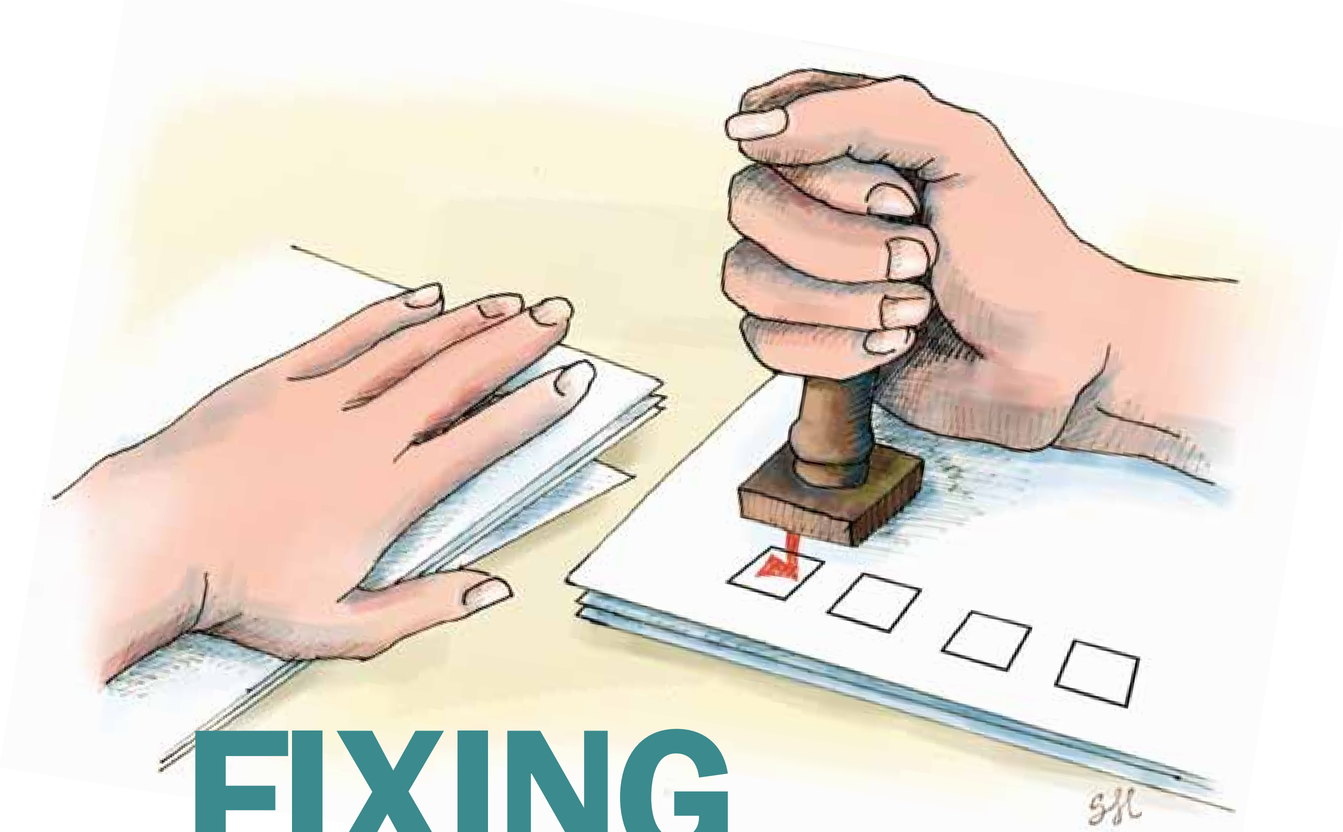

FIXING the SYSTEM

After a burst of effort to reform financial regulation widely perceived as contributing to the global crisis, the pace has slowed

Laura Kodres and Aditya Narain

WEAK financial regulation in advanced economies—regulation that was poorly designed, impractical, and inconsistent across institutions and market segments, not to mention country by country—was a significant contributor to the worst global economic crisis since the Great Depression.

Regulation was also perceived as too lax, with government authorities catering too much to the private sector in order to reduce costly adherence to rules. It is no surprise, then, that beginning in 2009, the policy agenda of the leaders of the Group of 20 (G20) advanced and emerging market economies has focused on financial regulation reform to help address the kind of systemwide risk and spillovers to other institutions, countries, and the real economy that the crisis revealed.

There has been significant change since 2009 as a result of pressure on the multinational Financial Stability Board to better coordinate global financial regulation as well as some regulatory revamping in the United States and Europe.

