Comments on Masa Kono’s “Evolution of Bank Regulation and Supervision after the global financial crisis”

Christine M. Cumming
Adjunct Senior Research Scholar, SIPA, Columbia University
November 29. 2016
Mr. Kono’s Report Card on Financial Reform

- Two grades: one for design, one for implementation
- Evaluation standards are:
  - For design: mitigating systemic risk, reducing moral hazard, and enhancing transparency
  - For implementation, facilitating or impeding the achievement of the three objectives.
- Look at four key areas: bank capital and liquidity, ending too-big-to-fail; OTC derivatives; and shadow banking

- Overall grade: glass half-empty
  - For design, glass half-full
  - For implementation, glass still too empty
Grading by Area

- **Capital and Liquidity**: A passing grade or better on the concepts, but real concerns about latent pressures to keep raising the standards.

- **Too-big-to-fail**: design makes it sound too easy to resolve a major firm; skepticism abounds on execution

- **OTC Derivatives**: a solid concept embodied in the outcomes-based approach, but early emergence of gaps and underperformance as the approach is implemented.

- **Shadow Banking**: not much progress on design and large differences across jurisdictions remain.
Mr. Kono Highlights What Are Issues of Design

- The G-20 financial reform menu was meant to be comprehensive, but it has major gaps.
- Mr. Kono makes the excellent point that a series of bilateral agreements (e.g., regulatory equivalence based on outcomes for OTC derivatives) is less efficient and effective than sound, fully articulated and hammered-out multilateral standards.
- Country-specific unique requirements impede what are inherently global business models; again, a multilateral approach to such fundamental issues likely would be preferable.
Issues for the International Standard-Setting Bodies in Mr. Kono’s Remarks

- A need to deal with unfinished business, such as unlimited freedom to raise standards above the minimum, proprietary trading, deposit funding of capital markets activities
- Important that the international groups (Financial Stability Board, Basel Committee on Banking Supervision, IOSCO, etc.) don’t rest on their standard-setting laurels, but are proactive in coordinating implementation
- Need to address the already evident unintended consequences or suboptimal results of financial reform
  - E.g., Market liquidity
  - E.g., Correspondent Banking
Could the post-crisis reform have been less rushed and even more deliberative?

- There was a strong need to move forward, especially on capital and liquidity standards and on too-big-to-fail, immediately after the crisis.
  - Capital/liquidity standards are complex and could be simplified, if we are willing to jettison some of the old.
- Should have had more attention on a longer time scale of fundamental questions about what a bank is and what deserves bank-like regulation.
- Requires a willingness to change the regulatory landscape and perhaps some business models.
One more element we could focus on (Mr. Kono refers to it): governance of financial institutions

- Last March for a public lecture on financial reform, I came up with a report card similar to Mr. Kono’s.
- I probably gave more weight to getting the design right and was more U.S.-focused on the implementation.
- My starting point was the Financial Crisis Inquiry Commission’s (FCIC) 2011 report.
Distilling the FCIC’s Aspects of Failure into Four Deficiencies to be Fixed

- Risk-taking beyond a large financial institution’s ability to absorb losses
- Inability to put failing institutions into a workable insolvency proceeding
- Governance failures that allowed business strategies based on distributing risks in complex forms to clients who were ill-equipped to understand them
- Failure by financial authorities to identify systemic risk timely and act promptly to lean against it.
These in turn suggest four pillars for the reform agenda: Capital and liquidity, Resolution, Governance, Systemic risk identification and management.
## Conclusion: An Interim Scorecard

<table>
<thead>
<tr>
<th>Pillar</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital and Liquidity</td>
<td>Substantial progress</td>
</tr>
<tr>
<td>Resolution</td>
<td>Surprising progress: Past the halfway point</td>
</tr>
<tr>
<td>Governance</td>
<td>Reform regulation corrects important problems, but is largely preventive or defensive</td>
</tr>
<tr>
<td>Systemic Risk Monitoring and Management</td>
<td>Good progress; major strides in identifying and monitoring systemic risk “signatures”; issue is willingness to act.</td>
</tr>
</tbody>
</table>

10
A Depiction of the Scorecard....

And the Imperative to Keep Working