

## Paper Three

# A practical approach to the regulation of risk

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A peculiar characteristic of financial regulation today, and one of the causes of its failure, has been the divergence of theory and practice.

Recent proposals by regulatory and banking lobbies appear to be continuing this divergence. In theory, it is generally accepted that the core purpose of financial regulation is to mitigate systemic risks, such as a global credit crunch. In practice, however, the regulatory rules are focused entirely on risk-taking by individual firms.

It is a failure of composition to think that, if good behaviour is encouraged at company level, the system will inevitably look after itself. One of the striking things about the report requested by the Swiss Federal Banking Commission into the facts leading to [UBS](#)'s sub-prime losses is that much of what UBS did to get into difficulty was considered to be best practice for individual firms. Banks put their resources in places where their risk-management systems, using publicly available data, told them it was safe, generating systemically large concentrations.

As environmental regulators have found, formulating practical "systemic" policies is far from easy. But giving up is not an option. When confronted with this point, regulators have asked us, "What would systemic regulation look like?" The following four new proposals provide a flavour.

First, while financial institutions are encouraged by supervisors to conduct thousands of stress tests, few are conducted by the regulators on a system-wide scale. If it is possible to have system-wide stress tests on the impact of Y2K, or of avian flu, why not on liquidity? The regulator should conduct system-wide stress tests of those scenarios most likely to produce systemic stress – such as a 40 per cent drop in house prices. Fears of a meltdown in global house prices were not rare before the crisis. These tests will probably underestimate spill over effects, but the information gleaned from them could help regulators estimate these effects and consider mitigating action.

Second, the targeting of regulation targeted at highly leveraged institutions, whatever their legal status, would be an important step towards a comprehensive regulatory framework. Many years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of companies throughout the financial system. It is this leverage – when coupled with short-term funding liquidity – that threatens market gridlock in a disintermediated financial system. We need to

switch the attention of the central bank and the regulators from an institutionally defined approach to a functionally defined approach.

Institutions are not born with original sin or original virtue; it is their behaviour that can have potentially damaging systemic implications. It is the spread of pollution that matters, not the legal entity of the polluter.

Third, It would also be useful to distinguish short-term funded leverage from arrangements with longer-term funding. Consider, for example, the current debate over the impact of mark-to-market accounting. From a risk management perspective, the problem with the current value accounting rules is that the focus is on the asset: its perceived liquidity and the intention of the asset holder to hold it to maturity or to trade it. We have seen how asset liquidity and holder intentions can change rapidly in a crisis leading to an increasingly artificial view of value and solvency. It would be far better to focus on the *funding* liquidity of the asset. Where assets are funded with short-term liabilities, then whatever the perceived liquidity or intentions of the asset owners, it is appropriate to mark the value of that asset to market in case funding dries up and the assets need to be sold tomorrow. But where assets are funded with long-term liabilities or set against long-term liabilities, as is typically the case with a young pension fund, then marking asset values to market is not appropriate and can lead to an artificial view of risk and investment decisions based on a risk that is not important to the holder

Fourth, a clear distinction must be made between a capital charge à la Basel and provisioning that is available to cover losses in a downturn. One of the main problems is that a minimum capital requirement is a charge, not a buffer. If resources are to be available in the downturn, then they must be freely released as necessarily as they have been compulsorily accumulated. Because the economic cycle is the big source of systemic risks, Charles Goodhart and Avinash Persaud have suggested that capital charges should be raised in a boom and relaxed in a slump. There are complicating issues with this proposal, but the point is that counter-cyclical charges should be based as much as possible on systemic phenomena and less on the characteristics of the individual firm.

These four measures are practical steps toward the regulation of systemic risk. There remains the cross-border problem. Many sensible proposals are wrecked on that rock. But if widespread improvement is to be achieved, the Basel committees and the Financial Stability Forum must shift away from sole reliance on the new Basel consensus of regulation – greater transparency, more disclosure and more market-sensitive risk management at the company level – and instead develop practical systemic proposals.