But five years after the first signs of the crisis occurred in the U.S. mortgage market, there is a sense that the initial burst of regulatory reform has slowed, partly because of the reformers' fatigue and growing indifference among a citizenry more concerned about the economic aftereffects of sluggish growth and high unemployment than financial regulation. The global financial industry has resisted too, aligning its position with studies that emphasize the cost of overregulation and the risk of unintended consequences of regulatory change. National authorities are under siege from their financial institutions, which are worried about the domestic effects of measures in other countries. Policymakers worry about a reversal of the gains from financial globalization driven by some instances of divergent national implementation of the reform agenda. Against this backdrop, this article will take a look at what has been achieved and what remains to be tackled.

Progress

Much has been achieved so far. With the leaders of the G20 taking a direct interest in financial reform during this crisis, there is an impetus for regulation as never before. The international architecture has been strengthened through an empowered Financial Stability Board with a mandate to coordinate the world's regulatory response. The rules of the game have been so thoroughly rewritten that the current reform might well be termed "reregulation."

A major achievement is the Basel III agreement to strengthen both the quality and quantity of capital. This agreement also introduces internationally agreed liquidity requirements (cash and securities that can be quickly and easily sold for cash). When fully implemented at the end of 2017, banks will have larger buffers to meet sudden stresses of the kind experienced in 2008, when lending between banks virtually stopped and funding costs went through the roof. The new capital surcharge on so-called globally systemically important financial institutions is a nascent international response to the risks of interconnectedness—that is, the effects that one institution may have on others due to their tangle of linked financial relationships and positions.

The notion in the U.S. Dodd-Frank Act that banks "too important to fail" should plan for their own demise is a sign that their internal complexity and the associated secondary effects from interconnectedness are being taken seriously. These plans—the financial institution equivalent of a living will—aim to ensure that a failed institution can wind down its operations without disrupting the financial system. Progress has also been achieved in what was once considered the last frontier: international standards for resolution frameworks that make it easier to shut down financial institutions operating in more than one country.

Heart of the crisis

Reregulation is also taking direct aim at certain types of activities that were at the heart of the crisis.

The so-called shadow banking system—where financial institutions perform activities generally associated with banking but outside the bank regulatory system—is now center stage in a review of activities and institutions that may need to be within the purview of regulation—known as the regulatory perimeter. Much of the activity at the heart of the global crisis occurred between the shadow system and the more formal banking system. U.S. broker-dealers, bank-sponsored special investment vehicles and conduits, money market mutual funds, hedge funds, and an assortment of financial institutions interacted to spawn a growing systemic mismatch between longer-term assets and the short-term liabilities that funded them. Some of the institutions had an unhealthy dependence on shorter-term deposit-like instruments that are traded in money markets rather than on traditional deposits. (See "What Are Money Markets?" in this issue of *F&D*.)

The shadow system was a large contributor to both the supply and demand for exotic and risky securitized products, which triggered the financial meltdown in the United States. Securitizers pool loans (for example, mortgages, credit card balances, auto loans) that back securities sold to investors. The principal and interest payments on the loans are used to pay the owners of the securities—usually in a tranche arrangement that gives different classes of investors different priority when it comes to payment. Low interest rates spurred investors to reach for the small additional yield these securities provided.

Regulations to make securitization safer have tackled many of its detected flaws. For example, originators must now hold more of the products (or have "skin in the game"), which forces them to examine more carefully the underlying loans' riskiness. New international accounting rules limit the ability of financial institutions to hold securitized assets in off-balance-sheet entities where insufficient capital could be held against them. The Dodd-Frank Act requires originators to be more transparent about the assets these products contain. Regulations now in effect in the United States and the European Union require credit rating agencies to pay more careful attention to how the products are rated.

Other forms of shadow banking are also under scrutiny by the Financial Stability Board and elsewhere to see whether they present the same potential for leverage and other risks that could harm the financial system.

National authorities are under siege from their financial institutions, which are worried about the domestic effects of measures in other countries.

One step removed

Even bank activities that were one step removed from the crisis—for example, trading securities for themselves (not for customers) and bank-sponsored hedge funds—are viewed as too risky for those receiving government (that is, taxpayer) support as a backstop. The so-called Volcker rule in the United States and the Vickers report in the United Kingdom advocate separation of traditional consumer banking activities—collecting deposits and making loans—from riskier banking activities that might put a bank at risk for taxpayer support. Most of the affected banks have pushed back, since these initiatives, if fully implemented, would likely lower shareholder returns.

