Limiting financial crises: Demands upon the new financial architecture

and

The case for development banks

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Introduction

This paper seeks to evaluate the recent regulatory changes to the global financial architecture in terms of their capacity to stabilize financial markets; this should help provide greater stability in short-term funding for enterprises and households globally. This paper focuses on regulatory reform in major capital market countries. However, due to the strong linkages between the financial systems of developed and developing countries, a crisis in the former can seriously impact the latter. A stark example is the effect of the most recent financial crisis on Eastern Europe, where from 2008 onwards, subsidiaries of Western banks drastically reduced lending, thereby leading to a credit crunch (Popov and Udell 2010). Only the "Vienna Initiative", a coordinated international action on an ad-hoc basis (Pistor 2011) could mitigate these negative effects, showing how vulnerable peripheral countries are to crises in the center[1].

The paper will focus on four of the priority areas of financial regulatory reform the Financial Stability Board has outlined in its most recent address to the Group of 20 (G20): "the Basel capital and liquidity framework; policy measures for global SIFIs;[2] resolution frameworks; and shadow banking" (FSB 2013a, 7). The paper is followed by a brief note on the positive role public development banks could play in steadying financing available for development. The note describes 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, where this is a national priority. Development banks also can finance small and medium-sized enterprises, as well as provide long term funding, e.g. for infrastructure.

The paper proceeds as follows: Section 1 first sets out the regulatory context of current initiatives. Section two assesses 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 it will address "Basel III", and those policies addressing the "too big to fail" problem ("SIFIs" and resolution frameworks) as well as their implementation, asking if and in how far they properly address the main sources of the build-up of systemic risk. It then asks if these policies can ensure that in the next crisis, the banking industry, its shareholders and creditors will have to pay the majority of costs or if the main burden remains with tax-payers. Section 3, Reducing systemic risk from shadow banking analyzes the post-crisis initiatives to limit the dangers from a sector prone to runs (Gorton 2010), whose breakdown has been central to the most recent crisis. The paper will evaluate not only how much progress has been made in terms of actual regulation, but also policy efforts to combat "regulatory arbitrage", which is to say moving financial activities to less-tightly regulated jurisdictions or transforming them into new and less regulated activities, the detection of which is a financial oversight responsibility. Lastly, it looks at the overnight funding market (repo) which is a vital element of the so- called "shadow banking system", pointing to its lacking regulation. In Section 4, the paper takes up the political question of how NGOs and other civil society actors can better influence the technical and generally non-

[1] On the general effect of European banks' deleveraging after the crisis on their lending in emerging markets, s. Feyen and del Mazo 2013.
[2] SIFI= Systemically important financial institution

transparent financial regulation process to limit crises and ensure a fair distribution of their societal costs when they do occur. This is especially important given the heavy anti-regulatory lobbying by the financial industry on behalf of its narrow interests. The paper thus assesses the political economy of regulatory reform and tries 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? The paper concludes with a summary advocacy agenda drawn from the preceding discussions and a call to action.

1. The regulatory context

Market economies cannot function without banks to operate the payments system and provide short-term financing to the economy and yet these institutions have inherent incentives to take excessive risks which interrupt the functioning of market economies. Before they were effectively restrained through regulation, economies would go through periodic banking crises that caused economic recessions, followed by unstable recoveries and renewed crises. As banks increasingly engaged in cross-border activities in the 1960s and 1970s, national regulators became concerned that the stability of their own system increasingly depended on the stability of others, while the banks became concerned that banks from less-tightly regulated countries would have a competitive advantage over them. Hence the Basel Committee on Banking Supervision (BCBS) was established in 1974 and continues to be the central international forum for bank regulation.

However, in the ensuing decades, the non-bank financial system grew to huge size and not only complemented the banks by mobilizing long-term credit and equity finance in an increasing global marketplace, but also came to compete with the banks in intermediating short-term finance through securities transactions ("shadow banking"). While there had long been a measure of international discussion and some harmonization among national non-bank financial regulators (e.g., International Organization of Securities Commissions, International Association of Insurance Supervisors) and within industry associations (e.g., International Capital Markets Association, International Swaps and Derivatives Association), it became clear after the financial crises and near-meltdowns of the late 1990s that there was no overall oversight of the international financial system. To remedy that, the Financial Stability Forum, since 2009, enlarged to become the Financial Stability Board) was created, whose members represent the finance ministries, central banks and main national regulators of the major financial centers, along with the main official international standard-setting bodies (such as BCBS) and the primary international financial organizations (such as the International Monetary Fund).

On the eve of the most recent global financial crisis, this was the institutional structure of global financial system oversight. The government leaders that met as the Group of 8 exerted a measure of political control, but usually did not enter into the details of this highly technical topic. Moreover, in a policy world that had great faith in the rationality of financial markets and distrust of regulation, international policy was relatively passive, focused more on

opening global access to financial markets in developing and transition economies than on protecting those markets and central ones from international instability. That worldview suddenly became obsolete in the fall of 2008, as the world's central financial markets and institutions seized up and the Group of 20, a finance ministers' discussion forum that had been established along with the FSB in the wake of the late 1990s crises, was transformed into the premier leaders' forum for political oversight of global financial reform as well as its rescue.

Manifold initiatives at the national, regional and global level were undertaken to stabilize international financial markets. The objective of these initiatives was to reduce the likelihood of future (banking) crises and make crises, if they were to occur, more manageable for public budgets by shifting the costs of such a crisis to shareholders and bondholders of banks. The most important initiatives in this respect were the revision of the Basel Accord (Basel III), which is the main agreement of the BCBS. In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act were adopted. Equivalent regulatory initiatives were adopted in the European Union, notably those concerning the regulation of derivatives markets under the recently established European Market Infrastructure Regulation (EMIR). There have also been attempts in the United States and United Kingdom at separation of commercial banking from the more risky financial market activities of investment banks and hedge funds. In the UK, ring-fencing of investment and commercial banking activities have been implemented with the Banking Reform Act in December 2013.[3] Moreover, under G20 guidance, the FSB has pursued a more stringent and global regulation of the shadow banking sector.

