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# Structure of regulation: Lessons from the crisis. A view from the Institute of International Finance (IIF)☆

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ABSTRACT

The IIF's Committee on Market Best Practices has been working on five subjects: (1) Risk management, realignment of incentives is necessary; (2) Ratings, an SRO for CRAs is proposed; (3) Valuations, more dialogue on processes; (4) Disclosure, some new initiatives; (5) Liquidity risk, a review is in hand. Regulation's enforcement intensity is not a good measure of effectiveness; instead a more supervisory, risk-based approach is desirable. There is a need for a framework of mutual recognition in the context of cross-border regulation, with greater use of colleges of supervisors. Within Europe a start would involve putting the Level 3 Committees onto a stronger legal basis.



## 1. Introduction

I have been asked to discuss the structure of regulation following the market events of recent months.

At this stage both the industry and official sectors are understandably focused on strengthening risk management and the balance sheets of firms, and on rebuilding confidence in the markets. In this context, both the official sector and the Institute are working to address the current weaknesses.

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Industry is, of course, responding to the crisis at two levels. Individual firms are tackling their internal risk management processes, raising capital where necessary, dealing with the valuation challenges and reimporting SIVs on to their balance sheets. While all of that is continuing, there is recognition within industry that there is a need to address the issues arising from the crisis at a broader industry level to develop industry standards and best practices.

The work of the regulatory community, and in particular of the Financial Stability Forum (FSF) Working Group, on the crisis should be welcomed. To date, it seems to be a reasoned approach to exploring what went wrong and what actions need to be taken.

However, let us not lose sight of the longer-term picture. The long-term objectives of developing an efficient and effective cross-border regulatory regime remain critical. Regulatory improvement in the long-term should not fall victim to a short-term focus on the crisis. The most appropriate responses to current issues are likely to involve improved supervision, not more regulation.

It is important to recognize that the lessons learnt by regulators and by industry from this crisis are intrinsically linked. Public/private sector dialogue is essential and must be maintained. There continues to be a need for a robust dialogue on a range of issues at a global and regional level.

In December 2006 the IIF published its *Proposal for a Strategic Dialogue on Effective Regulation*. In the first paragraph of that document we state that "financial services firm and regulators have a common interest in a regulatory environment that supports economic development, growth, financial stability, customer service, and consumer protection." The publication goes on to list the contributions and responsibilities that firms and regulators should respect for effective regulation to be achieved.

In that context, before discussing the role of regulation in the crisis, and the implications for regulatory structures, I would like to briefly outline the work that the Institute has undertaken so far this year to analyze the critical issues resulting from the sub-prime crisis, and to promote recommendations that can secure the support of the financial services industry to enhance best practices. These findings are not yet final. We will be releasing an interim report following our Spring Membership Meeting in Rio de Janeiro in March 2008, and are aiming to publish our final report by June 2008.

In October 2007 the Institute established a Special Committee on Market Best Practices chaired by Rick Waugh, President and Chief Financial Officer of Scotiabank, and Cees Maas, former Vice Chairman and Chief Financial Officer of ING Group[1]. The Committee has been working on 5 key areas of focus and has been engaged in informal dialogue with the regulatory authorities.

The five areas of focus are:

- Risk management and credit underwriting practices;
- Ratings process issues;
- Valuation issues;
- Transparency and disclosure;
- Conduits and liquidity risk management.

### *1.1. Risk management*

The quality of risk management within individual banks has varied considerably. Some have done very well, but others have been questionable, to say the least. This is being addressed both internally within individual firms and also by efforts such as the IIF's Committee. It is clear that some firms have yet to develop a risk culture, even if they have the mechanics of modern risk management. It is essential that sound risk management be a core component of the overall culture of financial services firms.

The question of incentives, both individual and institutional, is also key to the discussion of risk management. Firms will need to realign their incentives to serve shareholder interests better and to achieve risk-adjusted performance evaluation and compensation more aligned with the long-term strategic objectives of firms.

[1] The involvement of senior executives from more than 65 leading financial services firms built on the initial concepts and led the Special Committee, on July 17, 2008, to publish, *The Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations. Financial Services Industry Response to the Market Turmoil of 2007–2008*. Institute of International Finance.