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Summary overview of the recent development of the agenda of financial reform

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Backcloth

A cursory read of the FSB's report on progress in the implementation of G20's reform agenda indicates how vast the agenda has become. Agreement on the international agenda is being accompanied by measures implementing this agreement at national level and at the level of the EU. The focus attention of policy makers and regulators concerns not merely the effectiveness of reform measures in reducing financial risks but the need perceived by national authorities for a reasonably high degree of convergence of reform to prevent frustration of the reform's objectives by regulatory arbitrage in the form of firms' search for locations in which activities will be most lightly regulated.

Major lessons of the crisis for financial regulation

1. The crisis illustrated the how far-reaching contagion can be in globally integrated financially markets. By and large, with honourable exceptions like Australia and Canada, the direct effects of the financial contagion in the form of threats to financial systems involved major financial markets in advanced countries. However, the effects of this contagion on interest rates and prices have been felt globally – by emerging-market and other developing countries - as have the challenges to policies in areas like the control of capital movements.

2.Regulation with a primarily microprudential focus does not adequately monitor and control systemic or macroprudential risks.

3. Regulation must keep up with transactional and institutional innovation and other changes. Failures to exercise control or even to actually outright prohibit certain activities and products can exacerbate microprudential and macroprudential risks.

4. Regulatory models relying heavily on market signals provide inadequate incentives for effective risk management.

5. Questions need to be faced concerning both the reality and the desirability of the policy objective of increased global financial integration based on concepts like an international level playing field and progressive removal of obstacles to the expansion of international banking and to cross-border financial transactions. The crisis has highlighted the huge divergence between the capacity of advanced and developing countries to subsidise financial activities (which in some cases in advanced countries was required to ensure the survival of large financial institutions and thus their continuation as participants – and thus competitors of institutions from developing countries - in international financial markets). Furthermore

the case for "speed bumps" in financial markets is now stronger.

Expanded range of the reform agenda

After the Asian crisis of 1997-1998 the international reform agenda was codified in international standards. Of the 12 key standards nine were directed specifically at subjects bearing directly on financial markets: banking supervision, securities regulation, and insurance supervision, market integrity (a heading covering money laundering), payments and settlement, accounting, auditing, corporate governance, and insolvency. The targets of the reform agenda now also covers commodity markets, trade finance, remuneration within financial institutions, shadow banking, and credit rating agencies. As a result of the insolvency or near-insolvency of major cross-border financial institutions during the current crisis the amount of attention given to such insolvencies has been greatly increased.

Changes in the institutional framework for setting and implementing the reform agenda

The Financial Stability Board (FSB) has been assigned by the G20 the task of coordinating the design and implementation of the reform agenda. The FSB represents an extension of the Financial Stability Forum (FSF). As part of this extension the membership of the FSF was expanded so that it now includes several emerging-market and developing countries – Argentina, Brazil, China, India, Indonesia, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. Arguably, although countries responsible for the bulk of global financial and activity are now included in the FSB, its representativeness could still be improved, Africa, for example, being ill served. The Basel Committee on Banking Supervision, a body which now occupies the role of a sort of Vatican of banking supervision, also now has a membership expanded to include new member countries of the FSF/FSB.

Basel capital standards

A central place in the reform agenda for banks continues to be occupied by capital standards and the integrally related subjects of the management of credit, market and operational risk. This central place reflects not only the obvious relation of capital standards to the existence and size of a buffer against banking insolvency but also the intrinsic limitations of the scope of international initiatives regarding bank regulation and structures, and bank management since prescription of international standards for many subjects related to policy towards banks would entail unacceptable infringement of national sovereignty.

The revisions of the Basel capital standards reflect weaknesses in the rules highlighted by and other lessons of the crisis. Basel 2 cannot reasonably be held responsible for the crisis since its introduction was at too early a stage to have played a substantial role in the outbreak of the crisis. Nevertheless the crisis mercilessly exposed actual and potential weakness in the regulation, supervision and risk management of banks in major advanced countries, some of which were supposed to be controlled by Basel 2.

Of these perhaps the most important was the basic one of inadequate levels of capital in relation to poorly assessed risks. Ratios of capital to risk-weighted assets proved highly misleading indicators of the strength of major banks, as should have been evident earlier from comparison of these ratios with ratios of the capital to assets not weighted for risks in accordance with Basel 1, which were often three to five times lower. The ratios of capital to market risk exposures were often egregiously low. Other weaknesses of the Basel capital standards which have been the subject of increased attention by regulators owing to experience of the crisis were procyclicality and the closely associated subject of inadequate attention to systemic risk, conditions for the removal of securitised assets from banks' balance sheets and the risk weights for those remaining, and excessive regulatory discretion and in some cases regulatory capture.

