THE OECD AND ITS ROLE IN INTERNATIONAL REGULATORY RESPONSES TO THE FINANCIAL CRISIS

International Conference on Improving risk regulation: from crisis response to learning and innovation

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Overview

Where are we coming from?

- Origins of the crisis and reaction: OECD’s Strategic Response and the G20 process

Where are we?

- Assessing current reforms: unfinished agenda

Where are we going to?

- The new financial landscape
A low interest rate environment led to a search for yield and increased risk-taking...

- which was also reflected in strong demand for new and higher risk assets such as securities backed by subprime MBS and CDOs...

...supporting “originate-to-distribute” model, with various entities participating...

Some linkages:

- Underwriting criteria were relaxed
- Credit rating agencies and bond insurers artificially boosted credit quality
- Investors performed little due diligence
- Supervisors failed to adequately enforce proper underwriting and risk management criteria
Overblown financial system as a root cause of the crisis

Global primary securities versus OTC derivatives

Source: OECD, BIS, World Federation of Stock Exchanges, Datastream.

Where are we coming from?
Disregard, complacency and failure of analysis and understanding

- Many analysts, OECD included (Atkinson et al.), failed to adequately monitor and interpret numerous signs of trouble ahead of the crisis (e.g. balance sheet imbalances, spikes in asset prices, and declines in risk premia)
- Failure to understand the inter-linkages between the financial sector and the real economy and how these could lead to unsustainable imbalances
- Under-regulation and optimistic view on self-regulation

Many observers missed the onset and the magnitude of the problems and/or underestimated the severity of their impact

Over the years, the 2007 crisis changed the thinking about the inherent stability of the financial system
Crisis response and resolution need time …

1. **Shock and disbelief:** Crisis, what crisis?
   - Long path from liquidity to solvency crisis, and from subprime turmoil to financial and economic crisis

2. **Denial:** This can't be happening to me!
   - Good ratings, sound balance sheets, no subprime exposure…

3. **Emotions - Disappointment and resentment:**
   - How will we ever manage these losses?

4. **Acceptance and conclusion:**
   - Working out policy measures, including exit strategies

…and communication & cooperation

• **Communication is most important**: listen and react appropriately; supportive dialogue
  
  -> *don’t feel bad to overthrow preconceptions*

• **“You are not alone”**: co-operation on national and international level between authorities and the private sector

• **‘Share Feelings’**: share experiences with peers, also on crisis resolution mechanisms

➢ **Take steps**: engage in bold policies (quantitative easing, government spending & guarantees) and regulatory reforms…

Devising exit strategies from unprecedented policy measures and the shape of the post-crisis financial landscape (2009 book)

General Considerations:

- Exit to which ‘new landscape’?
  - Do not repeat the previous mistakes,
  - create more resilient financial structure
  - with proper incentives (e.g. risk taking)

- Timing and sequencing
  - Systemic risks need to be addressed immediately
  - Long-term reforms: “Getting it right” is more important than speed

- Communication & co-ordination
  - Policy co-ordination via G20, FSB, IMF, OECD....

Where are we coming from?

The OECD reacted to the crisis early on in the OECD strategic response…

www.oecd.org/finance
Starting point: Pittsburgh financial reform proposals, September 2009

- Revision of capital rules (higher and better quality capital, countercyclical, leverage ratio)
- Better liquidity risk measurement and management.
- Enhanced disclosure (off-balance sheet positions taken into account.)
- Oversight of credit rating agencies
- Unified accounting standards
- Market practices and underwriting standards in particular have become better regulated.
- Centralised clearing of CDS contracts and the trading of standardised OTC derivatives on exchanges
- Compensation standards aim to align compensation with long-term value creation
- Supervisory colleges and contingency planning for co-ordination between supervisors and firms for crisis management involving major cross-border firms, a legal framework for crisis intervention and improved information sharing in times of stress.
- Tools and frameworks for the effective resolution of financial groups

Source: Leaders’ statement, the Pittsburgh Summit, 25 September 2009, available at www.g20.org
But have no illusions: implementation of reforms needs time

Dodd-Frank rulemaking progress
by month, as of October 2014

US Regulators’ meetings with outside participants over time
As of January 2013

Notes: Values refer to number of rulemaking requirements; rulemaking counts are based on estimates and require judgment. The Progress Report only includes rulemakings explicitly required by the Dodd-Frank Act. Many discretionary rulemakings will be needed to implement Dodd-Frank’s mandates.
Source: Davis Polk, Dodd-Frank Progress Reports, various issues, 2011-2014.
Current challenges

- Basel III and other reforms well underway, but bank concentration has increased and too-big-to fail (TBTF) and interconnectedness issues are still pertinent...

- …while a push into non-banking sectors (shadow banking) continues – and is supported by policy makers and the industry (away from the traditional bank-based finance model in Europe)

- Reform fatigue and ‘go it alone’ national regulatory approaches undermine “Pittsburgh spirit” of 2009 and (re-)create unlevel playing fields that were so pertinent in the build-up of this crisis

- Unbalanced economic recovery may reinforce this trend

- Cooperation and coordination of reforms is necessary to avoid regulatory arbitrage
Selected OECD activities to respond to the crisis

- **Improving banking structure and competition** (OECD proposed bank separation before Volcker, Vickers and Liikanen….)
- **Reducing distortive government guarantees** for the financial sector
- **Promoting financial education** (since 2003!) via dedicated network (INFE, since 2008)
- **Enhancing financial consumer protection** via G20/OECD OECD/G20 Task Force on Financial Consumer (since 2011)
- **Fostering long-term investment** financing by institutional investors: foster institutional investors’ investments in infrastructure, innovation and SME finance, via dedicated G20/OECD Task Force (since 2013)
- **Keeping international capital markets open**, now via Advisory Task Force on the OECD Codes of Liberalisation (since 2012)
- **Participating in the work of the Financial Stability Board (FSB)**

Summing up:
Reforms should focus on stability **and** growth

- **Regulatory reforms** should make the financial system more stable and resilient.
- Finding the right **balance between stability and growth** is crucial!
- A broader range of policies is needed to **foster the provision of finance** and to **overcome investors’ reluctance** to invest in the real economy, in innovation, SMEs and infrastructure
  - The OECD has been supporting such efforts especially via its project on **Institutional investors and long-term investment** (G20/OECD Task Force)
  - The OECD has also undertaken work to **improve capital-market based financing for SMEs** (e.g. securitisation, mezzanine & equity finance, crowdfunding)
  - But we also need to **strengthen bank finance** beyond Basel III: participation G20 initiative on structural banking reforms to improve cross-border consistency between ‘go-it-alone’-approaches (Volcker, Vickers, Liikanen etc.)
  - Avoid financial fragmentation and keep capital markets open (OECD Codes)
…so we don’t have to ask ourselves:

Panel No. 3

What’s the next crisis
We’ll not anticipate
And totally miss?

...and so the conclusion is “we don’t know”
THANK YOU!

Any questions?

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