Progress with Reforming Global Banking and Financial Regulation

- The global crisis has uncovered a host of regulatory shortcomings and gaps that require decisive treatment by policy makers and authorities.
- The G20, the group of leaders of the twenty largest economies, has pushed ahead with an ambitious and comprehensive program to reform the global financial system and its regulation with the objective of reducing the risk and cost of future crises
- Progress with reforms has been significant but remains in its early stages.
- Central banks and regulators in the region have sought to improve supervision and tighten bank regulation.

In IBQ's latest GCC Brief: It has been three years since the start of the global financial crisis. With the urgency of the crisis largely behind us, we are left with the economic aftermath: recovering from recession and dealing with larger government deficits in most advanced economies. We are also left grappling with the implementation of a financial reform program that hopes to avoid future crises, or at the very least reduce their impact on the economy and employment.

Today, reforms of the global financial system and bank regulation are in full swing. Improvements to the Basel capital adequacy standards should be adopted soon. A global macroprudential coordination body is in place and expected to propose a working framework by the end of the year. Legislation in the US and the EU is reshaping the way their financial systems are regulated and supervised. Banks globally have beefed up their risk management and governance systems.

The global crisis

The crisis, which emerged out of the US subprime mortgage crisis in 2007, reached its height in September 2008. The bankruptcy of the US investment bank Lehman Brothers and the near collapse of the insurance company AIG marked the most urgent time in a crisis that would affect banks and financial markets globally. Financial institutions across the world found themselves holding "toxic" hard-to-value assets. Short-term funding internationally was hit and a number of institutions faced financial distress (see Box 1 for more detail).

A global economic recession followed as banks and investors became more cautious and asset prices including house values tanked, sharply crimping household wealth and finances. This further undermined the operating environment of financial institutions as corporate and household finances deteriorated. It also led to deterioration in sovereign finances and a decline in the quality of public debt.

In 2010, a sovereign debt crisis emerged in Greece while debt levels of other European countries were also put in question. European banks were particularly exposed to Greece and other highly indebted European sovereigns, shaking banking sectors once more and threatening further fallout.

Lessons of the crisis

The global financial crisis brought to the attention of policy makers a host of gaps and shortcomings in the existing financial regulatory regime. The most important of these was weak and inconsistent regulation of systemic risk, also known as macroprudential regulation. Systemic risk takes account of the fact that aggregate financial risk is dependent on the behavior of individual firms or banks in the system. Its regulation aims to monitor sources of systemic risk and to alleviate the excessive buildup of such risk in the system.

Another shortcoming was that moral hazard resulting from the belief that some institutions were "too big to fail" was significant and was not adequately treated by regulators. Banks can be "too big to fail" when their failure is judged to threaten the stability of the financial system and the economy in general. When this happens, financial institutions receive an implicit assurance of support from the government in the event of their failure which tends to distort their appetite for risk.

A third gap in the financial system was that the scope of bank regulation was too narrow and failed to capture unregulated firms and markets. This gave rise to a "shadow banking" sector. Financial and banking activities migrated to the unregulated sector where costs are lower. However, without regulation, these activities contributed to instability.

Another area of concern was weak cross-border bank regulation. Large international banks, whose activities crosses borders, were not sufficiently regulated and supervised by their home-country regulator. Adding to this was the various regulatory standards and accounting rules that applied in different countries, making it difficult to properly ascertain the risk exposure of global banks.

Another major shortcoming which helped precipitate the global financial crisis was that financial markets were insufficiently regulated and organized. Trading in some securities and derivatives were often over-the-counter and were not traded on an organized exchange. This meant regulators were often not aware of the size and condition of these markets, which made it impossible to ascertain their liquidity and ability to withstand a shock.

Policy response

Governments and central banks initially responded by providing emergency liquidity to banks and financial institutions. This was particularly important when the market for mortgage-backed securities seized up in August 2007. However, as the crisis developed and the extent of the problem became apparent, authorities were forced to take even more drastic measures, including the outright acquisition of financial institutions, providing funding against more risky assets and shares, and purchasing mortgage-backed securities (MBSs) now deemed "toxic".

The need for more fundamental reform also became apparent. The financial crisis revealed serious problems with the existing regulation of banks and financial institutions, the most serious one being a near complete absence of a macroprudential regulatory framework. Central banks and regulators were not able to properly identify increasing risks to the financial system, much less deal with them on a global or even a national level.

The immediate policy response was seen as necessary to prevent economic and financial collapse on a global scale. Longer term, however, authorities understood that the crisis required a deep and thorough reform program to deal with all of the system's weaknesses. This intention was clearly stated in the G20[1] summit in Washington, DC in November 2008, when the leaders of the twenty largest economies agreed to an ambitious

[1] The Group of Twenty (G20) represents the twenty largest economies and includes, from the region, Saudi Arabia and Turkey.

reform program. The program's goals included the following principles for the reform of international and national regulatory regimes:

1. Strengthening transparency and accountability

Financial market transparency should be strengthened by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms. Incentives should be aligned to avoid excessive risk-taking.