These initiatives seek to address what were identified as the main shortcomings of the financial system pre-crisis: banks which were too big to fail, overleveraged, under-capitalized and incentivized to take on too much risk (Admati and Hellwig 2013), the "pro-cyclicality" of the financial system as a whole, which made credit easier to obtain in good times and harder to obtain in bad times (Griffith-Jones and Ocampo, 2010; BCBS 2011, 5), aggravated by financial and banking regulation that increasingly based itself on banks' own metrics of risk (Persaud 2010, 151); further problems identified included an over-reliance on short-term funding (Gorton 2010, Perotti 2010) and an increasing complexity and opacity of the financial system (Gai et al 2011), exemplified by the growth of the shadow banking system, which in the crisis had negative spill-over effects on the real banking system (Gorton 2010, Acharya et al. 2013, Gabor 2013).

The Basel reform, to which we turn first, seeks to address these points from the vantage point of coordinated national banking regulation, setting global minimum standards for capital and liquidity requirements for banks. Most of the BCBS measures in Basel III are now in the crucial implementation phase (BCBS 2013a,12 ff), which the financial industry seeks to weaken as detailed implementing rules are written, trying to regain regulatory advantages that it lost in the negotiation phase (Mattli 2013). Full implementation of all measures is supposed to be achieved by 2019.

[3] https://www.gov.uk/government/policies/creating-stronger-and-safer-banks

2. Reducing systemic risk from the banking system

As no market economy can withstand multiple, simultaneous bank failures, especially when the biggest banks are involved, a great deal of attention has been directed to better discouraging banks from taking excessive risks, in particular from excessively borrowing money to lend money (leverage). Banks might well take such risks if confident that they would be bailed out should they run into trouble. Thus, in addition to BCBS reforms to discourage unsafe lending, the FSB has been seeking ways to allow huge banks to go bankrupt without taking the financial system down with them.

Addressing the problems of too much leverage and pro-cyclicality

Research supports the hypothesis that the more leveraged banks are, the greater the probability of excessive risk-taking (Perotti and Martynova 2012). This makes the reduction of excessive leverage in good times one of the primary necessities in creating a more stable financial system (called 'good deleveraging', Feyen and del Mazo 2013) in order to avoid 'bad deleveraging' in crisis times, where deleveraging processes via credit contraction exacerbates the feedback loop between losses, falling bank capital, and shrinking credit availability (BCBS 2013c, 1). The primary regulatory means to forestall excessive leverage has been to require that each bank maintain equity capital equal to or greater than a specified fraction of the bank's total assets outstanding (loans and securities on its books). By raising core capital requirements Basel III does indeed go some way in forcing banks to reduce their leverage. The new requirements will fully come into force in 2019, by when minimum common equity capital (the purest form of core capital) is supposed to reach 4.5% of "risk-weighted" assets.[4] In conjunction with the capital conservation buffer (to be explained below), it will reach 7%. The minimum total capital buffer will reach 10.5% (from 8% in Basel II) in 2019. These numerical changes go hand in hand with changes in the criteria defining what can count as core capital, seeking to increase the reliability of core capital in times of crisis (old instruments are phased out from 2013 until 2023).

Despite being an undeniable progress with respect to Basel II, this increase in core capital requirements should only be seen as a first step in a long battle to raise core capital, a process which needs to be smoothed over time via retained earnings of banks used to increase equity. *How high optimal equity should be is a discussion that should not distract from the fact that it is currently too low and that it needs to be raised beyond Basel III in a stepwise progression* (Admati/ Hellwig 2013 for the most radical proposal, Miles et al 2011). This battle for higher core capital requirements needs to be led on different fronts, not only concerning the capital requirements for risk-weighted assets, but also regarding a new simple "leverage ratio".

Given the large variation in the risk-weighting of assets which was observed among banks before the crisis and can still be observed today (BCBS 2013a, 2), the BCBS regulators

[4] In calculating the risk-weighted total, bank assets that are deemed lowest risk (e.g., loans to major governments) have a weight of about zero and intermediate risk assets are valued at an intermediate discount off face value, while the full face value is counted of high risk assets (e.g., many loans to companies).

introduced a simple leverage ratio in Basel III, which is not dependent on the risk-weighting of assets but simply sets a minimum ratio of the equity of banks to the face value of their assets (loans and securities held). This is a step in the right direction. It may be more difficult for the banks to optimize actual leverage with respect to two measures of leverage at the same time, such that the effect of two measures upon actual bank leverage will be greater than only one. What is important in this respect is that the simple leverage is indeed a binding constraint, not being set too low so that it has no limiting power.

The simple leverage ratio of 3% tier 1 core capital to un-weighted assets, as is currently proposed by the Basel Committee (BCBS 2013c) may be too low in this respect. It is noteworthy that the Federal Reserve Bank has set the US leverage ratio at 4% and is considering the proposal by Fed Governor Daniel Tarullo to raise it to 6% for globally systemically important banks (Onaran and Hamilton 2013, AB+F 2013, Lautenschläger 2013 for a counter-position). This deviation is important because it shows that the most important national banking regulator, the Federal Reserve Bank, sees the measure as too lenient. *There seems to be a strong case therefore, for European banks to also increase the leverage ratio further. An important policy question is the extent to which developing countries should also adopt the leverage ratio in their bank regulations, and what the appropriate level should be.*

Basel III also contains counter-cyclical elements, including rules requiring the maintenance of "capital conservation" and "countercyclical capital" buffers. The capital conservation buffer comes into play when a bank's portfolio of loans grows relatively rapidly so that the bank begins to approach the minimum capital ratio. It then requires that the bank use its profits to rebuild the buffer rather than distribute them to shareholders or as staff bonuses (BCBS 2011, 55), which was not a requirement before 2008. The buffer will apply when the capital ratio enters a range that is 2.5% above the actual minimum allowed. It will be phased in between 2016 and 2019.

