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GLOBAL FINANCIAL REFORM
How might the 2015 International Conference on Financing for Development strengthen reform momentum?

Report on a roundtable discussion organized by Brot für die Welt and the Financing for Development Office of the UN Department of Economic and Social Affairs, 20 October 2014 at UN Headquarters, New York

In the context of a current economic situation in which the financial system again produces excessive *financial* risk taking, but only limited *economic* risk taking, as reported by the International Monetary Fund (IMF), this daylong conference sought to assess the regulatory changes post-crisis and their capacity to provide financial stability.

This discussion was made all the more urgent by today's linkages between financial systems in emerging and mature markets, which are greater than before the crisis, which implies greater contagion effects should there be disruptions in either group of countries. These linkages have been primarily intensified via capital market credit intermediation, be it bonds or other forms of financing, especially those involving "shadow banking" activities. In 2014, portfolio managers in the West held 4 trillion dollars in assets from Emerging Markets, making up 12% of their portfolio, making asset managers in developed countries a main potential conduit for financial instability. This risk is heightened by a "search for yield", encouraged by very low interest rates, which creates a liquidity illusion in financial markets. That is, credit spreads for risky assets are reduced by unusually high demand in this phase of the financial cycle, only to reverse in the moment of crisis, as these credit spreads are now too low to compensate for actual default risk.

The content of post-crisis regulatory reform

As the IMF itself warns, investors are too complacent about these rising liquidity risks which could compromise financial stability. Going forward, the IMF suggests a balancing act between promoting economic risk taking and reducing financial excesses through micro- and macro-prudential policies. Exactly how this could be achieved was the topic of discussion. In the first session, we evaluated the recent regulatory changes to the global financial architecture in terms of their capacity to stabilize financial markets and we asked what measures have been taken to help provide greater stability in short-term funding for enterprises and households globally. We focused on regulatory reform in major capital market countries and on four of the priority areas of financial regulatory reform "the Basel capital and liquidity framework; policy measures for global SIFIs;[1] resolution frameworks; and shadow banking", as delineated by the Financial Stability Board (FSB).

[1] SIFI= Systemically important financial institution.

We first assessed the recent agreed and proposed regulatory proposals of internationally coordinated policies aiming to reduce the risks of financial collapse that emanate from commercial banks. In particular, we discussed "Basel III", and those policies (e.g., resolution frameworks for SIFIs) meant to address the "too big to fail" (TBTF) problem, as well as their implementation, asking if and in how far they properly address the main sources of the build-up of systemic risk.

As several discussants agreed, it is in this area where the greatest progress post-crisis has been made. Not only have capital requirements increased, but also what counts as core capital has been sharpened. But in order to ensure that in the next crisis, the banking industry, in particular, its shareholders and creditors, will have to pay the majority of costs of a banking crisis rather than taxpayers, it is equally important that the additional proposal, called "Gone Concern Loss Absorption Capacity" (GLAC), is installed. As banks still remain too big to fail, further increasing core capital requirements seems necessary, given that the political will to break up big banks is missing. Thus, increases in core capital requirements should continue, and be phased in over time.

In any case, the current core capital surcharges have been insufficient to change the dynamics of growing balance sheets of large banks. A discussant suggested an alternative solution to the TBTF problem, involving calculating the subsidy which goes to too big to fail banks by virtue of creditors knowing the government will cover the bank's obligations in case default threatens, and forcing these banks to increase their equity each year by the amount of the subsidy, thereby forcing bank managers and shareholders to face a trade-off between bigger size and profits to take home, making further state intervention less likely to be necessary.

In the next step, we evaluated the work of the FSB to reduce systemic risk from shadow banking, which is to say of credit-intermediation which is undertaken outside of banking regulation. This function can be undertaken by banks or non-banks, requiring that regulators focus on activities rather than entities. Shadow banking is the outcome of an intensifying banking-non-banking nexus, where these two actors most of the time interact in credit intermediation. Recent theoretical thinking, as by Stijn Classens and Lev Ratnovski at the IMF, points to the systemic risks these activities pose due to their need for a public or private backstop.

While actual regulation has closed some of the regulatory loopholes that were used by banks and non-banks to escape regulatory oversight, we see the danger of "regulatory arbitrage" as being persistent. Moving financial activities to less-tightly regulated jurisdictions or transforming them into new and less regulated activities is a continuing process, which needs to be controlled. The systemic dangers which emerge from these activities are not taken into account by private agents (they are a form of externality); they need to be brought into their calculations in order to dampen the threats of financial instability. Therefore, this area of credit intermediation outside of banking

regulation definitely needs stronger financial oversight responsibility and increased interaction between regulators and regulated concerning financial market developments.

