Paulson’s welcome strategy

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Paulson’s welcome strategy

Henry Paulson’s plan to reform the current hodgepodge US regulatory setup marks a breakthrough in several respects. Here we highlight the reform’s potential significance for the US and for the international regulatory landscape. We subsequently offer some comment informed by the current financial market crisis, as well as by experiences in the Netherlands with the Twin Peaks model that we helped introduce five years ago.

We see three key reasons why the US Treasury’s proposal – already by its mere issuance – constitutes a breakthrough.

First, the mere announcement is likely to make reform in the US inevitable. Putting the existing model up for change is likely to unleash a dynamic with one certain outcome: not the existing model. This is progress in its own right, the need for change being abundant.

The US regulatory landscape for financial services is broadly seen as an overly complex, history-driven accumulation of what are, in principle, cooperating but in practice often competing regulators. Regulatory competition within the single US jurisdiction has sometimes been advocated as healthy, fostering regulatory innovation and best practice. Such an approach may have certain merits, especially when the search is still on for the appropriate model. But increasingly this regulatory competition within the US jurisdiction has become a costly model – costly in terms not only of efficiency and effectiveness, but also of losing out to other cutting-edge and coherently modelled regulators promoting financial market quality and competitiveness. The latter increasingly are setting the international regulatory agenda. As an obvious example, look at the insurance sector where the plethora of US regulators play an underweight role in the global arena.

Second, Paulson’s strategic choice for an objectives-based model should set a coherent agenda for debate in the US.

Jeroen Kremers and Dirk Schoenmaker say the shadow of the Twin Peaks model hangs over the US treasury secretary’s new regulatory proposals.

Jeroen Kremers and Dirk Schoenmaker were responsible for introducing the twin-peaks regulatory model in the Netherlands five years ago. Since then they moved on to the IMF and ABNAmro and to the Netherlands Economics Ministry, respectively. Dirk Schoenmaker is director of European affairs, competition and consumer policy. Their work is cited in Henry Paulson’s plan.
In this model, there is a regulator for financial system stability, one for prudential supervision of financial firms (banks, insurers, securities firms, conglomerates), and one for proper conduct of business by all financial firms. The current US model is essentially sector-based (Fed and OCC for banks, SEC for securities, state regulators for insurers). But markets have become overwhelmingly cross-sector in nature, with firms engaging in all sorts of financial activities no longer limited by sector boundaries and with consumers buying all sorts of cross-sector products (think of a mortgage combined with life insurance buttressed by client-driven investment). Whatever the outcome of these trends may be, they will certainly not end up within the neat old sector boundaries that long ago defined the sector model of regulation still existing in the US (and many other countries). And there is no reason they should. Having lost the sector rationale for regulation, it makes more sense to seek new coherence by organising it along key objectives, or alternatively by lumping it all together into a single mega-regulator like the UK’s Financial Services Authority (FSA). How best to organise the objectives-based model within the specific context of US financial markets: that will be the important US policy debate going forward, now that the choice against a mega-regulator has been made.

Third, internationally too the Paulson move may help foster the regulatory landscape of the future and put the US back on the map. Many countries are changing their model, or are bound to do so in the years to come. Essentially three alternative models are out there being tested in the real world: the old-fashioned sector model, the mega-regulator model of the UK and Scandinavia, and the objectives-based model of Australia and the Netherlands with a following in some other European countries as well as now in the US.

When introducing the objectives-based Twin Peaks model for the Netherlands in 2002, a few years after the UK opted for a mega-regulator, we advocated a spell of
regulatory “model competition” between countries to enrich the available knowledge of which model works best in what circumstances. Many countries have so far waited to see this play out. With the US chipping in for an objectives-based approach, other countries (as well as international regulatory forums such as Basel, the International Association of Insurance Supervisors and the International Organization of Securities Commissions) may consider their position. Cross-country experiences at the International Monetary Fund (IMF) are favourable to this approach, suggesting that regulatory standards tend to be higher in countries with an objectives-based model.

