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The future of global financial governance

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Global Economic Symposium

The Global Polity

The Future of Global Financial Governance

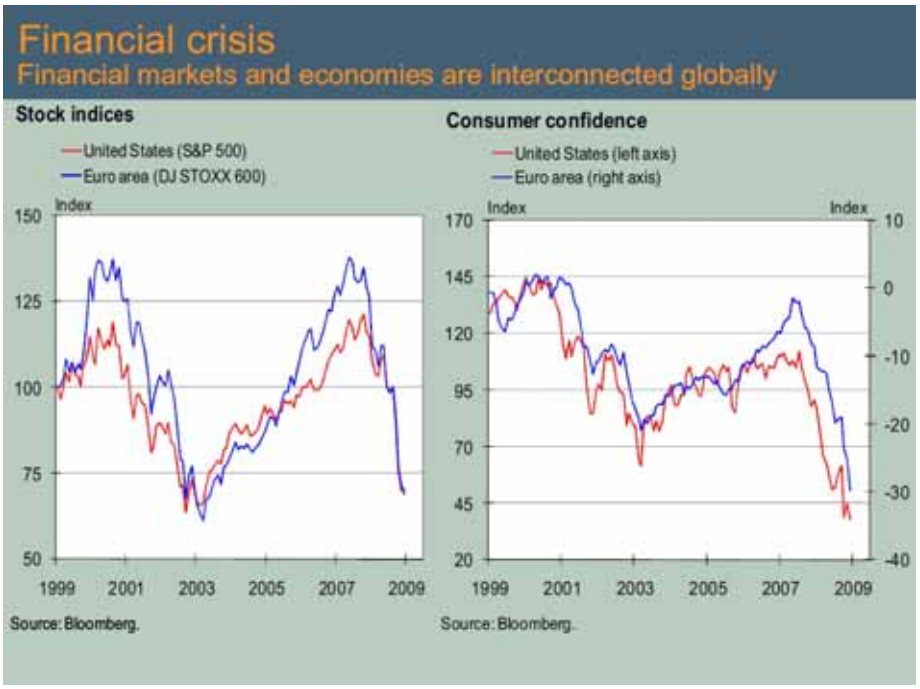
The Challenges

In their "Declaration on Strengthening the Financial System" the leaders of the G20 Summit which was held in London on April 2, 2009, have provided the foundations for a reform of the Global Financial System.

Important elements are the expansion of the Financial Stability Forum to a Financial Stability Board with a stronger institutional base and enhanced capacities, and the strengthening of the role of the IMF.

Important fields for reform that are identified in the declaration include international co-operation of supervisory institutions and a strengthening of the international frameworks for prudential regulation, the scope of financial regulation, the inclusion of principles on compensation in the supervisory process, the setting of accounting standards and the regulation of credit rating agencies.

While there is widespread agreement on the importance of reforms in these areas, there is still a substantial need for concrete solutions to the problems involved. This in particular concerns the issues of global supervision processes.



Global Economic Symposium

Proposed Solutions

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1. In a multinational college of regulators/supervisors, the host country regulator/supervisor should have the final say.

The national or supranational regulators that remain must work together closely to avoid being arbitraged and played off against each other by the private financial players. The Colleges of national regulators/supervisors will be ineffective if they are based on the principle that the home-country regulator (the regulator of the country where the parent bank is registered) takes the lead and is the dominant player in the College for any given crossborder bank. The pain of financial distress is felt primarily in the host country, where the branch or the subsidiary operates. Control has to be located where the pain is felt.

2. Establish a single EU-wide regulator for crossborder banks, and for other systemically important crossborder financial activities or institutions.

To avoid that the private financial actors play off one regulator against another, the number of regulators should be reduced as far as possible. While it is politically not feasible at the present moment to establish a single worldwide regulator, there should be at least a single European regulator for crossborder financial institutions.

3. A supranational EU fiscal authority is required to provide proper fiscal backup for the ECB/Eurosystem and for recapitalizing systemically important crossborder financial institutions.

A striking international dimension of the crisis has been the failure of cooperation between national fiscal authorities in recapitalising crossborder banks and the importance of fiscal backup for the central bank. In this second area, the ECB and the Eurosystem appear vulnerable. If the ECB/Eurosystem were to suffer a serious financial loss in its monetary and liquidity operations, its ability to perform effectively in the pursuit of its price stability mandate and as a source of essential liquidity for the Euro Area banking system would be impaired. Ultimately, some or all of the shareholders of the ECB/Eurosystem (the national central banks of the 27 EU member states) would have to go to their fiscal authorities to get the resources for a non-inflationary recapitalisation of the ECB. It is essential that there be a clearly worked-out fiscal burden-sharing agreement for recapitalising the ECB/Eurosystem that can be invoked with little or no delay. If a supranational European fiscal authority with independent revenue-raising powers and associated borrowing powers is politically not feasible, the next-best alternative would be the creation of an EU fund from which the ECB/Eurosystem could be recapitalised at short notice. If even this is beyond the reach of the EU member states, there should be binding ex-ante agreements on fiscal burden sharing among the 16 or 27 fiscal authorities of the Euro Area or the EU, respectively.