In addition to the global conservation buffer, there will be national countercyclical capital buffers, which will be set by authorities in each country according to domestic analyses of the credit cycle (BCBS 2011, 57ff, EU Directive 2013/36/EU paragraph 80, 81 for the European regulation). The intention is to slow the growth of lending during booms by requiring banks to hold additional equity capital at those times – more precisely, to remain further above the core minimum capital ratio – and encourage lending during bad times by reducing the required capital buffer.

A further development with respect to the permitted leverage of banks is important. The Basel Committee is encouraging the development of an accounting standard which allows forward-looking loan loss provisioning (BCBS 2011, 5, Wezel et al. 2012), such that a buffer for loan losses will be accumulated without the need for loan impairments already to have taken place. The introduction of this measure will then lead to greater loan loss provisioning of banks before loan losses occur, increasing the resilience of the system and through the deduction of these funds from equity reducing the amount of equity which banks can operate on. The International Accounting Standards Board (IASB) is currently developing such a standard, to be released in spring 2014. What will be important with respect to the international accounting rule changes is the degree of consistency between the American Accounting Rules

and the International Accounting Rules (regarding current differences in the proposed standards, see Grant Thornton 2013). Differences in accounting rules had been a major impediment to better harmonized prudential regulation before the crisis (Thiemann 2014) and the FSB rightly criticizes the delay in convergence (FSB 2013e, 2).

These measures in particular seek to be counter-cyclical. Allowing national regulators to adjust their capital requirements to national circumstances is a great improvement to the one-size-fits-all for all time approach practiced before the crisis. However, it will be faced with the problem of competitiveness concerns across countries (as in the earliest days of the BCBS) as well as the problem of dampening economic growth spurts. *Therefore, application of these national measures should be monitored by public advocates seeking to press for prudence, especially in boom times.* The financial industry will tend to resist counter-cyclical regulation in good times, as it is making large profits and so will politicians with short-term incentives; therefore public opinion could be an important counterweight regarding the sufficient capitalization of banks in order to deal with cyclical downturns.

Addressing liquidity problems

Regarding the too big reliance on short-term funding before the crisis, Basel III has proposed two new measures, the Liquidity coverage ratio and the Net stable funding ratio. When implemented over 2015-2019, the liquidity coverage ratio will require banks to prove to regulators that they have sufficient liquid assets on hand that they could quickly convert to cash to meet their liabilities for the next 30 days, even in adverse scenarios. In order to do so, banks need to prove the ownership of high quality liquid assets on their balance sheets that they can easily and without much loss liquidate during a crisis. The liquidity coverage ratio can be adjusted in a crisis, which means that banks may go below the 30 day requirement, installing a degree of flexibility in the rules (BCBS 2013b, 1). However, while being a direct and logical tool to lesson a bank's vulnerability to a crisis, it suffers from pro-cyclicality as the costs it imposes upon banks vary during the financial cycle (Perotti and Suarez 2011). That is, banks can boost their holdings of approved liquid assets using borrowed funds. Borrowing costs for banks decrease in a boom phase as the optimistic market imposes small risk premiums on their short-term borrowing. In contrast, in a bust, funding costs increase and thereby opportunity costs for banks that would have to buy and hold additional highly liquid assets. In this respect, an explicit Pigovian tax on short-term borrowing in order to equate private and social liquidity costs for individual banks might be more efficient (ibid, 5). More importantly, the liquidity coverage ratio may only prove efficient in stabilizing financial markets if coupled with the more radical proposal for a net stable funding ratio, which directly tackles the maturity mismatch between liabilities and assets of banks.

The net stable funding ratio (NSFR) is defined as "available funding over required stable funding". The calculation of "required stable funding" is meant to better match the maturity structure of a bank's assets and liabilities to ensure the institution's survival for at least one year from the outbreak of a crisis. On the one hand, this ratio would require banks to reduce their reliance on wholesale short-term finance and would have positive effects on the amount

of equity banks added (Dietrich et al. 2012, quoted in Scalia et al. 2013, 9). On the other hand, the basic financial intermediation function that banks provide converts short-term liabilities (in particular, demand deposits, but increasingly wholesale market borrowing) into a mixture of loans of different maturity. The NSFR could thus lead to fundamental changes in the asset and liability management of banks and in the loan to deposit ratios, as banks could only expand their balance sheets to the degree they had found a source of stable long-term funding to maintain the required maturity match on both sides of the balance sheet. Resistance against the NSFR by the banks has been massive, as it would mean a strong recalibration of banks' business models and profitability. As a consequence of that resistance, coupled with concerns over the potential negative effects on provision of sufficient credit to the economy, there is a question if and in which form the net stable funding ratio will become a binding constraint for banks. The view here is that an appropriate NSFR can be defined that lessens the riskiness of banks while preserving their intermediation function. This may be an important area for advocacy, since it is part of a bigger argument about reducing the scale and complexity of banks. It is straightforward that banks defend their capacity for large scale maturity transformation, refinancing long-term assets with short term funding. The question is if this is socially beneficial, once taking into account the vulnerability of the financial system and crisis dynamics.

