We still don't know enough

David Wright argues that, despite the lessons learnt from the 2007-08 crisis, much more needs to be done to ensure that the financial system remains safe

In 2007, I was working in the European Commission as Director of Financial Markets in DG MARKT, as it was known then. The first rumours of serious financial trouble in the US began to emerge just before the summer holidays. Drip by drip, more details appeared of critical systemic trouble in the country's property markets, with massive subprime mortgage credit exposures and defaults growing exponentially and internationally.

> *It was a regulatory and supervisory shambles. Few people understood what was really going on*

The crisis spread fast, dangerously and expensively. The EU member states were quickly sucked in, along with many other countries around the world. Looking back, some of the biggest pre-crisis risks were:

- how ignorant and incompetent many boards and chief executives of significant financial institutions were, often setting woeful corporate governance standards
- how grossly uninformed and poorly prepared major financial regulators were – lacking data and with paltry understanding of embedded financial risks that could lead to global contagion
- banking regulation, including insurance rules and parts of securities laws, was wholly unfit-for-purpose. Global regulators in the Basel Committee on Banking Supervision (BCBS) had allowed massive levels of systemic leverage to build up in bank balance sheets such that only marginal movements in asset prices could wipe out the institutions, which is what happened
- banks' gross exposures to derivatives, both over-the-counter and exchange-traded, were enormous and systemic, with markets highly volatile
- bank and insurance resolution policies, apart from at the US Federal Deposit Insurance Corporation, were virtually non-existent.

In short, it was a regulatory and supervisory shambles.

From late 2007 onwards, the crisis accelerated. The terminology was new – CDOs and CDOs squared – which were one aspect of the trend for tranching complex debt instruments – the monoline insurers, breaking the money market fund buck, and so forth. Few understood what was really going on. The Lehman Brothers and Bear Stearns debacles in 2007-08 finally convinced governments around the world that action was needed, rapidly and urgently, and it was decided to ask the G20 to oversee a freshly mandated Financial Stability Board that was to restore and maintain global financial stability in the future.

What the FSB wanted to achieve

The guiding principle for the FSB was to rigorously redesign global regulatory and supervisory systems to expunge the use of public money to bail out financial institutions and to end 'too big to fail'.

With good reason. In 2008, the US Congress authorised the $700bn Troubled Asset Relief Program to stabilise the financial system. Freddie Mac and Fannie May had to be bailed out, as did insurer AIG. Europe was forced to apply a fiscal stimulus of 5% of GDP, and European GDP fell by 4.4% in 2009. Five years later, it barely exceeded the level of 2008. Some commentators describe the great financial crisis and its aftermath as a lost decade, fuelling the development of political extremes.

The Basel 3 regulations

The BCBS responded to the 2008 crisis with changes that became the Basel 3 rules. Beginning with the banks, it ramped up basic bank capital requirements by six or more times, with a focus on additional equity. It also required the 40 or so global systemically important banks (G-SIBs) to hold capital beyond that. The major insurers faced similar measures – the European Solvency 2 standard being a good example of regulation that followed. Liquidity coverage was enhanced with the liquidity coverage ratio and other Basel provisions.

In addition, the FSB developed recovery and resolution principles, stress testing, living wills and bail-inable debt instruments such as contingent convertible bonds, which could convert to equity if a bank were failing.

In the markets, as many derivatives as possible were moved onto exchanges to reduce gross exposure levels. Regulators gained rapid access to information from trade repositories. Clearing and settlement had to put in more efficient margin calls, and resolution policies were revamped with more sophisticated risk

and liquidity management.

Credit rating agencies, whose ratings of complex products had been seriously wanting pre-crisis, didn't escape. Nor did the so-called shadow banks. Money market funds were just one example of the 50% of global financial assets that had been very lightly regulated and poorly understood pre-crisis.

Has post-crisis regulation worked?

There have been few significant bank failures around the world since 2008. More strongly capitalised banks, better risk management toolboxes and stricter, more competent interventionist banking supervisors have played major positive roles. The system withstood the stress test of the Covid-19 pandemic and the following downturn. But there have been some problems, including the US mid-sized provincial bank failures and the collapse of the G-SIB Credit Suisse in Switzerland.

One reason for these failures may be that Basel 3 rules have not been fully implemented by the major jurisdictions. The US has so far restricted full Basel compliance to its largest international banks and the EU's implementation of Basel standards is still a work in progress.

The international financial institutions, including the World Bank and the IMF, have no powers to require implementation of international financial recommendations and standards. None of the standards is legally binding. Countries yet to adopt standards make few efforts to coordinate timing to avoid first mover advantage, or disadvantage, or to agree definitions that avoid, say, regulatory fragmentation.

Dispute settlement procedures that deal with faulty transposition or inaccurate implementation are also lacking. The system relies on 'peer pressure and prayer'. The only fully functioning international disputes settlement venue, at the World Trade Organisation, has been neutered by the US.

