42, pp 52 and pp 86.
[3] Which is more or less the case in Germany, Japan, the UAE and the UK.
[4] Examples: Australia and France.
[5] *FSA*, Turner Review, p 88.