While the BCBS approved the liquidity coverage ratio in January 2013, it has scheduled a review of the NSFR for 2013-2014 (BCBS, 2013d). A minimum standard is supposed to be implemented in 2018, but the final shape of that minimum standard cannot yet be predicted. The BCBS hopes to finish the standard in 2014 (BCBS 2013a, 10). *In the end, the Net Stable Funding Ratio is an important policy device to break the reliance on short-term funding of banks and thereby to increase the resilience of the financial system. It needs to be part of a meaningful reform package,* as the Liquidity Coverage Ratio alone is insufficient to achieve these goals (Perotti and Suarez 2011) and its current delay should create concern for all those interested in fundamental financial market reform.

Addressing "too big to fail" (TBTF)

It is widely believed that key governments and central banks had no alternative to bailing out the huge banks in the recent global crisis. It is also widely believed that next time should be different. In this regard, the Financial Stability Board in cooperation with the BCBS has been seeking disincentives to increasing size in banking. One strategy has been to penalize size and the other is to remove the confidence of bankers that they will be bailed out.

Bank debt is indirectly subsidized due to depositor insurance and lender of last resort agreements (Kane 2009), a subsidy that increases with size, favoring an expansion of the balance sheet of banks to reach the too-big-to-fail status (CGFS 2010). As the Financial Stability Board points out, the too-big-to-fail status generates lower funding costs (as failure of such an institution and thus default on its obligations is seen as unlikely) "and adversely affects market discipline, competition, systemic risk and public finances" (FSB 2013b, 23). The Financial Stability Board in conjunction with the BCBS is seeking to make the too-big-to-fail status globally less attractive by adding surcharges to the required capital ratios to take into account the externality costs to taxpayers that have to overcome the failure of "globally

systemic financial institutions" or G-SIFIs (FSB 2013b, 9f). Additional loss absorbency requirements will thus be imposed upon these banks, which they will have to meet with additional common equity tier 1 capital, raising their capital ratios by 1 to 2.5 percentage points according to their systemic importance. The most systemically important banks could be forced to hold a further 1% in order to disincentivize further growth. In November 2012, 28 banks were characterized as G-SIFIs by the FSB, with 4 banks of a size requiring the 2.5% additional surcharge. The additional loss absorbency requirements, however, will only be applied from 2016 onwards to those banks that are identified in November 2014 as globally systemically important due to their interconnectedness and complexity (FSB 2012, 2).

Furthermore, the FSB has developed a bank insolvency resolution regime that is supposed to be a template for national resolution regimes. Globally important banks and other financial institutions need to develop resolution and recovery plans in collaboration with host and home supervisors, called "living wills". They are also subject to more intensive supervision and to higher standards in terms of internal governance (FSB 2011, 1). Besides establishing these measures for G-SIFIs, the FSB has also proposed additional measures for domestically systemically important financial institutions (D-SIFIs), measures which need to be adopted, implemented and enforced domestically.

What has not been addressed to date is the question of systemically important foreign subsidiaries in developing countries, especially those which are neither G-SIFIs nor D-SIFIs in their home country, but may be of systemic importance to the developing countries in which they operate. *The FSB should also envision regulation for such subsidiaries, in order to reduce the probability of a collapse of financial markets in developing countries in case of a crisis in developed countries*, as had been the threat in Eastern Europe during the global financial crisis. Again, this is an area where activity by civil society, including academia and the press, can be very valuable. *Financial stability in developing countries, so important for people living there, must be safeguarded.*

The sobering empirical reality over the course of the last 5 years, however, is that despite the announcements of future surcharges on large institutions and promises that no bank is any longer "too big to fail", the trend towards concentration and growth in the American banking sector continues unabated (Contessi 2010) and there is no visible reduction of concentration in the European Union (ECB 2013), with industry players requesting increased merger activity to solve Europe's problems (Atkins 2013). These trends underline the importance of resolution mechanisms that are effective in crises. We cannot know if the insolvency resolution mechanism will be effective or if the banks will have to again be bailed out. One may thus be concerned that the denomination of systemically important banks and the installation of living wills may create a false sense of security.

As the FSB remarks, these national initiatives, which also include French and German resolution regimes, should further contribute to limit too big to fail (FSB 2013b, 22). But it cannot be assumed that the problem is solved with the current initiatives or that future initiatives will necessarily be forthcoming. In September 2013, the Financial Stability Board wrote: "G-20 Leaders are urged to renew their commitment to addressing TBTF, and the FSB

and other international bodies also need to take further action, with the support of G-20 countries, to end the TBTF problem." (FSB 2013b, 7)

Therefore, *a general reduction in the size of large banking conglomerates and their risk-taking activity may be in order*. For this reason, national initiatives, such as the Volcker rule in the Dodd Frank Act in the US, that seeks to separate proprietary trading from market-making activity by banks[5] or the Vickers Commissions proposal in the UK to "ring fence" certain retail-oriented commercial banks or parts of large bank groups from undertaking investment banking activity are very valuable (Liikanen report 2012, 85f). The final decision on these issues by the European Union has still not been taken, but the high-level expert group of the EU seems to favor the idea of ring-fencing (Liikanen report 2012, 86), which is supported in the proposal on banking structural reform by the EU Commission on 29th of January 2014.

