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**A PROPOSAL OF A NEW APPROACH TO FINANCIAL SUPERVISION
AFTER THE 2007-2008 FINANCIAL CRISIS**

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EXTENDED ABSTRACT

The 2007-2008 financial crisis highlighted formidable criticalities related both to the markets functioning and to the regulatory and supervisory framework. The depth and complexity of the crisis require an overall rethinking of some structural aspects concerning financial supervision and regulation. The main objective of this research is to propose a new conceptual approach to financial supervision focused on systemic risk and Systemically Relevant Financial Institutions.

The financial crisis has provided empirical confirmation that systemic risk has not a sectoral nature anymore and, specifically, that commercial banking and depository functions are not as “special” as they used to be. Traditional analyses of systemic risk are largely related to the balance sheet structure of commercial banks and to the financial fragility due to the peculiar features of depository banks’ balance sheet (illiquid long-term assets versus liquid short-term liabilities, bank runs and contagion phenomena). However, the return of the universal banking model and the growth of financial conglomerates, the exponential development of securitisation techniques and the substantial elimination of depositors bank runs through deposit insurance schemes question commercial banks specialness. Moreover, the subprime crisis has introduced two significant novelties: “wholesale bank runs”, to which also non-depository financial institutions are subject, and the extension of the safety net to non-depository financial institutions. Depository banks may still have a systemic relevance, but for different reasons and dynamics, which are not confined to commercial banking functions any more and involve the insurance, securities and hedge funds business: systemic risk has assumed a financial markets nature.

The subprime crisis events are supportive of this view: all three “traditional” financial sectors - depository banks, investment banks, insurance companies - have received some type of public support, especially in the second phase of the turmoil, as the crisis became systemic after the failure of Lehman Brothers on September 15, 2008. The rescue, both in the US and in Europe, of many financial institutions of different size, core business and legal form on the one hand and the failure of

Lehman Brothers on the other hand indicate that the choices of authorities were neither determined by the nature of core business nor by the legal structure of distressed institutions. Moreover, bailouts have been cross-sector but selective. The most evident example of such selective approach is offered by the different behaviour of the US authorities and the US Treasury with regard to Bear Stearns and Lehman Brothers. The former avoided bankruptcy with the support of the Federal Reserve, which first made the discount window available to primary dealers and then facilitated the acquisition of Bear Stearns by JP Morgan Chase. Instead, Lehman was not bailed out and its failure – the largest failure in the US financial history – transformed a prolonged financial crisis into a systemic crisis, which ultimately hit the real economy as well.

Interestingly, Lehman Brothers was much larger than Bear Stearns, thus the too-big-to-fail doesn't seem to provide effective interpretation tools or, at least, it was simply not followed by the authorities. The cross-sector approach to bailouts has shed light on the uncertainty and “ambiguity” of the principles followed by governments and authorities in dealing with financial crises. Support to non-depository institutions may have the undesirable side effect of letting the market believe that a public protection is likely to be offered to all large financial institutions (too-big-to-fail doctrine): moral hazard could induce firms to take more risk than they would in absence of a public intervention presumption. Besides, the extension of the safety net to non-depository institutions clearly indicates that the authorities believe that depository institutions are not the only serious source of systemic risk any longer. Depository banks lose their specialness also with regard to the safety net protection, given that investment banks and insurance companies are admitted to benefit of it as well (basically through liquidity provision).

Overall, the framework for public intervention needs to be clarified, since current arrangements probably create a “destructive ambiguity”. A reform of regulation and supervision is necessary to ensure that a level playing field is maintained and that investment banks, insurance companies and, generally, all non-depository financial institutions “pay a price” - for example in terms of heavier regulation - for the access to the safety net and to any type of public support. Since

any type of financial institutions may be systemic, regulation and supervision should be reorganized accordingly, with a cross-sector approach.

The key for a reform of supervision (and regulation) should be systemic relevance of financial institutions. The identification of SRFIs is a fundamental but complex task: it should not be based merely on size, but on a wider range of factors, whose combination might provide effective indications on systemic relevance. Obviously, the choice of technical methodologies to select SRFIs requires a careful evaluation of which markets and which functions are more likely to have systemic implications: the inclusion or exclusion of certain variables undoubtedly has a great conceptual impact and this appears an extremely interesting area for further research. However, the objective of this work on this point is not to elaborate in details the technical procedures to select SRFIs, but to underline the importance of adopting a systemic functions-based approach instead of an institutions-based approach. This perspective is coherent with the view that systemic risk does not stem from a specific category of financial institutions but from the systemic impact of functions performed, regardless of the legal nature and core business of intermediaries.

