Comment on "Financial Crisis and the Paradox of Underregulation and Overregulation," by Joshua Aizenman

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Aizenman's paper addresses a timely and important topic. The global financial crisis has prompted a reassessment of financial regulatory systems worldwide. Financial crises by their very nature accentuate the need for (usually overdue) regulatory reform. True to form, the current turmoil exposed shortcomings in supervisory, regulatory, and prudential frameworks (see ADB 2009), leading national authorities—together with regional and global financial institutions—to reexamine approaches to financial regulation and supervisory oversight. How should the global regulatory framework be reconstructed to safeguard the stability of financial systems, prevent the next crisis, and ensure sustained, robust global economic growth?

Aizenman's paper focuses on the procyclicality and suboptimality of the current regulatory structure. Extended periods of economic tranquility and financial stability tend to reduce the demand for regulation, leading to underregulation. Similarly, there is the risk of overregulation following financial crises. Hence regulation tends to be procyclical.

Aizenman proposes a regulatory structure that can mitigate the suboptimality or procyclicality. To ensure a sufficient degree of regulation "through the cycle," the paper argues, regulatory reforms should improve information disclosure, increase the regulator's independence, centralize the regulatory process, and build global standards of prudential regulation and information disclosure.

The paper presents a model to show an imbalance between individual demand for regulation and the socially optimal level of regulation supported by the majority. The model emphasizes that financial reforms in the presence of individual-specific uncertainty could lead to a level of regulation below what is socially optimal in good times

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leading up to a crisis. In the wake of a crisis, the crisis response then brings on over-regulation. The simple political economy model draws this important prediction based on several assumptions: (a) regulation is costly, (b) agents have individual risks and update their assessments of the probability of crisis, and (c) regulation intensity (spending resources) is set by majority rule.

The model is innovative, offering interesting and paradoxical results that show financial reforms tend to add procyclicality to regulation. Some aspects of the model, however, remain unclear. Is it really true that underregulation is mainly an outcome of a political process where the majority rules? Can an omnipotent central regulator be a social planner who knows the socially optimal level of regulatory intensity? And, in practice, who can be that social planner or omnipotent central regulator?

In my view, the model does not fully account for the inadequate institutional capacity of the current financial regulatory structure to keep in step with rapid financial innovation and globalization. This is important because it raises two issues: (a) how to address systemic failures in the financial system and (b) how to build a new financial regulatory framework.

Systemic Failures of the Financial System

The global financial crisis exposed two major weaknesses in the current regulatory and supervisory structure: first, the regulatory structure was unable to deal with the innate procyclicality of financial systems, and, second, the lack of systemwide macroprudential oversight allowed systemic failures to occur in the financial system.

First, the current crisis highlighted several mechanisms that contributed to procyclicality in the financial system. Many factors influencing private sector behavior and practices, prudential regulation, and macroeconomic policies accentuate cyclical movements in the financial system.

The mechanisms that contribute to procyclicality in market and credit risk management systems include (a) use of the value-at-risk model, which encourages firms to increase their risk appetite in low-volatility environments and to reduce it in high-volatility environments, (b) credit ratings that are also procyclical, and (c) compensation practices that reward managers for taking excessive risks for short-term returns rather than for taking a longer-term view of business prospects and their associated risks.

The existing regulatory system inadequately addresses procyclicality and, in some cases, even encourages procyclical tendencies. The crisis revealed incidences where regulation, supervision, and risk management failed to tame excess leverage and poor risk management or to correct the flawed incentive structures of financial institutions. Procyclical regulation of bank capital, short time horizons in risk assessment, and fair value accounting contributed to the procyclicality of regulatory frameworks (see Andritzky and others 2009).

Second, the aim of macroprudential supervision is to ensure the stability of the financial system by appropriately monitoring all financial activities that may pose systematic risks. The existing regulatory framework, which emphasizes microprudential supervision, was unable to identify the buildup of systematic risks. In hindsight, aggregate shocks were underestimated.

The call for stronger macroprudential capabilities in no way implies that microprudential measures are wrong or no longer needed. Nevertheless, traditional regulation, which focuses almost exclusively on individual institutions and specific financial instruments, will likely fall short in providing effective regulation for increasingly interdependent financial institutions and markets. Effective regulation should take appropriate account of systemic and cyclical factors to create awareness of overall systemic leverage and to mitigate the potential procyclical effects of regulation.

How to Build a New Financial Regulatory Framework

We all agree that regulation of financial markets and institutions must be overhauled. The principal goals are to promote more robust risk management and to establish more effective prudential oversight.

First, we need a systematic approach to build up an adequate framework of macroprudential oversight that can counter the procyclical effects of prudential regulations. New mechanisms include (a) countercyclical capital regulations, (b) countercyclical loan-loss provisioning requirements, (c) measures limiting the procyclicality of property lending and unhedged foreign currency credit, (d) measures limiting foreign exchange risks by imposing limits on foreign exchange exposure, (e) more intensive monitoring of problem financial institutions, and (f) better information disclosure.

Second, there should be a balance between innovation and regulation. The crisis taught us that market discipline may not be a perfect substitute for prudential regulation. But we must also be mindful of the risks of overregulation when revamping the current regulatory system. Regulation should not constrain financial innovation. A strong institutional framework must ensure that the functioning of a financial system is aligned with appropriate market incentives—a key element for sustainable regulation. Market discipline also needs to be strengthened by improving transparency and creating more incentive-compatible compensation structures.

Third, there is no single international best practice, especially in constructing an effective regulatory environment. Regulatory costs and benefits change across economies and over time, depending on the structural and institutional characteristics of national financial systems. A regulatory structure should provide competitive neutrality, avoid duplication of scarce supervisory resources, and effectively address the issue of institutional solvency. Still, there is no one-size-fits-all regulation.

Fourth, national enforcement and global coordination should come together. Policy responses should be coordinated internationally to avoid regulatory arbitrage and competitive distortions. Financial integration limits the effectiveness of unilateral measures. Measures will be more effective if supervisory agencies collaborate closely (see ADB 2009).

There are practical impediments to institutionalizing a global regulatory agency. Therefore, existing global financial institutions—such as the Financial Stability Board or the International Monetary Fund—have important roles to play. We should promote global coordination in sharing information, employing international accounting standards, and harmonizing minimum prudential rules.

It is clearly in Asia's interest to be an active participant in efforts to design a global financial architecture that meets the challenges of globalized finance. We must work together in constructing a new global financial architecture.

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