3. Reducing systemic risk from shadow banking

The financial crisis, five years ago, was first and foremost a banking crisis, but policy makers also found themselves offering rescues to non-bank financial institutions, like money market mutual funds. It is not possible today to disentangle buying and selling securities on financial markets from the banking system, especially at the short-run end of the security market spectrum. There, a shadow banking system had formed in which credit was granted and processed by non-banks in a chain of transactions involving Special Purpose Entities, Money Market Funds and Banks (Pozsar et al 2010). Besides the use of these markets by banks to engage in credit-production outside of banking regulation (called the "internal, bank-based shadow banking system", Pozsar et al 2010), other actors such as investment banks have also formed systems of credit intermediation (called the "external shadow banking system", ibid). All of these systems have in common that their close interaction with the banking system created the need for liquidity backstops, first by banks and then by central banks (Claessens and Ratnovski 2014). Thus, the G20 and FSB regulatory agendas have had to address these systems as sources of systemic risk, which in this context meant to seek to limit spill-over effects on banks.

Addressing spill-over dangers

The Financial Stability Board has pointed out that shadow banking poses great potential for an additional supply of credit to the economy, and therefore should not be suppressed. However, it should be ensured that all the risks these entities carry and pose to the financial system as a whole are reflected in risk-provisioning by these actors (for the European attempts to regulate shadow banking on a common basis, see EC 2012).

[5] The rule is expected to be issued in December 2013. In order to simplify the task of separating trading on behalf of clients from proprietary trading, some have suggested that all banks be prohibited from taking positions on their own account and only permit agency trading on behalf of customers. It is as of now difficult to evaluate what consequences such a decision would have on "market-making" activities of banks (in essence, holding inventories of particular securities in order to carry out trades in them).

The reduction of potential direct spill-over effects of shadow banks to banks through what has been called the "bank-based shadow banking system" (Pozsar et al. 2010) can be seen as the greatest success of the regulatory measures regarding shadow banking taken after the crisis. In most jurisdictions, banks can no longer sponsor ABCP conduits and grant them liquidity lines without taking them on their balance sheet and providing for their risks with core capital requirements. Loopholes in the regulation of liquidity such as the non-application of core capital requirements for liquidity lines of less than one year have been eliminated in Basel III. All these changes make the off-balance sheet business of banks less lucrative or impossible, thereby limiting the size of the internal bank-based shadow banking system to a large degree. Given that the direct linkages between banks and shadow banks started the crisis in 2007 (Acharya and Schnabl 2010) it is not a big surprise to see that this channel for transmitting a financial shock from financial markets to banks was largely eliminated.

However, that does not mean that the problems of shadow banking itself have been resolved. One problem for the future is that financial market agents can be expected to react to new regulation by seeking unconstrained new avenues for investment, which will bring about new forms of shadow banking. A focus on activity, rather than form, as envisioned by the FSB will be helpful (FSB 2013c). In this respect, the FSB is also seeking to learn the structural lessons of the last crisis. The need to quickly extend the regulatory perimeter in response to regulatory arbitrage had been vividly demonstrated before the last financial crisis. Recent research has shown that the problems which shadow banking posed to the banking system were partially known well before 2008 (e.g. Jackson et al. 1999), but that in the interim period of 8 years before the crisis only few countries acted upon the information due to national competitiveness concerns (Thiemann 2014). These experiences suggest that the focus on a level playing field (such as in the Regulatory Consistency Assessment Program of the BCBS, see BCBS 2013, 6-9) needs to be supplemented with an analysis of developments at the margin of Basel regulation, an analysis that needs to be followed up by action. Therefore, the FSB has proposed a high-level policy framework for assessing and mitigating systemic risks posed by shadow banking entities and activities. As the FSB describes it,

"By focusing on economic functions (or activities) rather than legal forms, this framework is intended to allow authorities to capture innovations and adaptations that occur at or outside the bounds of bank regulation …, it is expected that the framework will provide a structured process to assess the need for extending the regulatory perimeter." (FSB 2013c, 6f)

What this process will look like is currently unknown. In order to overcome regulatory myopia, it will need triggers for policy action based upon research insights from academia and the concerned public. Annual conferences, seeking the dialogue between these actors on financial market developments from a stability perspective seem to be a possible avenue for such an exchange. The next problem, once these developments are deemed dangerous, is that such policy action is supposed to occur at the national level. There it will again be faced with national competitiveness concerns. In order to overcome these problems, such action should either be taken at the international level or the extent of home country regulation of internationally active banks should be reduced, allowing domestic regulators to regulate activity of all banks operating in their country, not only domestic banks (Pistor 2011,

Thiemann 2014). Such limits on the dominance of home country regulation on host country financial markets would allow countries to move ahead on their own, without fearing for the competitiveness of their banks, at least on domestic grounds. Such a shift would also harmonize well with macro-prudential tools such as loan eligibility criteria and credit growth limits in case of credit booms (Dell'Arricia et al. 2013, 26), which all need to be implemented on a national level, applying to all banks that operate in that country.

A further problem is that the market which has been a vital source of funding for non-banks and banks alike that engaged in shadow banking activities, the repo-market, has not been sufficiently reduced following the crisis. While the fire sales of collateral that Lehman granted in the repo-market before its failure set-off the crisis, the dangers inherent in this market for over-night funding have not been addressed.

Addressing the "repo" market

The market for Sale and Repurchase Agreements (in short, repo markets) is, in effect, a market in which loans are granted against collateral. The loans last from one night up to one year and the collateral is typically government bonds or notes. Repos are large-scale, customized transactions (albeit with a standardized contract), many of which are not centrally cleared. Thus, information about the market is not complete. Banks have been heavy users of repo financing (both bank-to-bank and bank-to-non-bank), but not the exclusive users. Customers in the repo market include institutional money managers, insurance companies, hedge funds, and non-financial corporations that actively manage their cash flow. There are also repo brokers, dealers and multilateral clearing houses (but bilateral clearing remains common). It is usual in a repo for the lender to ask for more collateral than the value of the loan to reduce its risk of loss in case of default. The difference between the value of the collateral and the loan being extended is called the "haircut",based on the perceived riskiness of the borrower and the assets he offers as collateral.