2. Enhancing sound regulation

Regulatory regimes, prudential oversight, and risk management should be strengthened. Regulation and oversight should be extended to all financial markets, products and participants. Credit rating agencies should also be subjected to oversight. Regulatory regimes should be made more effective throughout the economic cycle. Authorities should commit to transparent assessments of their national regulatory systems.

3. Promoting integrity in financial markets

The integrity of the world's financial markets should be enhanced by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. Information sharing should be promoted, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.

4. Reinforcing international cooperation

National and regional regulation should be consistent and coordinated across borders. Regulators should enhance their coordination and cooperation across all segments of financial markets. Regulators and other relevant authorities should strengthen cooperation on crisis prevention, management, and resolution.

5. Reforming international financial Institutions

The Bretton Woods institutions should be reformed to more adequately reflect shifting economic power in the world towards emerging economies and to increase their legitimacy and effectiveness. The existing Financial Stability Forum (FSF; since replaced by the Financial Stability Board or FSB) must broaden its membership. The IMF, the FSF and others, should improve monitoring in order to better identify vulnerabilities and emerging threats to financial systems.

Strengthening macroprudential regulation

Weak macroprudential regulatory infrastructure was found to be one of the key causes of the crisis. Macroprudential tools, whose aim is to reduce systemic financial risk, are still under development and include:

1. Tools to measure the systemic impact of a firm, such as value-at-risk, expected loss, stress tests, and macroeconomic scenario analysis;
2. Higher capital or liquidity requirements or capital surcharges for banks with higher systemic risk;
3. Countercyclical measures to ensure risk-taking does not rise unduly with the business cycle.

Reforming microprudential regulation

Regulators have long been involved in the regulation and supervision of banks and in some cases nonbank financial institutions. Microprudential regulation is concerned with minimizing individual bank failure and in the event of failure provides for the orderly resolution of failed institutions. Such a framework involves the setting of such rules as regulatory capital requirements, asset quality standards, and liquidity limits.

Such regulation also involves the regular monitoring of institutions to ensure compliance. Regulators have typically been allowed comprehensive and powerful authority to scrutinize the activities of regulated entities including the power to force institutions to take corrective action in the event of failure to comply with the rules.

In the wake of the crisis, however, it became apparent that existing microprudential regulatory authorities had failed to prevent a financial crisis. The failure of regulators to identify problems prior to the crisis was indicative of a major gap in the existing regulatory architecture. This criticism was particularly strong in the US where financial regulation is deemed quite sophisticated. Regulation also fell short in most European countries.

Progress on reforms

There has been significant progress made in the regulation reform agenda. Some of the key areas include:

1. Global macroprudential regulation

The FSF was reformed into the Financial Stability Board (FSB). The new FSB reflects the broader G20 membership and is tasked with monitoring and promoting the stability of the global financial system and identifying and addressing any threats to it. The new body is still in the process of formulating much of its responsibilities.

2. National macroprudential regulation

The regulation and oversight of systemic risk is also being enhanced at the national level. Legislation in the US has increased the powers of the Federal Reserve to monitor and address threats to financial stability. A systemic risk board and a coordinating body for bank regulators are also in the making in Europe. The EU also introduced the European Financial Stability Facility (EFSF) following the sovereign debt crisis earlier this year. The facility would provide emergency funding to governments in financial trouble. The EU is also looking at improving its crisis response capabilities.

Many countries have conducted tough stress tests on banks to evaluate their ability to withstand severe economic conditions. These tests have, in combination with the continued monitoring of financial stability by the IMF, provided an important source of systemic risk monitoring.

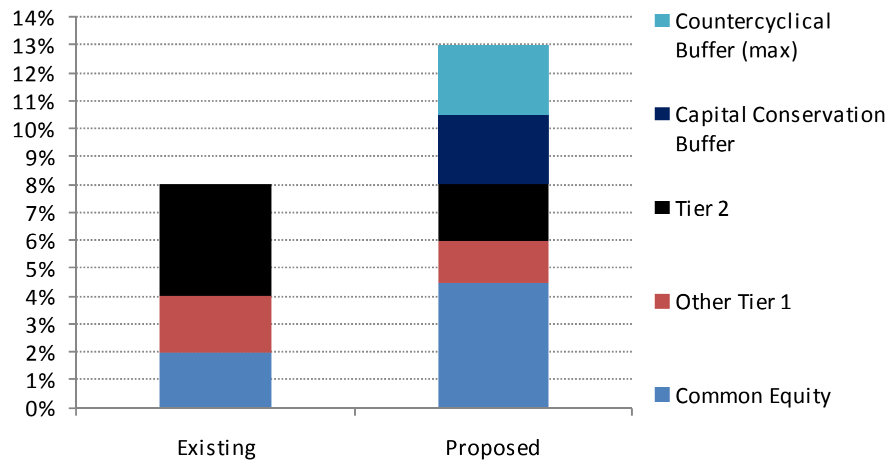
3. International capital adequacy standards