The new proposed model of financial supervision is based on SRFIs. The subprime crisis showed that there is neither an optimal nor a superior financial supervisory architecture. An extremely intense wave of reform of supervisory models took place in a high number of countries in the last twenty years, especially after the institution of the Financial Services Authority in the UK. Such wave of reforms has been largely explained with the economies of scale rationale and financial cross-sector integration (the so-called “blurring effect”). The latter was made possible by the removal of legal barriers and substantially transformed what was traditionally regarded as a tripartite market into a substantially unique market, despite the persisting relevant differences across sectors. A large number of studies have focused on supervisory structures, stressing the importance of adapting the architecture of controls to new market structures and dynamics. However, no supervisory structure was able to prevent the subprime systemic crisis, neither in the US (a complex mix of functional, sectoral and by objectives approach), nor in the UK, Germany, Belgium, (single

regulator outside the central bank), nor in Ireland (single regulator within the central bank), nor in France, Italy (sectoral/by objectives approach), nor in the Netherlands (twin peaks model). All these models have in common a functional mismatch regarding the role of central banks and the preservation of systemic financial stability. In fact, countries have assigned to central banks the task of ensuring macro-financial stability, even where they don't have, or have recently lost, direct supervisory functions on the banking system. However, if central banks do not dispose of micro-prudential supervision on SRFIs the risk of pursuing an objective without adequate instruments might arise. In the proposed financial supervision model the central bank has micro-prudential supervisory powers on SRFIs on a cross-sector basis: all SRFIs would fall under the central bank umbrella, regardless of their legal nature and type of business. It is crucial to stress that this perspective is different from that of the widely debated issue about concentrating supervisory powers on banks and/or financial markets within the central bank: here the key aspect is supervision of SRFIs, and also the model of the single regulator within the central bank should be adapted, with a specific supervisory focus on SRFIs.

Such supervisory structure has advantages but also drawbacks. Significant problems might arise from the combination of monetary policy and micro-supervisory functions, which could lead to accommodative monetary policy to preserve the micro-stability of supervised entities. However, the traditional drawback due to the implicit extension of the safety net to non-bank financial institutions has been *de facto* removed by authorities' behaviour during the subprime crisis. On balance, the costs of potential distortions might be lower than the costs of systemic crises, which can be preceded, exacerbated or even caused by a "destructive ambiguity" in the policy choices on bailouts: a "constructive certainty" appears preferable.

A potential risk of the central bank *ad hoc* supervision of SRFIs is moral hazard: such risk might be tackled through stricter regulation of SRFIs. An *ad hoc* regulation would be coherent with the special systemic status of these financial institutions: just as commercial banks were regarded as special financial institutions and thus deserved a specific regulatory regime, SRFIs need to be

subject to specific rules since they are the new special financial intermediaries. This new regulatory regime should be carefully elaborated: the need to limit moral hazard should not produce an over-regulation and cause undue competitive disadvantages for SRFIs. As for the identification of SRFIs, also the creation of a specific regulatory framework is a complex task: which issues should regulation address? How might regulatory arbitrage risks be prevented and managed? How should the “price” for systemic status – and for the consequent implicit commitment of governments and authorities - be calculated? This research suggests that regulation of SRFIs could focus on some aspects which turned out to have played a crucial role in the subprime crisis, such as capital and leverage ratios and off-balance sheet vehicles.

The shift to a systemic approach to financial supervision and regulation should not be limited to the national level and should assume a global scale: a European and a global supervisor of SRFIs might contribute to solve – at least for SRFIs - the current misalignment between the national dimension of supervisors and the international nature of financial business. These authorities might be participated by national central banks, since in the proposed model the latter would be in charge of supervising national SRFIs.

Besides, the current allocation of supervisory tasks between home and host country authorities might exacerbate asymmetric information and the risks of negative externalities on host countries. A complement or an alternative to the improvement of information sharing could be an ex-ante mechanism of internalization by the home country of costs stemming from faltering systemically relevant branches in host countries.

Finally, for how ambitious it may be, a new supervisory model would not itself solve all the complex problems highlighted by the subprime crisis: there is no first-best supervisory structure, also because path-dependency and countries’ peculiarities inevitably play a major role. However, since systemic risk has always been the main rationale for banking and financial regulation, the adoption of a new perspective based on the new nature of systemic risk and a coherent reform of financial supervision and regulation could provide second-best solutions.

The research is divided into three chapters. The first chapter provides an overview of the 2007-2008 financial crisis, with a detailed analysis of the policy responses in the US and in Europe. The aim of this section is to underline criticalities and inconsistencies in the choices and strategies adopted by governments and supervision authorities, to stress the need for a clarification of the public intervention mechanisms and the opportunity of a new approach to financial supervision and regulation. Since the heart of the new approach should be systemic risk and systemically relevant financial institutions, chapter two turns to a detailed analysis of traditional theories on systemic risk and financial regulation; a new perspective on systemic risk and a methodology for the identification of SRFIs are proposed. Finally, chapter three introduces a new financial supervision model based on SRFIs and suggests a few areas of intervention for the creation of a specific regulatory regime for SRFIs. Some proposals on European and international supervision and regulation of SRFIs are also presented.