Twin Peaks’ advantages

Have the US Treasury therefore chosen the right strategy? What model is best? Of course this is not rocket science, it all depends on the institutional and financial market setting in any particular country. The advantages of any cross-sector framework – be it objectives-based or a single mega-regulator – are obvious. Going cross-sector helps avoid gaps (stability of investment banks like Bear Stearns falling between the cracks) as well as uneven treatment (deficient consumer protection in sectors with weaker regulatory standards). It can make regulation more effective (less information and coordination problems) and more efficient (lower staff costs).

Subsequently, the present market turmoil offers lessons for the choice between the two alternative cross-sector approaches, the objectives-based models of Australia and the Netherlands and the mega-regulator of the UK. It is becoming apparent in the current crisis that the objectives-based framework now also chosen by the US Treasury may offer advantages for preventing and resolving financial crises. Why?

Clarity of focus

First, regulators with a clear focus (market stability, prudential soundness of firms, proper business conduct) have a strong incentive and a uniform culture within their organisation to strive for excellence in what they are supposed to do. Having separate regulators for financial soundness and for proper business conduct helps avoid one of these objectives getting snowed under by the other. A mega-regulator in boom-times tends to focus on high-profile business conduct, while in fact prudential stability has to be fostered precisely when markets are in bullish mood and the seeds for later busts are being sowed. Lack of priority given to prudential supervision of Northern Rock has been a key finding of the FSA’s internal audit review. Separating prudential and conduct-of-business supervision into distinct regulators, as in the...
Twin Peaks model and the US Treasury plan, may help avoid this – not by well-meant intentions within a mega-regulator context – but by anchoring priority for prudential supervision within an earmarked regulator.

In the Netherlands, we have now two supervisors. The Netherlands Bank (DNB, the Dutch central bank) is responsible for prudential supervision, while the Authority for the Financial Markets (AFM) is responsible for conduct of business. A clear focus appears to be helpful for both supervisors. The AFM can pursue the interest of clients with vigour. If a financial firm does not give sufficient information to clients, or worse, misleads clients, the AFM will take a strong stance on this firm. In that sense, the AFM has learned from the US SEC. The difference with the SEC is that the AFM has the full range of regulated financial firms under its watch, while the SEC has only the regulated securities firms or securities affiliates of larger groups. DNB has established itself as a supervisor with a strong focus on prudential issues. DNB pursues supervision on a consolidated basis, recognising that one part of a financial group can infect other parts. Next, with their early experience on the banking side, DNB is at the forefront of encouraging large insurance firms and pension funds to adopt advanced models for risk management. It is also common practice of the DNB to request stress tests across the whole range of regulated financial firms. In practice, of course there can be some overlap for financial firms in their supervision by DNB and AFM. However, after five years of experience, the supervisors have reduced this overlap in day-to-day operations and shown that it is quite manageable in practice (see also Gorter and Mosch says in this issue).

**Working together**

Second, to prevent and resolve stability crises, it is crucial for the central bank responsible for system stability and the regulator responsible for the stability of large financial firms to be able to work closely together. The experience with Northern Rock has shown the dangers of crisis management by committee (ie, the Tripartite Standing Committee established by the UK’s Memorandum of Understanding.

“**Having separate regulators for financial soundness and for proper business conduct helps avoid one of these objectives getting snowed under by the other**”
consisting of the Treasury, the Bank of England and the FSA). Having an earmarked prudential regulator offers a close and like-minded partner for the central bank. They have similar skills and cultures. In fact, in the Netherlands for these reasons we chose to merge prudential supervision into the central bank. This goes a step further than the Twin Peaks model of Australia, which includes a prudential regulator separate from the central bank.

The US Treasury plan does not propose to combine the prudential regulator and the central bank responsible for financial stability. The plan proposes that the new prudential financial regulator and the market stability regulator (Federal Reserve) should work closely together and share information. Moreover, the Federal Reserve can impose information reporting requirements on holding companies.