We located the greatest regulatory short-coming post-crisis in the overnight funding market via repurchasing agreements ("repos") which is a vital element of the so-called shadow banking system. While there have been regulatory initiatives to deal with the systemic risks emanating from this market, most recently the proposals by the FSB for minimum "haircuts"[2] in October 2014, these proposals were deemed to be insufficient. Given the central role the repo market played in propagating the 2008 crisis, this tepid regulation of the market was deemed astounding. The proposed minimum haircuts on assets used in repos, meant to lower the pro-cyclicality of the market, currently cover only a small proportion of the market, and seemed to be diluted by industry demands. Given that the repo-market remains subject to pro-cyclicality and poses grave dangers in case of crisis, further measures are necessary. Limiting "safe harbor" (in which payment obligations cannot be reduced through bankruptcy) and other legal means to control the repo market need to be discussed.

Finally we took up the political question of how civil society actors can better influence the technical and generally non-transparent financial regulation process to limit crises and ensure a fair distribution of their societal costs when they do occur.

In the debate, contributors broadly agreed that since the crisis regulators are far more aware of the dangers and systemic risks posed by globalized finance. Lessons have been learned, as exemplified by the inclusion in Basel III of requirements based on liquidity and leverage ratios. There is also an increased emphasis on transparency and more granular data (as in the IMF and Group of 20 Data Gaps Initiative). Recognizing the perils of cross-border financial flows, the IMF also now endorses the use of capital controls, albeit as a last resort. However, one recurring question was: if regulators have the theoretical tools/ideas to understand systemic risks generated by distinctive activities, markets and institutions, what prevents them from acting to mitigate them (the best example being the tepid regulation of the repo market)?

To explain delays or non-reform, contributors reflected on political economy factors, including the difficulty of international coordination and in particular, the power of private finance lobbies to influence the agenda for reform. One contributor mentioned Ms. Christine Lagarde's comment in early 2014 that one of the most significant barriers to global financial reform was fierce resistance from banks. Another stressed that delays may be acceptable as long as the substantive content of reforms does not get watered down. Furthermore, contributors asked whether it is important to rethink the *big* structural questions in banking and finance, including the desirability of a more

[2] Formally, a repo is a sale and repurchase of a security, although it is effectively a loan guaranteed by a security given as collateral. The haircut is the amount by which what is in effect the collateral exceeds the value of the loan extended through the repo.

diversified financial system, and a different approach to regulation that puts the burden of proof for the *utility* and *necessity* of financial innovation on market actors.

A reoccurring theme in the discussion was the mandates of regulators. Regulators present in the discussion stressed that their mandates are national – in terms of domestic financial stability, or growth and employment. There is no global regulator. Also, whereas some pointed to a need for an increasing mandate for regulators to be able to sufficiently intervene in markets, others pointed out that in general mandates had been large enough before the crisis, although they were not sufficiently used. This factor points to the need for an engaged civil society, which asks and demands that regulators fulfill their mandate, and at the same time offers them support for interventions which may be unpopular in financial markets.

In essence, the discussion revolved around the difficult situation faced by a regulator, whose intervention in seemingly well-functioning markets is challenged as unnecessary. On the other hand, if a crisis occurs, regulators face a public outcry over their lack of action. In their work, regulators face asymmetries of information with respect to private activity. They need good linkages to industry without being captured and they need sufficient funding to be able to employ the expertise for regulation to co-evolve with financial markets. To strengthen regulators, other stakeholders, such as non-governmental organizations (NGOs), should be involved to make finance more democratically accountable.

A fundamental proposal to shift these dynamics between regulators and regulated with respect to interventions was to create a pre-approval mandate for new financial instruments and activities. In this way, regulators could avoid intervening in seemingly well-functioning markets. Instead, these markets would not even be allowed to evolve without prior approval. While this proposal poses challenges as to how such products should be evaluated, it puts regulators in a more comfortable position in regulatory dialogues, putting the burden of proof upon the regulated that their product indeed is not increasing systemic risks. In this line of thought, private market agents suggested regulation prohibit custom-made derivatives and get rid of off-balance sheet items, both of which are expressions of the search for the opacity that drives profit-making in financial markets. Here, regulatory intervention was seen as needed because private agents could not limit these tendencies on their own. The situation was likened to an arms race, where private agents feel impelled to get involved in financial innovations to keep profit margins up, even if they have negative systemic consequences.