While most regulations aim at ensuring the health of institutions, others address dysfunction in the financial market overall. These include efforts to move settlement of derivatives contracts bilaterally traded over the counter to central counterparties (CCPs). When enough such contracts are settled within a CCP, rather than directly between the two trading parties, risk is lowered because the central counterparty can offset multiple contracts' cash flows to buyers and sellers. Of course, if multiple CCPs crop up (as is happening) the multilateral netting benefits are lower and more resources are needed to ensure the safety of this key piece of the financial infrastructure.

The repurchase (repo) market—where institutions sell securities they own to obtain short-term funds with a promise to buy them back in the near future—is also receiving attention. If such funding mechanisms suddenly dry up or become prohibitively expensive, some institutions that rely on them can suffer a debilitating shortage of needed cash. Collection and publication of information about the cost of repos (the haircuts applied to the face value of the underlying collateral) and the types of acceptable collateral should help ground the market. Despite much attention to the repo market, recent working groups (such as one coordinated by the Bank for International Settlements and the New York Federal Reserve Bank) have been unable to push reforms forward.

Progress has also been made in addressing systemic risk through macroprudential policies, which recognize that keeping individual financial institutions healthy is not enough to guarantee the soundness of the overall system. (See "Protecting the Whole" in the March 2012 issue of *F&D*.) More holistic macroprudential approaches deal with some of the underlying phenomena that cause credit and leverage to amplify the ups and downs of the business cycle. They also identify the interconnectedness of institutions and markets to explain why a problem in one institution or market can quickly affect others. Early efforts to address the more systemic problems include the Basel III countercyclical capital buffer—which requires institutions to increase their capital in good times to enable them to better handle bad times—and the more recently agreed capital surcharge on globally systemically important financial institutions.

More to do

While much thought has been given to what to do, the finish line remains some distance away. Indeed, some areas, such as the meshing of transatlantic accounting standards into one global standard, have been slow to change. Furthermore, three years after the leaders of the world committed to the reform agenda, countries have yet to begin implementation of some of its key elements—such as policies to deal with systemic liquidity risk.

To some extent this is by design, because implementation was to be phased in to mitigate the impact on both industry and the overall economy. Still, lagged implementation means that the world remains exposed to a replay of the same risks that froze the financial markets only three years ago.

In addition, reforms face two key hurdles—pushback against what has already been agreed and inadequate implementation.

Pushback against agreed reforms initially came from the financial industry as the first phase of the crisis ebbed, but now some national authorities are resisting as they struggle to cope with slow recovery during the second phase of the crisis. The enhanced capital and liquidity requirements accepted by a committee of regulators from around the globe—Basel III—have yet to kick in, though some minor improvements have been established as Basel 2.5. Nonetheless, the Basel III rules are being blamed for the ongoing bank deleveraging (shedding of assets) and slowdown in credit growth. Finger pointing across countries has also begun, alleging that some have engaged in competitive manipulation—for example by failing to adhere to agreed timelines.

The result of inadequate implementation can be seen in several areas. Provision of the resources needed to strengthen the supervision of proper regulation enforcement has received little attention. Regulatory arbitrage—investors' exploitation of different prices in different markets resulting from different rules or regulations—is rearing its head. Attention has only just begun to identify ways that supervisory capacity in general and its autonomy, mandate, resources, authority, and techniques in particular can be beefed up to ensure even implementation across institutions, markets, and countries. Still, supervisory autonomy is unlikely to obtain the status of central bank independence anytime soon, and supervisors will continue to face both industry lobbies and government pressure as they struggle to influence the incentives faced by institutions too important to fail—which show little inclination to reduce their size or scope.

Difficult path

Regulatory reform efforts may have slowed, but there has been progress. The relatively low-hanging fruit has been picked, and the harder, more exacting, job of addressing tougher problems lies ahead. On the still-to-do list are

- identifying and building tools—still in the early stages of development—to mitigate systemic risk;
- improving the ability of the authorities to deal with the aftermath if the tools designed to prevent systemic events fail; and
- providing a framework for financial intermediation (the transfer of savings to investments) to assist in strong and stable economic growth, without overly prescriptive regulation.

Continued financial distress in some parts of the world, notably Europe, is hindering progress, particularly because of additional problems that affect reform of the regulatory regime when a sovereign government's ability to backstop the financial system is potentially compromised.

Nevertheless, forward momentum cannot be lost, because failing to address the most difficult questions will undoubtedly affect future global financial stability. Clarity about the end point is necessary to build confidence about the future—confidence that is sorely lacking in the current environment. ■

Laura Kodres is Assistant Director and Aditya Narain is a Division Chief in the IMF's Monetary and Capital Markets Department.