We suggest that the link between the new prudential financial regulator and the Federal Reserve should be considered further, including the possibility of linking the two closely together in some way as appropriate for the US setting (e.g., joint staff but distinct decision-making bodies). Those of us who have experience with government bureaucracies know that the information exchange between large agencies is not always as smooth in practice as envisaged on paper. Moreover, direct hands-on experience with day-to-day supervision can come in handy when the central bank is in the middle of a financial crisis and tries to understand how large the exposures of financial institutions are, how well their risk management systems capture moving market prices and what their likely response to further market disturbances will be. Finally, crises are to be prevented before they occur, and it is therefore a must in normal times also that the stability regulator should be fully on the ball.

Clear and defined functions

Third, and reinforcing our previous point, we feel that the current crisis offers its most challenging lessons in the interface between micro-prudential stability of individual firms and the stability of the entire system. The best chance for tackling these challenges may be within a Twin Peaks setting based on an effective division of roles, and on effective cooperation, between the prudential and system regulators.

Of course, the crisis is still ongoing and hence too fresh to allow fully gauging its policy implications. Nevertheless, the many improvements to prudential supervision suggested by the Financial Stability Forum and the Basel Committee, while no doubt in large part useful and important in their own right, seem in essence to remain technical improvements within the existing prudential regulatory framework rather than addressing some of the more pertinent underlying
challenges to the framework itself as revealed by the crisis. These challenges in our view lie in the interface between micro and macro.

Should we revisit Basel’s system of capital requirements and make it less pro-cyclical or, better still, anti-cyclical? The Basel system is geared toward the stability of individual financial institutions, and does little to take account of their interaction with their environment and its stability. Capital requirements that “breathe with the cycle”, however imperfect because of difficulty with design, may help avoid banks overly expanding credit and causing or contributing to asset bubbles when capital is ample in boom-time and, conversely, help avoid them tightening lending standards in the aftermath precisely when this is least conducive to system stability.

Something similar seems to be true for accounting rules: those that are in place and those that are in the pipeline tend to be geared toward transparency of individual institutions, but there does seem to be a valid question about unintended pro-cyclical side-effects that may need to be addressed.

And finally, there is the interaction between monetary policy on the one hand, and prudential and financial system stability on the other. Clearly the current crisis has been fed by a prolonged period of overly expansionary monetary policy. Following the era of monetary targeting and subsequently of inflation targeting, we will need to think about a new framework for monetary policy taking adequate heed of financial market stability. The debate has already started, also at the Fed under Messrs Bernanke and Mishkin, on the appropriate division of labour between monetary policy and policies aimed at financial system and prudential stability. For the totality of these policy objectives, clearly the lone instrument of interest rates is not sufficient and it will need to be combined in some fashion and in some situations with some of the instruments of prudential regulation. This once again reinforces our point that the link between the central bank and the prudential regulator is crucial.

One comment made about the current crisis is that prudential regulators – even

“The many improvements to prudential supervision suggested by the Financial Stability Forum and the Basel Committee seem in essence to remain technical improvements within the existing prudential regulatory framework rather than addressing some of the more pertinent challenges revealed by the crisis”
though some saw the crisis coming – tend to be allergic about individual institutions getting into trouble, but care less about the system going down (which can always be blamed on the Treasury, the macroeconomy, or the weather more generally). With this in mind, having an effective regulatory incentive structure for tackling these micro-macro challenges seems an important consideration for weighing pros and cons of alternative regulatory models. We had all of that when we did our reform in the Netherlands – it sure wasn’t easy in our country without the “benefit” of a crisis to push it through. Nevertheless, regulatory reform for US financial services is long overdue, and a lot of excellence that is present within the various US regulatory agencies also deserves it. Consumers, firms and the economy at large stand to benefit if this project is brought to a coherent end. □

“A reform of this magnitude directly affects the huge interests of sectors involved, of closed shops, and of influential persons holding on to influential positions”

Having separate regulators for prudential and conduct-of-business supervision, as in the Paulson proposal, may help foster an effective relation between micro- and macro-prudential regulation and, beyond that, monetary policy. As mentioned, this relation needs to be worked out, suited to the financial market circumstances specific to the United States.

Turning back to the outlook for path-breaking reform, obviously Paulson’s strategy will need to be further specified and vested interests will need to be overcome. A reform of this magnitude directly affects the huge interests of sectors involved, of closed shops, and of influential people holding on to influential positions.

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