The capital standards of Basel 3 include increased levels of capital in relation to risk-weighted exposures (though levels considered by many in the regulatory community and academia as still too low), a more rigorous definition of the items which can be included in capital based on their capacity to absorb losses, requirements for market risk which take account of many more dimensions of such risk (including that of securitisation exposures) than the rules of Basel 1 (which in early drafts were largely carried over into Basel 2), and an explicit countercyclical buffer. The capital standards are also to be accompanied by rules for liquidity risk which should enhance the contribution of Basel 3 to mitigating systemic risks.

Basel liquidity standards and macroprudential risks

It is often remarked that financial crises usually start as crises of liquidity among institutions whose solvency as measured by their capital positions does not initially seem threatened. However, the effects of the liquidity crises on banks' access to financing and on the value of their saleable assets can soon transform liquidity crises into solvency crises. Prior to the current crisis the standards for liquidity management enunciated by the Basel Committee were of a general and qualitative character. By highlighting the intimate relations between liquidity and solvency the crisis served as a tocsin for regulators. Standards for liquidity management are now an integral part of Basel 3, and the assessments by the Basel bodies of the likely macroeconomic impact of Basel 3 – and the protests directed at Basel 3 from parts of the banking lobby - have included the liquidity as well as the capital standards.

The rules on the management of liquidity risk come in the form of two supervisory indicators, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). Under the LCR rules the ratio of high-quality liquid assets to total net cash outflows over the next 30 days (as estimated by stress testing) is to be at least 100 per cent. Under NSFR rules the ratio of stable funding to the amount of required stable funding is to be at least 100 per cent. Funding for the purpose of inclusion in stable funding is weighted according to its susceptibility to volatile outflows, unsecured wholesale funding, for example, receiving a substantially lower weight than deposits meeting certain conditions. Contributions of assets to required stable funding are weighted according to their liquidity, cash, for example receiving a zero weighting and loans to retail customers and many SMEs a weighting of 85 per cent.

The Basel capital standards never completely ignored liquidity risks. The rules and risk weighting for different exposures and for collateral made some allowance for such risks. But this allowance was always in a conceptual framework which was microprudential. The new rules for the management of liquidity risk represent a considerable step in the direction of addressing systemic risks. However, they should be a complement of and not a substitute for other measures which have been proposed for the mitigation of systemic risk – and which have already been part of the regulatory tool kit in many countries since well before the current crisis.

Commodities and securities markets

Proposed reforms of the commodities and securities markets are part of an agenda which is a response not only to the current financial crisis but also to longer-standing concerns as to market integrity and price volatility. In the case of the commodities markets the pressures for regulatory changes have been triggered partly by recent cases of extreme volatility in grain and oil prices. Volatile grain prices have historically been associated with political instability – on occasion of an extreme or revolutionary character - , a prospect likely to be not far from politicians' minds as they confront the manifestations of such volatility. The proper functioning of securities markets is not only a matter for investors in them but also for financial institutions since large fluctuations in securities prices contribute to determining the risk exposures of financial institutions.

The principal policy initiatives on the front of securities and commodities markets take the form of standards being developed by the International Organisation of Securities Commissions (IOSCO) and of measures currently under discussion or being implemented in the United States and the EU. Some – but not all – of these initiatives are mentioned in the April progress report of the FSB. I shall not attempt even a summary treatment of these measures and initiatives beyond mentioning that many of them are designed to increase market stability and transparency through extending the range of derivative contracts which are to be subject to clearing through central counterparties. Hopefully some of the initiatives and measures will be taken up by other members of this panel. But I shall make a few of preliminary points which may help to orient questions and discussion here.

- We are experiencing a profound transformation in the markets for commodities and securities at an institutional level driven both by technology and by pressures for cross-border consolidation of exchanges. Introduction of the technology –large-scale computer technology – is hugely costly. In the case of high-frequency trading the technology has proved capable of contributing to incidents of extreme volatility. Both the new technology and the consolidation of exchanges would appear to need to be assessed against the benchmark of the social and economic function supposed to be performed by capital markets, namely allocation of capital. Increased fees generated by increased turnover on exchanges and profits generated for institutions by being nanoseconds ahead of one's competitors do not appear to add social value.

- When considering such developments, it should not be forgotten that the globalisation of securities markets, including those of emerging-market countries, which is still sought by major financial institutions and lobbies is likely eventually to be accompanied by pressures on countries participating in the globalisation of securities markets also to allow the introduction of similar trading technologies in their jurisdictions.