One concern about the repo market, which has not yet been sufficiently addressed, is that it appears to reinforce crisis dynamics (Perotti 2010, Gorton 2010). The haircuts that counterparties demand in order to accept collateral and make the loan are pro-cyclical, "tending to be compressed in the upswing of a cycle as financial institutions become increasingly exuberant" (Gai et al. 2011, 455) and tending to become very large in moments of crisis, leading to liquidity shortfalls of all those institutions relying on the repo-market for financing. In order to deal with the pro-cyclicality of haircuts, the Financial Stability Board is working on proposing minimum haircuts for securities financing transactions by spring 2014 (FSB 2013c: 2), thereby dampening the pro-cyclicality of repos in the upswing. Again, as in the case of the leverage ratio, Governor Tarullo of the Federal Reserve has criticized current proposals by the FSB (FSB 2013f) and come out in favor of much higher requirements (Tarullo 2013).This project is fiercely opposed by industry as it decreases the availability of funding in good times.

Independent of the appropriate size of these minimum haircuts, the proposal of the FSB, does not address the problem of the negative feedback loop in times of crisis, despite the fact that

the specter of "fire sales" remains an issue for regulators (Garcia 2012, Perotti 2012). That is, counterparties in repo-markets do not seek to hold the collateral they would take ownership of on default, but rather will seek to immediately sell it if the borrower goes bankrupt. This implies that counterparties pay close attention to changes in the market prices of the securities offered as collateral. Therefore, in a moment of crisis, often characterized by declines of asset prizes, they will increase haircuts on new loans, offering less cash to the borrowers. This puts pressure on the borrowers, leads to worsening liquidity shortages, possibly ending in bankruptcy. In case of bankruptcy, counterparties will flood the market with these assets, leading to further price declines. This self-reinforcing disastrous feedback-loop is even facilitated by a clause in repo contracts, known as the 'safe harbor' clause which, exempts collateral from bankruptcy proceedings (Perotti 2010). Whereas common lenders have their claims frozen in case of borrower bankruptcy until the bankruptcy proceedings are finished, those to whom collateral has been pledged "jump the queue" (ibid), immediately seize full ownership of the pledged collateral and sell it.

In 2012, the Financial Stability Board summarized it thus:

"Since the financial crisis, a number of academics have argued that the "safe harbour" status of repos may in fact increase systemic risk, because it can: (i) increase the "money-likeness" of repos and result in a rapid growth in cheap and potentially unstable short-term funding; (ii) facilitate the fire sales of collateral upon default; and (iii) reduce creditors' incentives to monitor the credit quality of repo counterparties." (FSB 2012, 25)

But while the FSB admits that these considerations and options developed to deal with this problem make sense theoretically, the FSB points out that their implementation would be too difficult, which is why the FSB stopped to further pursue the idea of altering the standard "safe harbor" clause. The argument of the difficulty of implementation rather points more to the amount of opposition than technical difficulties. This defeat is an important drawback for any attempt to reduce the dangers that emanate from the repo-market onto the financial system as a whole. It reflects the fact that the "moneyness" of repos that allows an expansion of credit in good times is highly valued by bankers and politicians alike. Again, the challenge is to recognize the pro-cyclical nature of such benefits (Gabor 2013).

But there are still some other initiatives to reduce the dangers stemming from the repo-market. The FSB has announced that it will

"develop proposals for contractual or statutory approaches to prevent large-scale early termination of financial contracts. …G-20 authorities can encourage ISDA [International Swaps and Derivatives Association] and other industry bodies to review contract provisions to prevent large-scale early termination of financial contracts." (FSB 2013b, 15f)

This initiative, which is still very vague, directly addresses the dangers of safe harbor and should be supported, as it is very likely to encounter large-scale resistance. In addition, regulators need more knowledge about the repo-market, in particular the bilateral repo market, a market of $3 to 5 trillion, where the lack of custodians leads to dangerous data gaps (Mackenzie and Alloway 2013). In this respect, the data initiative by the FSB (FSB 2013b,

19) is of major importance to grant regulators the knowledge that must lie at the basis of any fruitful intervention in the repo-market.

Though these issues are quite technical, involvement by the public is important, as repos have a large potential impact on financial stability, installing, due to their set-up, fragility at the heart of financial systems.

4. The political economy of regulatory reform

It must be clear at this point that financial regulation is highly technical. And yet there is strong public interest that it is done in the public and not the private interest. Regulation is a political process and advocacy for the public interest needs to confront advocacy for the interest of the financial industry. This section thus asks how civil society and organized public advocacy organizations in particular might influence the policy process to get the changes they want. And how can they place the changes which are desirable from a sustainable and inclusive growth perspective, as well as financial stability, at the core of the reform process?

Before we directly address these questions, we would like to point out a nascent but potentially powerful new way of thinking about financial markets. The belief in the "efficiency of financial markets" and the "light touch" regulation it inspired have increasingly been challenged, both theoretically and by practitioners, in the light of the global financial crisis. The experience of such pervasive and deep market failures makes the case for strong financial regulation much clearer. Furthermore, a new policy paradigm of "macro-prudential" or "counter-cyclical" regulation and supervision has gained sudden popularity. This policy paradigm has at its heart the idea of inherent financial cycles in market economies, i.e., the inherent pro-cyclicality of financial markets (Borio 2012; Kindleberger, 1978, Griffith-Jones and Ocampo, 2010, Ocampo, 2003). It also appreciates the occurrence of "herding behavior" of investors in financial markets, possibly reinforced by regulations that have allowed banks to base their capital ratios on internal models of risk exposure that quickly signal the need for more capital or less exposure to an asset deemed more risky as its price falls (Persaud 2000). It thus argues for the need to see financial regulation within the context of regulation of the system as a whole, rather than the regulation of financial institutions alone. This policy paradigm implies a critical evaluation of various financial practices and may lead to the taxation, regulation or even prohibition of such practices when their effects are deemed negative on society as a whole. Despite these advances, macro-prudential policy making is in no way a completed project and may well take a few decades to be accepted and then fully implemented.

