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.