- In discussion of recent fluctuations on commodity markets there has been controversy between those claiming that the prices are driven by speculation and those claiming that the prices reflect fundamentals. In many cases this argument seems to me to be related to a false dichotomy. In the case of commodities for which organised exchanges exist, prices - including those negotiated between parties who do not necessarily have corresponding positions on exchanges - are typically connected to prices on the exchanges. For instance, it used to be – and probably still is if my sources are not out of date - the case that crudes in the Western hemisphere were priced off the futures prices for West Texas Intermediate. Likewise oil prices in much of Europe, the Mediterranean and West Africa were priced off the market for Brent crude futures. To the extent that benchmarks based on futures prices are applicable, then it is the expectations and trading strategies of participants in these markets which determine prices. At times the main influence on these expectations may be of a speculative nature, and at other times the main influence may be information – almost always partial – concerning the balance between demand, production and inventories, in other word fundamentals.

Systemically important financial institutions

Policy towards this category of institution perhaps better characterised by the term, Too Big To Fail, or the acronym, TBTF, is proving the sources of much controversy as well as problems formidably difficult to solve. It has long been acknowledged that the lack of generally accepted arrangements for dealing with large cross-border insolvencies was an important Achilles heel of the global financial system. Nevertheless policy makers had not anticipated how immediate difficulties associated with such insolvencies could become until 2008-2009. Agreement on supplementary capital requirements for TBTF institutions now seems likely. But a long-term, comprehensive framework for procedures to be followed in the cross-border insolvencies of TBTF institutions and the ways in which the costs should be distributed among the countries in which these institutions have a commercial presence still seem some way off.

WTO negotiations, FTAs and BITs

Attention was drawn earlier to the way in which the current financial crisis has rendered both the reality and the policy objective of a level international playing field for suppliers of financial services still more unreal than previously. The financial crisis has also strengthened the case of those who have argued that speed bumps in the network of international financial markets serve a useful purpose. In the light of this the rules of the WTO General Agreement on Trade in Services (GATS) as they apply to banking need revisiting and possibly extensive revision. Provisions of FTAs and BITs on the cross-border opening of financial markets, which are often more constraining on the policy autonomy pf countries affected than the GATS, should also be opened for revision which takes account of lessons from the current crisis and the generally more restrictive regulatory framework that is likely to emerge from current initiatives.

Other issues

The FSB's April progress report covers other important matters which I shall not attempt to elaborate. These include peer reviews including those of rules for financial institutions' remuneration policies, filling gaps in data essential to the monitoring of crises, the avoidance of conflicts of interest at credit rating agencies and the role of their ratings in financial regulation, and agreement on the convergence of accounting standards enunciated by the International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB).

Concluding remarks

1. Work on the agenda of financial reform is still in flux. The bank lobbies continue to exert formidable pressures in both the United States and the EU regarding many features of proposed reforms. A threat to the timely and full implementation of the Dodd-Frank Act in the former has emerged in the form the reluctance of Congress to provide the funding required for finalising sections of the Act and then implementing it.

2. The reforms enunciated under the international agenda have been very much a response to problems revealed by the crisis in the regulatory regimes of advanced countries rather than emerging-market and other developing ones. Statistical data concerning the latter suggest that at the aggregate level their banks should be able to introduce the capital standards of Basel 3 without major problems, though some of its rules for capital requirements for particular sectors or activities may require modification in the light of local circumstances. A source of greater difficulties may prove to be the rules on liquidity management whose designers appear to have had fairly highly developed financial markets in mind.

3. Beyond the debate on policy towards TBTF institutions the international reform agenda has not addressed issues posed by concentration in major countries' banking sectors (often greater since the current crisis) or by the extreme difficulty of establishing effective supervision, management and internal controls for large complex financial institutions.

4. There are reasons to doubt whether measures taken or envisaged so far have properly aligned incentives and risks in the financial sector. Remuneration in the form of shares was widely and ineffectively used in several financial firms before the crisis. Eventual success of the new rules on remuneration of the reform agenda is likely to depend the effectiveness of provisions on claw-back in response to positions taken by employees eventually shown to entail excessive risk. I dream of reintroduction of unlimited liability partnerships for investment banks/broker dealers (still common until relatively recently and requiring bankers to write cheques to their institutions in some years) or, if this too radical, of arrangements which mimic the functioning of such partnerships.

5. Adam Smith, regarded as the father of free-market economics by many (who often have probably never read him), recommended the joint-stock-company form (as opposed to that of the "private copartnery") as appropriate only to banking whose operations were of a routine character and reducible to strict rules. It is reasonable to assume that in making this argument he had in mind speculative bubbles in his not too recent past. I wonder what he would have made of recent financial excesses of the financial sector. I am confident that he would have considered the activities with which they were associated as more appropriate for "copartneries" than for institutions benefitting from limited liability.

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