Current problems

In the EU, the lack of a banking union, of an EU-wide deposit guarantee scheme and of good securitisation are penalising the region's banks. The big EU banks 20 years ago were approximately the size of the top US ones. No longer. EU Capital Markets Union, designed *inter alia* to spread equity and risk in the bank-dominated EU financial economy, is still on the drawing board.

In the US, the recent banking failures have highlighted some weaknesses. The multi-level approach to implementing Basel rules has evident fault lines. US supervision, with numerous Federal and state-wide bodies, failed to pick up clear signals of banking stress. At the same time, not using mark-to-market accounting masked dangerous asset-liability balance sheet imbalances.

The limited opening times of the Fed discount window proved problematic, and the speed of deposit withdrawal in the stressed US regional banks was accelerated by social media. The liquidity coverage ratio came up short and will need to be strengthened. Many of these are also global issues.

> *Banks are not the only institutions where crisis resolution could be tricky despite the new rules*

The US is tabling its 'Basel 4' implementation package later this year. But one argument I do not understand in the US is that having a swathe of competing financial regulators and supervisors scrapping over turf increases economic efficiency. The EU has a single supervisory board at the ECB to oversee all mid- to- large-sized eurozone banks. So far it has worked well. The Bank of England (BoE) has set up a tough and effective Prudential Regulation Authority inside the bank.

But not everyone is happy with tougher rules. In particular, EU and UK insurers argue that the Solvency 2 rule book is too risk-averse, with negative impacts on equity investment by insurers. In this case, it may be that the pendulum has swung too far toward 'cautious', curtailing economic investment.

What the reforms mean for resolution

Have the new rules solved 'too big to fail' and taxpayer bailouts? I am not convinced the job, a massive one, has been completed satisfactorily. Some aspects worry me. Will the different systems in the major financial markets be able to cope with multiple large bank failures without recourse to public funding? In the latest US banking failures, the Fed rapidly moved in to insure all bank deposits above the regular $250,000 limit to avoid contagion. Moral hazard is not dead.

The EU Recovery and Resolution mechanism remains largely untested. Could it deal with a serious, systemic multi-bank pan-European crisis? Back-up funding in such a scenario would not be adequate. And who would take the resolution lead – EU institutions or member states? There would be a great deal of legal and political complexity.

Regulators wanted to ensure that investors, not taxpayers, absorb bank losses, but will contingent convertible bonds really work under stress? Holders of Credit Suisse's 'co-cos' are challenging the write-down. More fundamentally, would a standalone bank that writes down its co-cos still be able to do

business on Monday morning, or would stigma kill it? If a bank 'dies', would the thousands of pages of complex living wills really support resolution in crisis conditions?

Banks are not the only institutions where crisis resolution could be tricky despite the new rules. What about clearing and settlement institutions and the systemic risk they pose? And there are still risks in the derivatives market. For example, many banks in the EU are concerned that the credit default swap markets are thinly traded, too open to herding and speculation, and a potential trigger for bank runs.

> *Sanctions for financial bad behaviour, incompetence and outright crime remain far too low to deter bad apples*

When I was Secretary-General of the International Organisation of Securities Commissions from 2012-16, we were already discussing appropriate regulatory standards for non-bank finance, leverage in securities markets, Reits property funds, the broader impacts of hedge funds, money market funds and private equity, among other issues. Frankly, I am not sure much has progressed since. Do global regulators better understand today how these very big non-bank markets interact with 'traditional' financial stocks and flows? Do regulators have dashboards with real-time data, so they can quickly assess the build-up of systemic risk? Do we understand enough about inter-connectedness?

It is extraordinary, given the size and importance of financial markets – and the colossal costs that failures can bring – that far more public and private investment is not made in ensuring the real-time availability of data to regulators so that they can better understand the flows of capital around the world. It's like running a nuclear power station without understanding the pipework.

Conclusion

The world has moved on from the great financial crisis. Covid-19 was an important stress test. The financial system is safer today, but it is still not safe enough. Our understanding of how it functions must improve. We are still being unpleasantly surprised, regularly, about different forms of market stress.

We should do everything possible to reduce these risks, including urgently improving the provision of real-time data and enhancing global cooperation. Global financial institutions should be given the necessary legal enforcement powers and responsibilities. In most jurisdictions, apart from the US, sanctions for financial bad behaviour, incompetence and outright crime remain far too low to deter bad apples and encourage better governance. The Senior Managers and Certification Regime in the UK is a good approach and should be replicated.

Finally, we should always keep in mind that systemic banking crises are often preceded by booms and busts in property markets. ■

__David Wright__ was Deputy Director-General for financial services in DG Internal Market and Services at the European Commission until 2010 and Secretary-General of the International Organisation of Securities Commissions (IOSCO) from 2012 to 2016.