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**

Evolution of the 2007 financial crisis

A **low interest rate environment** led to a search for yield and increased risk-taking…

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

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…supporting "originate-to-distribute" model, with various entities participating…

Some linkages:

> Underwriting criteria were relaxed

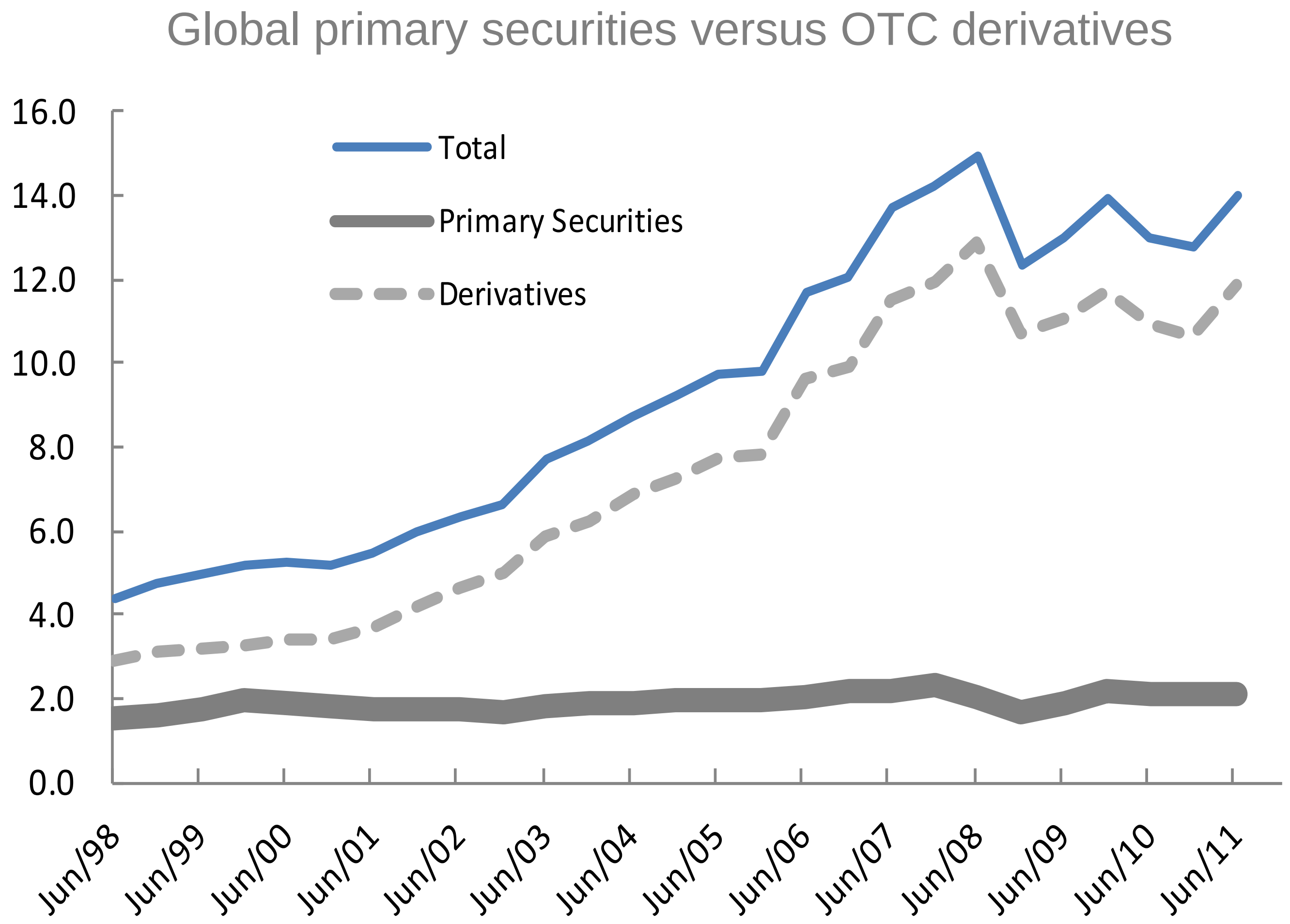
> Credit rating agencies and bond insurers artificially boosted credit quality

> 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

Where are we coming from?



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

Failures in monitoring, supervision, regulation

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 unstainable 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 …

Where are we coming from?

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

Source: adapted from Cohen R, Culp C, Genser S: *Human Problems in Major Disasters: A Training Curriculum for Emergency Medical Personnel*. Washington, DC, US Government Printing Office, 1987.

...and communication & cooperation

Where are we coming from?

- **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…

Source: adapted from Cohen R, Culp C, Genser S: *Human Problems in Major Disasters: A Training Curriculum for Emergency Medical Personnel*. Washington, DC, US Government Printing Office, 1987.

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

Where are we coming from?

- 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….