4. Reduce the systemic problems which result from the existence of too large and complex financial institutions by a bundle of measures.

- Legally and institutionally, unbundle narrow banking and investment banking.
- Legally and institutionally prevent both narrow banks and investment banks from engaging in activities that present manifest potential conflicts of interest.
- Limit the size of all banks by making regulatory capital ratios an increasing function of bank size.
- Enforce competition policy aggressively in the banking sector.

It is essential that the authorities be able to insulate the systemically important parts of the financial system from the rest. The list of systemically important arrangements and institutions includes the retail payment system, the retail clearing and settlement system and deposit banking. The wholesale payment, clearing and settlement system is part of it. So are the securities clearing and settlement system and the provision of custodial services intimately connected with the securities clearing and settlement process. These functions can be performed by "narrow banking institutions" which are tightly regulated.

All other activities currently undertaken by the banking sector and the shadow banking sector will be called investment banking activities. Narrow banks and investment banks should be clearly separated to avoid conflicts of interest. It might seem that, since the products, services and instruments created exclusively by the investment banking sector are not systemically important, these investment banks could be left to play by the normal rules of the market game, with little if any regulation. This is not the case because of a well-known problem: the "too large to fail," "too interconnected to fail," "too complex to fail" and "too international" to fail problem.

The main issue is size. Even if a financial business is highly interconnected, it can still be allowed to fail if the total amounts involved are small. A complex but small business is no threat to systemic stability; neither is a highly international but small business. Size is the core of the problem; the other dimensions (interconnectedness, complexity and international linkages) only matter if the institution in question is big. This suggests to adopt measures which prevent financial institutions to become too large to fail, such as strict competition policy or introducing capital requirements that are progressive in the size of the business.

5. Create a special resolution regime with structured early intervention and prompt corrective action for all systemically important financial institutions.

Every systemically important bank or other financial institution should be subject to a special resolution regime (SRR) with structured early intervention (SEI) and if that fails to resolve the problems, prompt corrective action (PCA). An SRR is a preventive or anticipatory insolvency regime – a Chapter 11 "lite." Under the SRR a bank can be put into conservatorship by the regulator before it has become balance-sheet insolvent or liquidity-insolvent. So there is a third form of insolvency for systemically important financial institutions: regulatory insolvency. The conservator appointed by the regulator has full executive authority. He can ring-fence business units, financial instruments and activities. For instance, for a prime broker or broker-dealer, he can ring-fence the securities clearing, settlement and custodial activities, including the systemically important counterparty role of prime brokers in the tripartite repo markets. He can transfer the deposits of the bank to another bank, sell assets, mandate a partial or complete debt-for-equity swap, break up the institution or order its liquidation. To facilitate a regulatory insolvency, systemically important financial institutions should be required to develop a bankruptcy contingency plan that would lay out how they would resolve themselves quickly and efficiently. Such a "shelf bankruptcy" plan would require banks to track and document their exposures much more carefully than they do now and in a timely manner.

Background

In recent years the global community has witnessed an extraordinary development of the global financial system with highly increasing international integration, soaring complexity of products, and lavish rating agencies. Additionally, a transformation has taken place away from the traditional banking model towards an "originate and distribute" banking model, i.e., banks repackage loans and sell them to financial institutions to relay the risks involved.

During recent years in the United States, low interest rates and inclining housing prices had led to a sizeable increase in house ownership and a large decrease in lending standards. Consequently, a change in the clientele of banks took place, e.g., even NINJA (no income, no

job or assets) were suddenly eligible for loans on houses. This led to a substantial increase in the overall risk of bailout and was creating a steadily growing housing bubble.

Investment bankers on their "search for yield" hushed these risks in the ever-increasing complexity of financial products, unable to monitor or track risks even for experts. Rating agencies supported this "originate and distribute" strategy with doubtful rating procedures, blurring risks even further. Consumer's and businesses' confidence plummeted and the financial system in its contemporary from had become unsustainable.

As a consequence, the 2007 financial turmoil which started with subprime mortgage defaults in the US has developed into a global financial crisis of unforeseen dimension.