Meanwhile, scholars concerned with financial market resilience are convinced that higher core capital requirements for large international banks are necessary in order to increase the potential in the financial industry to bear losses, so as not to resort to tax payer money (Hellwig and Admati 2013) or possibly even splitting up banks and making them smaller and thus more controllable (Liikanen-report 2012). Although not explicitly counter-cyclical, a world of better capitalized big banks or a world of smaller banks could moderate a financial bust by seeing fewer large institutions fail in the downswing or reducing the impact of failures, thereby making market shake-outs possible. But even these measures face opposition

from banks as well as short-term oriented politicians. Furthermore, these measures are vulnerable to industry lobbyists' arguments, as there is only a limited amount of knowledge concerning the effects of such policy measures (Baker 2013, although there is some data regarding the experiences of developing countries that have raised capital requirements, Dell'Arricia et al. 2013, 24). This information environment empowers private sector actors to push back against, for example, higher core capital requirements, threatening possible unintended consequences such as a credit crunch (Admati and Hellwig 2013 for a critical discussion of these arguments). On the other hand, some regulators have expressed their dismay at low equity charges in the Basel III process attributable to private sector pressure (Turner 2011; Miles et al. 2010, quoted in Baker 2013, 131).

The initiatives for regulation which takes the system wide consequences of individual action more into account as well as considers the interplay of markets and financial agents in times of crises deserve support from the informed public, such as non-governmental organizations (NGOs), but the question remains how can NGOs most effectively support this movement? In the following discussion we base ourselves upon a conceptualisation of the regulatory process as a five stage process (agenda-setting, negotiation, implementation, monitoring and enforcement[6]) linked to an organized set of actors at each stage[7] and we review possibilities for NGOs and other civil society actors to exert influence at each stage.

Agenda Setting

How can civil society ensure that rigorous and macro-prudential policies stay on the agenda? The first part must be the production of knowledge to counter unfounded claims of the detrimental impact rigorous and macro-prudential policies would have on the economy. The production of this counter-expertise needs to be organized in alliance with those scholars who are involved with the macro-prudential paradigm, and more broadly see financial markets as having key market failures that need correcting via regulation and taxation. A second task, which can be undertaken in conjunction with specialized organizations, such as Finance Watch, or academic and political think tanks such as the Center for Sustainable Architecture for Finance in Europe in Frankfurt, is the dissemination of macro-prudential thinking and other measures that seek to reduce financial fragility in order to bolster the change in the intellectual climate and to push back the ideology which seeks to simply equate the interests of the financial industry with those of society as a whole. Organized interests in the financial industry are working to reverse the pro-regulation intellectual climate in order to limit the negative impact on their short-term profitability. These attempts to reshape public opinion need to be opposed.

Second, it is remarkable that many of the problems that materialized during the crisis were already well understood before. One example is the recognition of the development of the bank-based shadow banking system before the crisis. In the first working paper of the Bank for International Settlements, the danger of the bank-based shadow banking system, , is well

[6] Abbott and Snidal 2009: 46

[7] This is a conceptual distinction, but as will be seen, these different stages of the process interweave with each other.

described (Jackson et al. 1999, also Jones 2000). Another early warning was the critique of internal risk management regimes used in Basel II for calculating minimum capital requirements, for example, by Timothy Geithner (2004), who then headed the New York Fed. Some of these sources also refer to the opposition to regulation and the lack of political will at that time to do something about it (esp. Jones 2000). If policy-makers had picked up these texts, including their own analysis of the risks, and sought to place the problems they raised on the agenda, requesting answers about how the problems raised would be tackled, much harm could have been prevented.

These findings point to the possibility of inconsistencies between knowledge and action by regulators who encounter political resistance. Civil society advocates could identify critical analyses and evaluations of financial innovation by the regulatory community and hold regulators accountable if there is a lack of action. It would be best if this was not mainly undertaken by individual NGOs; rather pooling resources and expertise seems to be a meaningful path forward. NGOs could support think tanks and financial advocacy groups such as "Finance Watch", as well as academics, to undertake these tasks, as well as doing some work themselves.

Negotiation of legislation

Regarding measures which are currently under negotiation, such as the European Resolution Regimes, it is important to note that the financial industry is not a hegemonic block, but instead often is divided. Advocates for the public interest should form pro-change alliances with those parts of the financial industry which would stand to benefit from such measures; e.g. measures that make the too-big-to-fail status less attractive are of interest to smaller banks. Similarly, measures to encourage greater lending by both public and private banks could forge important alliances, for example, with associations supporting small and medium-sized enterprises. Research shows that pro-change alliances that include industry and civil society are more likely to succeed and therefore the creation of "unconventional" alliances is a tool worth considering.[8]

Drafting rules for implementation

In the implementation phase, regulators issue "exposure drafts" and seek input from interested parties on the impact of the proposed rules on the industry and on the public interest. It is important that at this point voices of civil society and think tanks are heard to push for the most radical propositions in order to open up a space for debate in which societal and industry interests can be reconciled,[9] reminding the regulators of the initial goals that the legislature meant to achieve in the negotiation period, and the current short-comings with respect to these goals. NGOs can also push for proposals at the BCBS and the Financial Stability Board through workshops they organize on these matters, as well as by responding to requests for comment from stakeholders on policy proposals via public consultation (FSB 2013a, 9). Linking up with regulators (and more broadly with policy-makers) from developing countries,

[8] Mattli 2013, 2

[9] For example, in the context of this paper, the net stable funding ratio, ring-fencing, limitation of trading activities of banks, minimum haircut proposals for securities financing transactions

especially those participating in the FSB and Basle Committee, may be a fruitful avenue for promoting regulation that supports both financial stability and inclusive growth.