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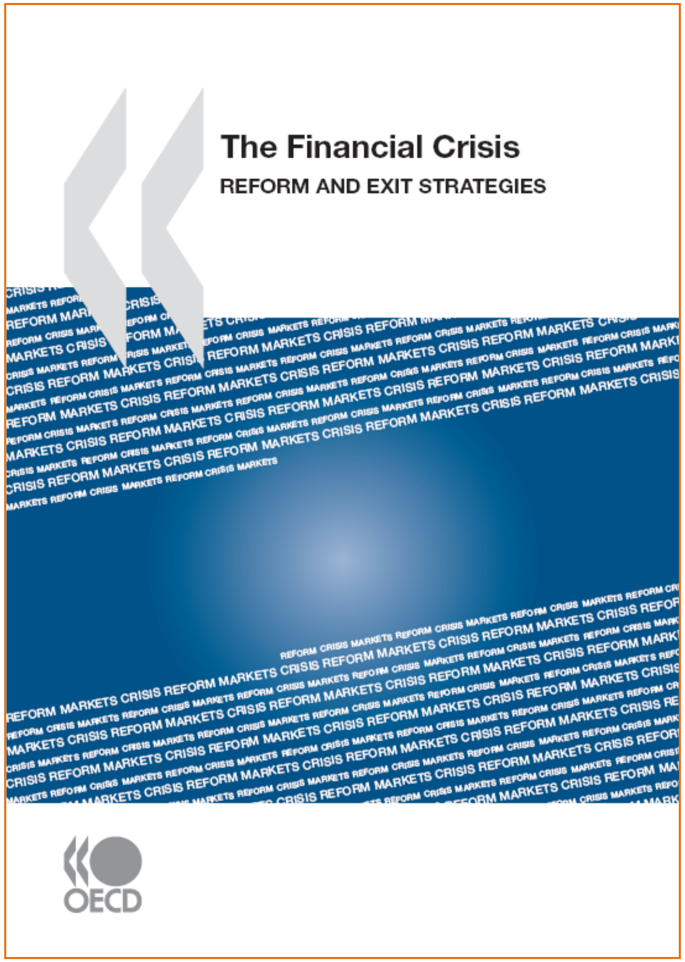


… and strongly cooperated also at the G20 level

Where are we coming from?

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

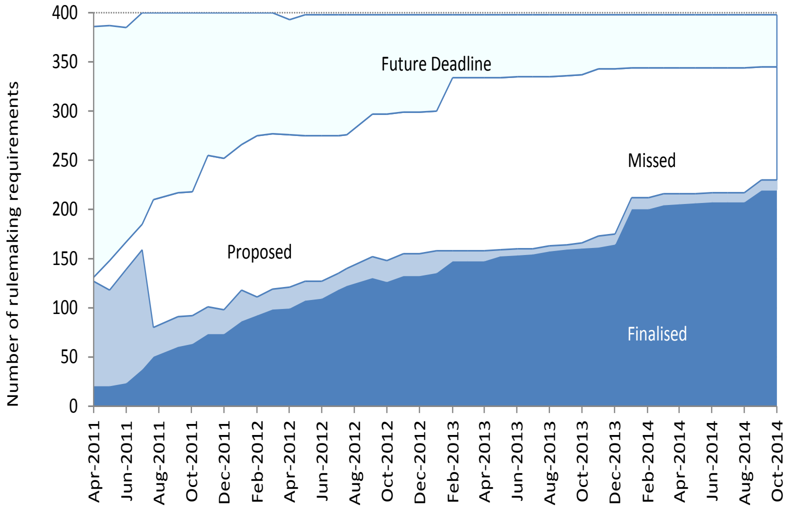
Source: Leaders' statement, the Pittsburgh Summit, 25 September 2009, available at www.g20.org

But have no illusions: implementation of reforms needs time

Where are we?

Dodd-Frank rulemaking progress

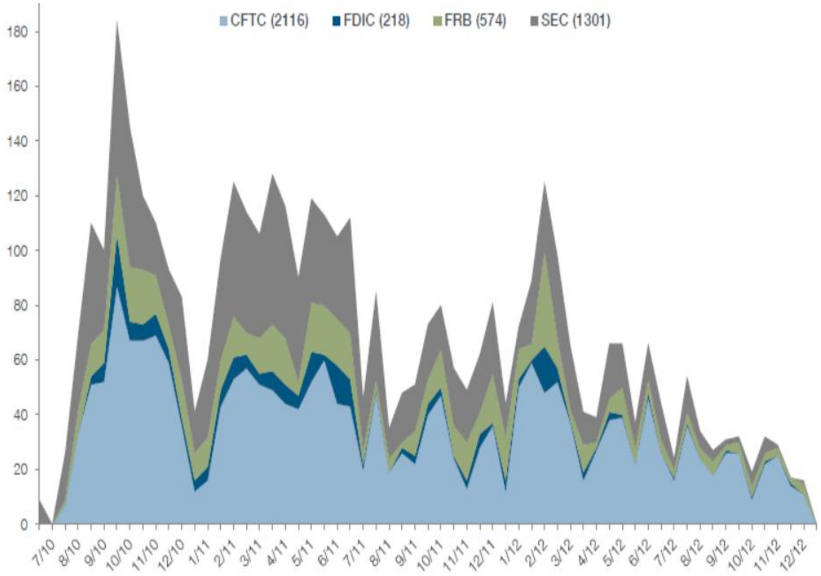
by month, as of October 2014



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.

US Regulators' meetings with outside participants over time

As of January 2013



Current challenges

Where are we?

- 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 was 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

- **OECD Policy Framework for Effective and Efficient Financial Regulation** (Council Recommendation, December 2009)
- **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)**

Source: "Five Decades at the Heart of Financial Modernisation: The OECD and its Committee on Financial Markets", *Financial Market Trends*, Vol.2011, Suppl.1 (April2014); http://dx.doi.org/10.1787/fmt-v2011-sup1-en.

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 **strenghten 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:

Where are we going to?

Source: Thomson Reuters Datastream

THANK YOU!

Any questions?

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