Governments and central banks have reacted to the crisis by providing enormous rescue packages for the financial system as well as the real economic sector on a national and frequently also internationally coordinated basis.

The measures that were taken up to now resulted from decisions under extreme time pressure. There was no opportunity for a thorough analysis of the long run ramifications as well as the suitability of these measures for a new system of global financial governance after the crisis.

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CEO, Booz & Company

Background

Traditional values in Financial Services (FS) encompassing capital strength, high levels of liquidity and a sustainable funding base are making a rapid comeback. The FS industry is a global, dynamic and fragile eco-system where mistakes are prone to chain reactions and low system-wide transparency could lead to additional vulnerabilities as issues intensify when they travel through the system. Overall, there seems to be agreement that a number of measures need to be taken (e.g., the macro prudential approach suggested by the UK FSA and G20) to strengthen the global financial services industry. An effective minimum requirements financial services industry "risk" management framework should address key characteristics/ issues to improve the stability of the global financial services industry and proactively identify future risks and threats to the global financial system.

Hypothesis to Ensure Proper Global Financial Services Governance

Level and Purpose of Oversight

The global nature of financial markets requires oversight and regulation to take place in various local/national jurisdictions, complemented by international regulation, to ensure holistic and transparent oversight of a global industry and thus avoid the possibility for regulatory arbitrage and gaps in regulatory coverage between home and host jurisdictions.

H1. There is a need for oversight/governance and regulation at local and international levels with a requirement for an all-encompassing, globally consistent regulatory framework with clear accountabilities between regulators that covers all industry players.

In addition, recent events have shown that the roles and responsibilities between finance ministries and regulators need to be reevaluated to ensure accountabilities and areas of collaboration are clearly defined.

H2. Effective regulation and governance rests on the ability to monitor the stability of the global financial services system in "real time" to determine the overall health of the system and assess responses that reduce the risks of chain reactions and system wide failures. Identified

risks need to be mitigated in an efficient and effective manner across all affected players and jurisdictions.

At the same time, the financial services industry is already one of the most regulated industries, and more regulation is on the horizon, which may have a detrimental impact on innovation and on other financial services-dependent industries. To build stability and create the required transparency in the global financial services industry, lessons learnt from other industries should be taken into account.

Given the importance of the financial services industry for the overall economy, a part of the industry could become a highly regulated low risk utility that provides basic financial services such as deposit taking.

H3. An "optimal" level of regulation and risk oversight should ensure overall macro-economic stability of global financial markets while avoiding an overly restrictive system that does not curtail economic purposeful innovation. A clear message from financial and economic history is that "incentives" that trigger the right behaviors are generally more effective and thus often better suited than pure regulation, or should at least complement regulation where possible.

H4. In the absence of a strong risk culture or the presence of a significant amount of organizational risk DNA that guides and informs the "right" behaviors, a regulatory framework is unlikely to achieve the desired financial services stability effect and thus will fall short of achieving the desired macro-economic stability effect.

A complementary measure to regulating FIs is to regulate complex products more systematically. For example, product regulation could be mandatory for all products exceeding certain thresholds. In addition, high risk products could be routed through global clearing facilities which would further reduce systemic risks. This in turn would promote the creation of standardized products, increased transparency and thus further reduce liquidity and counter-party risks.

Capital Requirements and Risks Need to Be Fully Aligned

The capital requirements need to be assessed in the context of who would ultimately bail out a Financial Institution (FI) should that be required. (Recent history seems to indicate that this is done by national governments and ultimately the tax payers.) The ability of a sovereign to bail out a FI will influence the optimal/ maximum size of an FI (e.g., if the size of a potential bail out is too large then the FI would be too big and needs to be downsized to make a bailout "palatable" for national tax payers).

H5. Capital buffers should be build in a counter-cyclical manner; overall capital requirements need to be in line with the business model and the risks inherent in the business.

According to common belief, banks should be required to hold more capital – more capital for credit, market, liquidity, investment and operational risk – in short for any kind of risk that exists. However, just increasing overall capital requirements is not a panacea for the problems that caused the current credit crisis because they fail to take into account the different types of risk and the differences among FIs. Moreover, higher capital requirements in their own right may even exacerbate the problem in that they raise the barrier to entry for smaller banks, leaving the playing field largely to FIs that are deemed "too big to fail (TBTF)" and may thus require a significant capital injection.