The Basel Committee on Banking Supervision (BCCS) has recently approved revisions to the existing Basel II bank capital standards. The revised standards, also known as Basel III, include:

1. Increasing the quality of bank capital by lifting the minimum required core and tier 1 capital banks must hold (to be phased in from 2013);
2. Stricter definitions of what constitute non-core tier 1 and tier 2 capital (to be phased in from 2013);

3. Introducing a capital conservation buffer to protect against future periods of stress (to be phased in from 2016);
4. Introducing a countercyclical buffer to control risk taking at different points of the economic cycle;
5. Introducing a non-risk-based minimum leverage ratio to limit excessive bank leverage (likely implementation in 2018).

Chart: Proposed Basel III Capital Requirements
(% of risk-adjusted assets)



Source: Bank for International Settlements.

The FSB and the Basel Committee published reports concluding that the impact on economic growth of these new capital requirements will be modest. The new standards still need to be endorsed by G20 leaders when they meet in November.

4. Financial sector oversight

A host of new regulations were introduced in the US this summer though their implementation in most cases will take some time. Some of the most prominent reforms include putting limits on the activities of banks. Particularly, the legislation bans banks from some types of trading. The new law also consolidates the regulatory regime within the Federal Reserve.

In the EU, more ambitious legislation is being pursued to create EU-wide regulators, including creating a banking authority, a securities regulator, and an insurance authority. The new institutions will replace existing committees that lack the institutional authority to take necessary action at the EU-level. The EU is also eyeing laws placing limits on bank activities including on the trading of derivatives.

The global financial crisis also had its clear impact on the region affecting the financial sectors and banks, in some cases substantially. As such, policy makers and regulators in the region have been busy reshaping how finance and banks are regulated. However, the shape of reform has been different due to the nature of the banking sector which has relied less on derivatives and tradable debt securities.

Policies included taking immediate action to provide banks with liquidity. In order to avoid bank failures, several countries reintroduced bank deposit guarantees including Kuwait. Other policies were intended to ensure better

risk management and capitalization of banks, including requiring an enhanced Basel II implementation and the reporting of derivatives activities. Banks were also required to submit detailed work plans and strategies to their central banks to reveal their preparedness for challenges in their operating environment. Central banks also required banks to conduct comprehensive stress tests designed to uncover any weaknesses in the event of severe economic conditions.

Conclusion

The IBQ report concluded: The coming months will prove critical in the process to reform financial markets and financial regulation, as well as the effort to guard against another financial crisis. While much progress has been made, the outcome may leave many unconvinced that the change has been sufficient. □

Box 1: Key areas of reform

1. Improve capacity to tackle threats to financial stability
- ✓ Creation of Financial Stability Board
- ✓ Enhancing the monitoring role of the IMF
- ✓ Broadening global action by creating G20
- ✓ Creation of national systemic risk authorities (US, EU)
- ✓ Increasing the coordination between monetary policy and systemic bank regulation

2. Enhance the resilience of individual financial institutions
- ✓ Increase loss absorbing capital through reformed Basel rules
- ✓ Introduce liquidity standards in new Basel rules
- ✓ Improve supervisory standards
- ✓ Extend regulation to unregulated "shadow" banking
- ✓ Enhance international supervisory coordination
- ✓ Restrict bank activities (e.g. Volcker rule)
- ✓ Reduce moral hazard arising from the perception of implicit bank guarantees (i.e. too-big-to-fail)
- ✓ Eliminate practices which promote excessive risk taking (e.g. compensation practices, accounting standards)
- ✓ Improve bank risk management standards and practice
- ✓ Refine and harmonize accounting standards

3. Enhance the resilience of financial markets
- ✓ Increase transparency through better disclosure
- ✓ Increase regulatory monitoring of financial markets
- ✓ Promote organized exchanges versus over-the-counter
- ✓ Regulate and set standards for rating agencies

4. Reduce systemic impact of individual firm failure
- ✓ Regulate financial markets and payment systems
- ✓ Set up a credible cross border bank resolution regime

5. Reduce systemic risk
- ✓ Introduce special regulation targeting systemically important financial institutions (SIFIs) (i.e. two-tiered regulation)
- ✓ Introduce capital surcharges for systemically important firms
- ✓ Introduce countercyclical capital buffers to reduce risk taking in periods of rapid economic growth
- ✓ Introduce stricter definitions for eligible liquid assets