The intervention of financial regulators in markets not only concerns individual financial products but also the implementation of macro-prudential (i.e.., counter-cyclical) policy interventions in the future. Because it requires intervention to temper boom times, discussants agreed that it is important to have simple ex ante rules for this intervention, such as counter-cyclical accounting for losses. In general, the incentives have to be calibrated to soften both the up and down swings of the cycle. In addition to adoption of

international rules, much of this work has to be done on the national level, and it is important that especially the large and developed countries do it well.

In order to accomplish national macro-prudential regulation, the powers of host country regulators need to be strengthened, which might require assistance for regulators in developing countries. Participants at the roundtable from developing countries added that it was necessary to adjust global requirements to the situation in developing countries, where for example the fulfillment of the liquidity coverage ratios posed severe difficulties to banks simply because deep liquid markets do not exist in the countries in sufficient volume. The same applied to different notions of shadow banking, which in developing countries often refers to a segment of the financial sector that disproportionally serves "unbanked" parts of population and thus serves an important social function. Broad financial regulations thus need to be tailored to fit specific country requirements.

Macro-prudential regulation was also seen as a further instance where the conflict between nationally-bound mandates and the global nature of finance needs to be better reconciled. Cooperation between central banks of different countries is important and has at times worked – as in the swap agreements in the wake of Lehman's collapse – but there may be scope for better institutionalizing a framework for cooperation that sets clear rules of how to reconcile conflicting priorities between countries. An example of the problems that arise that was mentioned was that global finance is dominated by global banks that are subject to different regulations, raising difficult questions of coordination between home and host regulators. These are particularly difficult when a global bank is systemic in both the home and the host country. As Eastern Europe's experience suggests, unilateral moves in the European Union to tighten regulation of cross-border activities had negative spillovers in Eastern Europe.

A second example is the impact of low interest rates in developed countries on developing countries. Since the collapse of Lehman Brothers, we live in a period of very low interest rates and abundant global liquidity created by central banks in high income countries. Economic theory suggests that this increases appetite for risk and yield search, with important cross-border spillovers and potential market tantrums that could prove destabilizing for developing and emerging countries. To contain spill-overs might require international negotiation between central banks and governments.

In this context, contributors reflected on the increasingly assertive role that emerging and developing countries play in global governance negotiations. The acceptance of capital controls and the Basel III rules are important steps to reduce the risk of systemic stress from incorporation in global financial architectures. However, it is important to recognize the unintended consequences of post-crisis policies, including large short-term capital inflows into emerging countries and difficulties in managing the distinctive risks – and power imbalances - associated with the presence of foreign banks in their banking sector. Another issue we addressed refers to the importance of tailoring

reforms to the specific country context: for example, emerging and developing countries may view shadow banking less of a systemic threat than high income countries do, but rather a necessary solution to ensure access to credit that regulated banks cannot or are not willing to provide.

Towards reforming the reforms

In our afternoon discussion, we tried to answer the following questions: How do we get the changes needed so that finance can serve the needs of the real economy, thus being a good servant, instead of a bad master? How can we place the changes desirable from a sustainable and inclusive growth perspective, as well as financial stability, at the core of the reform process? How can we bring these topics into the discussion at UN level, especially in the context of the preparations for the third Financing for Development Conference in Addis 2015?

The debate emphasized the need for a common, international approach to problems and in this respect positively noted that the FSB allowed for greater inclusion of developing countries than its predecessor, the Financial Stability Forum. The new governance structure needs to be used to also raise concerns of developing countries as they seek to manage risks from cross-border banking, such as sudden withdrawals of liquidity from emerging markets. Special emphasis here needs to be put on the operations of banks which are less than systemic from a global perspective or possibly even in their home market, but have a systemic importance in host countries. Such a situation can provide power advantages for large banks in their relations with host country regulators. One recent initiative to deal with this problem is the call for the conversion of overseas branches into subsidiaries, which gives host country regulators more control over their local activities.

The debate highlighted the duality of policy goals that seek, on the one hand, to provide funding for development and at the same time reduce the probability of financial instability, which can be very costly . In this vein, the issue of long-term lending was discussed. Capital markets were seen as an important channel for such long-term financing. However, it was pointed out that financial institutions should avoid excessive maturity mismatches (borrowing short-term and lending long-term). Interest rate differentials between long and short-term credit is one of the main sources of profit but is also a source of financial instability if excessive. Instead, institutional infrastructures should be developed which encourage long term financing to be provided by agents with balance sheets with low maturity mismatch (e.g., pension funds).