H6. Most proposals that address the "TBTF" problem rest on regulating complex FIs more tightly. An alternative is to address the root cause in the first place – namely to prevent FIs from becoming TBTF. Options include antitrust/ anticompetitive measures and levying capital charges on institutions in proportion to the level of systemic risk they pose – in effect charging these institutions a market price for the TBTF guarantee. In addition, a split between basic utility and more risky activities could be achieve through a "revised" Glass Steagall Act .

However, if a FI ends up being nationalized, the role of the state as a significant shareholder needs to be understood to avoid potential conflicts of interest (e.g., the use of FIs to drive policy). Likewise, the state needs to determine how it wants to manage the potentially conflicting objectives of its portfolio companies – i.e., support the economy, promote lending and/or make a modest return on its investments on behalf of its shareholders (the tax payers).

In addition, increased capital requirements need to be aligned with an organization's risk taking and its risk capacity. Modern regulation (often erroneously) assumes that risks are a precisely quantifiable property of an asset. Apart from the fact that risks come in many facets (e.g., credit, market, liquidity risk), different parts of the financial system have different capacities to hedge risk. Accordingly, risk has as much to do with what the asset is as with who is holding the asset – the popular notion of "safe" instruments that should be promoted at the expense of "risky" ones that should be banned needs to be re-evaluated in that context. Consequently, capital requirements should be considered in the context of an organization's ability to hedge the types of risks it takes (e.g., bank deposits and liquidity risk). Banks, for example, should be able to hedge effectively against credit risk by diversifying their lending and proactively using the information that they have on potential borrowers.

It is debatable whether "significant" regulation actually makes FIs safer. During the present crisis, markets, not regulators, first identified and acted on the problems. The "true" riskiness of FIs and financial activities/transactions can best be determined closest to the source of risk buildup – proposals for different types of FIs need to take into account their different risk profiles. This asymmetry of information and the lack of transparency are thus likely to lead to a level of regulation above the optimal level of regulation.

H7. The inherent stability of a financial system would be increased in an environment where the various types of risks flow to those FIs that have the best ability to hedge them (i.e., in the case of credit risk, modern regulation encouraged the opposite by requiring banks to set aside more capital for credit risk than for non-FIs and thus encouraged banks to shift their credit risk to whose who wanted a higher yield but had very limited ability to hedge this type of risk).

Therefore, the objective of financial regulation should not be to identify and reduce risk, per se, but rather to ensure that the risks are dealt with appropriately by those FIs that are best equipped to handle them.

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A simpler way to solve the "dollar problem" and avoid a new inflationary cycle

When China's Premier Wen Jiabao recently expressed concerns about the future of the US dollar, the currency in which most of his country's official reserves are denominated, his remarks provoked contrasting reactions among US economists.

Some, like Fred Bergsten of the Institute of International Economics, exhorted the US government to take Mr. Wen's concerns seriously and listen to Beijing's suggestion to create a substitution account in the IMF, which would allow Fund members to exchange unwanted dollar balances for SDRs, as part of a gradual process to replace the dollar with a supra-national reserve currency over the long run (Mr. Bergsten was particularly enthusiastic about the substitution account idea since it matched a similar proposal he had made in 2007, see Fred Bergsten, "We should listen to Beijing's currency idea," FT April 8, 2009, and "How to solve the problem of the dollar," FT December 11, 2007).

Other US economists, including last year's Nobel laureate Paul Krugman, were less enthusiastic. According to Mr. Krugman (Paul Krugman, "China's dollar trap," New York Times, April 2, 2009), China had fallen into a trap of its own making due to its reluctance to adopt a more flexible exchange rate policy in the past. Since any attempt by China or any other country to diversify away from the dollar too much or too quickly would be self defeating, there was no immediate threat to US or world financial stability, hence no need for the US government or the IMF to intervene on China's behalf.

In our opinion, Mr. Krugman's view is very simplistic for it fails to take into consideration the effect that a large amount of unwanted dollars and dollar assets will have on inflation once recession fears dissipate. It is possible that Mr. Krugman believes that some increase in inflation is a good thing, as it could help cure the "dollar overhang." If so, he is not alone. Kenneth Rogoff, the former chief economist of the IMF, has recently written that "a sudden burst of inflation would be extremely helpful in unwinding today's epic debt morass" (Kenneth Rogoff, "Embracing inflation," The Guardian, UK, December 2, 2008). Put in other words, by increasing inflation, the US would "solve" two problems at once. On the one hand, it would debase the value of its national debt, hence preventing it from growing too much relative to GDP. On the other, it would reduce the real value of the debt (unsecured and secured) of financial institutions and other US corporations, hence diminishing the need for explicit haircuts or public bailouts.

