Comments on Masa Kono's "Evolution of Bank Regulation and Supervision after the global financial crisis"

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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 derivataives) 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 actvities
- 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: **C**apital and liquidity, **R**esolution, **G**overnance, **S**ystemic risk identification and management.

Conclusion: An Interim Scorecard

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

A Depiction of the Scorecard….

And the Imperative to Keep Working