In this respect, we also discussed the positive role public development banks could play in steadily providing financing for development. The emphasis was on how public banks can help both in providing counter-cyclical financing and in funding visions of development, for example by financing investment in renewable energy. Development banks also can finance small and medium-sized enterprises, as well as provide long term funding, e.g. for infrastructure.

We noted that evidently different metrics are used to evaluate public and private failures. Whereas 70% of venture capital investment fails, these failures aren't subject to public criticism. Furthermore, they are part of the business plan of private capital providers. On the other hand, almost every single failure in public investment is subject to public outcry. In order to change this situation, it was suggested that an explicit portfolio approach be taken to public investment, whereby failures of a number of public investments were explicitly embraced as part of the business model. With respect to private-public partnerships, this would also imply to structure contracts such that governments do not only bear risks, but also have the possibility to capture the upside.

Lastly, the difficulties in maintaining appropriate prudential policies were again discussed. How can a polity impose something that might be against the perceived short-term interest of the majority? Countercyclical is counter majority, and thus requires regulators to be steadfast. The notion that finance and money are technical and therefore need to be handled by technocrats plays into the hands of special interests. Instead, to overcome the status quo bias, it is important to point to the direct political economic consequences of financial regulation, which requires the intervention of the public at large.
It was pointed out that the state of knowledge on appropriate regulatory interventions at the international level is less well established than debates on monetary policies or the role of central banks. Thus the politics of international regulation could still hijack the debate. Vested interests and some jurisdiction's concerns about the competitiveness of their financial systems might drive decision making. In order to provide a counterweight in these debates, civil society actors are needed, especially from the South. The discussants thus strongly supported the notion that the Financing for Development Process should seek to integrate insights from NGOs concerned with Finance in the South in the reform process. The UN also should seek to propel research on topics of financial stability by encouraging the mobilization of research funding .

Conclusions

In summary of the discussion, the following points stood out:

1. Inadequate progress on existing reform agenda. Five years after the crisis, there is little confidence that the financial sector has been rendered sufficiently less risky. Steps to curtail systemic risk are diluted and delayed. The frictions between national and global regulations continue. How much confidence can the world have that national regulators will impose appropriate counter-cyclical macro-prudential policies? Much work remains to be done to strengthen host country regulation and the resolve of regulators to impose unpopular decisions.

2. Missing topics of reform. The repo-market is no longer a topic of reform, even if among important practitioners there are concerns about the dangers from shadow banking, e.g., concerning the possibility of runs on repo-markets. Another example is the continued existence of banks that are too big to fail. The risks of unbound

financial innovation are not yet under control and in this respect the proposal to install the pre-approval of financial innovations by regulators just as in the case of drugs seems worth re-considering. This is in line with an application of the Ruggie principles on human rights to finance, as multi-national corporations themselves find it impossible to impose self-regulation to this end in the competitive environment they are in.

3. The standard process for regulation reform entails drafting proposed regulations that are then put out for comment, almost all of which come from the affected financial sector. In addition, the Group of 20 assesses the state of financial oversight in its finance ministers' meetings. It welcomes comment from various stakeholders, but seems to pay most attention to business (B20) groupings. The regulated financial sector has disproportionate influence over its own regulation, in part because it is so technical. There is need for a better forum for discussion and political guidance to bring more voices to international regulatory processes than just regulators and the regulated.

4. Towards a more inclusive regulatory oversight process. Finance needs to work for the economy and in particular for an enabling international and domestic environment for development. That means the highly arcane and complex regulatory approaches need to be translated into accessible concepts and language that can be understood and appreciated as guided by accepted principles. Society needs to be able to monitor how and whether the principles are being implemented and how improvements might be made. The population at large cannot become experts in regulation policy but they can hold regulation to agreed standards.

5. As a first step, some participants called for a global assessment of the state of financial instability and insecurity jointly by finance and development ministries and other stakeholders in an open and democratic forum, leading to policy guidelines on the global interest in financial regulation and supervision. The UN could offer to host such discussions under the Financing for Development process, bringing the relevant ministries and other stakeholders to the table. One advantage is that the UN is not itself a financial institution and is a universal membership body with well-established practices for engaging multiple stakeholders in an informal intergovernmental setting. The discussion should be prepared by an expert group, jointly serviced by the UN and key multilateral partner institutions. The discussions should ultimately lead to a negotiated text on guidelines and their implementation, possibly including the Ruggie human rights principles as applied to finance and conclusions reflecting remaining systemic concerns.

09.11.2014 Matthias Thiemann