The problem with this "solution," aside from the reputational problems it creates for the US government, is that once the inflation genie is out of the bottle, it will be very difficult to put it back in. As for the solution proposed by the Chinese central bank and Mr. Bergsten, there are, unfortunately, several problems. First, the plan requires a complex multilateral negotiation, including a change in the IMF's Articles of Agreements, which is unlikely to be supported by the US, if anything because the SDR will compete with the dollar as a reserve currency unit. Second, the proposal restricts the menu of potential dollar substitutes to the SDR, itself a basket of currencies with a predominant dollar share. Third, a substitution account in the IMF makes the IMF rather than the US government liable for losses resulting from the depreciation of the dollar vis-à-vis the SDR, a condition likely to be opposed by other Fund members.

However, the most important drawback of the China/Bergsten proposal is that it does not really protect US official creditors from a persistent fall in the dollar. This is because in the event of a protracted dollar depreciation, it is highly unlikely that the central banks of Europe, Japan, and the UK will stay put and let their currencies appreciate. More likely, these countries will resist appreciation by engaging in a process of competitive devaluations, the end result of which will be an increase in global inflation. If so, the reserves of China and other emerging markets will lose real value whether they are in dollars or SDRs. More importantly, inflation will be high everywhere in the world, and it will take years of high real interest rates and low growth to bring it down.

Fortunately, there is an easier and better way to protect the value of emerging market reserves while reducing the risk of a resurgence in world inflation. This is to reduce the incentive of the US government to "inflate its way out of debt." For this to happen, all US creditors need to do is demand that the US government swap nominal US Treasury bills, notes, and bonds for inflation-adjusted instruments (TIPS) on demand. Since, at present, the supply of TIPS is very small in relation to the rest of the US national debt, bilateral coordination would be necessary to avoid distorting their value.

One of the advantages of this idea is its simplicity. For starters, it can be executed bilaterally rather than multilaterally. This not only makes it easy to implement, but also gives the US government leverage to extract concessions from the other governments. For example, in the case of China, it would be possible for the US to negotiate a quid-pro-quo, whereby China commits to reforms geared to reducing its structural current account surplus – including, but not limited to, a more flexible exchange rate policy. For this reason, it would be preferable that the swap proposal comes from the US rather than from its creditors.

But, more important than the practical advantages are the beneficial long term effects of such a policy, particularly in averting the specter of global inflation. By substituting TIPS for nominal bonds, the US government would be sending a strong signal that it does not plan to "inflate its way out of debt," as disingenuously suggested by Mr. Rogoff but, to the contrary, will commit itself to adopting a more disciplined monetary and fiscal policy going forward.

Jeffry Frieden

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While regulatory aspects of global financial governance are extremely important – and widely recognized – it is usually the underlying macroeconomic realities, and policies, that are at the root of problems that arise and require attention. For example, in the current crisis, it was the massive inflow of funds to the United States (and other deficit countries, such as the UK, Spain, and Ireland) that drove a class classic capital flow cycle. As is often the case with a capital flow cycle of this type, the inflow created an economic expansion, then a boom, then a bubble. As is also typical, it was concentrated in the nontradables sectors, especially finance, insurance, and real estate. It was the capital inflows that created the conditions for the financial melt-down that ensued; while adequate and appropriate regulation could have softened the impact of the crisis, it probably could not have avoided serious consequences in any circumstance.

This is not to underestimate the importance of responsible financial regulation and the national level, and of consistent international cooperation among regulatory authorities – up to and including harmonization, and even a global regulatory regime. But in discussions of these issues, I think it is equally important to deal with the macroeconomic trends that typically are the root causes of major financial crises – whether in Latin America after 1981, East Asia after 1996, or the United States after 2007. For in most instances, these sorts of serious financial difficulties are the result of serious macroeconomic imbalances – whether in exchange rates, monetary and fiscal policies, or capital flows.

In this context, there is scope for international cooperation to monitor such imbalances, and to attempt to encourage their amelioration. There are dozens, even hundreds, of examples of national governments that delay adjustment until it is too late and that face a financial crisis as a result. Typically, domestic political pressures are put forward as the reason adjustment could not be undertaken in time. But this is not a purely domestic or national problem, for financial crises are often transmitted across borders, and almost always impose serious externalities on other nations.

There is a strong normative case for focusing international attention on governments whose macroeconomic policies risk causing financial difficulties, especially when (as is almost always the case) the consequences spill across borders. Such international attention, and even pressure, might help clarify the situation, reduce domestic resistance to adjustment, and encourage appropriate policy changes. Some international institution – such as the IMF, which already has the embryo of a surveillance function – could serve as the focal point for global attention to national policies that risk a potentially contagious financial crisis.