Monitoring and Enforcement

An effective system is needed for monitoring compliance with the new rules and enforcing these rules. In this respect it is remarkable that proposals by the Financial Stability Board (FSB 2013b, 18f) for enhanced supervision have not yet received the required financial resources. A recent Financial Sector Assessment Program by the International Monetary Fund shows that only 25% of FSB jurisdictions are fully compliant with regulator independence and resources for adequate monitoring of financial markets, with 50% largely compliant (ibid, 5). Again, anti-regulation lobbying by the financial sector and possibly captured politicians may have contributed significantly to undermine funding and implementing such initiatives. Given the new tasks that are about to start to monitor globally systemic banks and other financial institutions, the financial resources need to be provided. Civil society may also push for this aspect of financial regulation, which is less attractive in terms of public relations, but is really essential for financial regulation to work.

There is an additional noteworthy element to the monitoring and enforcement of the new rules, which is based on the discretionary nature of many of the macro-prudential measures that have been or are about to be installed. Policy tools such as the countercyclical credit buffers have to be triggered by national authorities. Making such a decision will test the independence of national regulators against an opposition of banks and politicians who will want to delay policies that discourage lending growth. There is a need for civil society groups to pressure regulators to trigger macro-prudential measures when the provision of credit starts to grow too quickly. Public pressure may make it easier for regulators to act and NGOs may be the actors to bring it about. Again, counter-expertise may be crucial here, as the financial industry may argue that current trends are in line with the underlying growth potential of the economy and contrary arguments may benefit from economic expertise.

In summary, civil society should support the production of macro-prudential knowledge, and other knowledge leading to a functional financial sector that serves and does not undermine the real economy, and disseminate this knowledge to influence agenda-setting. It should also hold regulators accountable if there is a lack of action given a diagnosed danger. In the negotiation and implementation phase, NGO's should push for the most stringent macro-prudential requirements and ally with those members of the financial industry and the non-financial companies, as well as actors such as trade unions, which would stand to benefit from these rules. A self-evident but often neglected aspect is the proper financing of regulatory agencies to ensure good monitoring and enforcement of rules, which is why civil society should support higher funding for the supervision and monitoring activities of regulators. In addition, given the discretionary national elements of macro-prudential policies, somebody needs to monitor regulators, as they may be biased towards inaction.

5. Conclusion: an advocacy program

The privatization of gains and socialization of losses by the financial sector needs to be stopped. Therefore, we need changes which make it possible in the future to let large banks fail, without endangering the real economy, and to let creditors and shareholders bear the maximum amount of the costs of failure. Secondly, we need a financial system which is more resilient and less cyclical. Therefore, we need a higher ratio of equity to financial assets in the banking system and a set of macro-prudential policies which dampen the boom and bust phases of the financial cycle. Third, we need to end the overly large reliance of banks and other financial intermediaries on short-term financing from the wholesale financial market, in order to further strengthen the resilience of the financial system and to dampen the volatility of the availability of credit. Therefore, we need policies to discourage banks from relying so heavily on this type of funding, which would include a required minimum "haircut" on collateral for sale and repurchasing agreements (repos), as well as a "net stable funding ratio", an end to the special treatment of collateral when repo borrowers go bankrupt.

It is important to note that the formulation and implementation of policies has not yet come to an end. As the FSB states, "FSB Members are continuing to review the need for further national policy initiatives in light of (i) the continued growth of many TBTF firms in relation to the size of the financial system, (ii) concerns about dependence on short-term wholesale funding and increased secured borrowing at banks and non-banks." (FSB 2013b, 22) All of the policy decisions in table 1 go into the direction of limiting the TBTF problem, the dependence on short-term wholesale funding and increased collateralization the FSB is concerned about, yet none of them is certain at the moment. Therefore intervention by civil society actors can make a difference in pushing regulation in this direction.

Table 1: Potential Sites of Regulatory Policy-Intervention

Policy goals	**Policy measures**	**Problem**	**Potential Role of civil society**
Reduce reliance on short-term funding	Net stable funding ratio	Under review	Push for a stringent NSFR
	Minimum haircut proposal for repos	In development, large resistance by industry leads to measures that are seen as too weak (FSB 2013f, Tarullo 2013)	Push for more demanding measures (Tarullo 2013),
	reduction of 'safe harbor' bankruptcy exemptions for collateral	On hold, stopped by industry resistance	Put it back on the agenda,
Eliminate too-big to fail	Establish core capital surcharges that reduce leverage and profitability for large banks, making size less attractive	Measures have not yet produced a reduction in balance sheet sizes	Demand larger surcharges, there is no economic evidence for efficiency gains in large scale banking
Separate more speculative and basic banking	Ring-fence investment banking and commercial banking	Under debate, eg Vickers and Likaanen report	Support strong versions being implemented
Make the financial system more resilient and less pro-cyclical	Increase equity in the banking system by recalibrating capital adequacy for risk-weighted assets and simple leverage ratio	Basel III a first step in a long process, simple leverage ratio seems to low	Request higher core capital charges and a simple leverage ratio that is smaller
	Curb credit booms (e.g. increase capital requirements in booms), as credit booms are a good indicator of ensuing financial instability (Schularick and Taylor 2012, 1045)	Calibration phase, national or regional-level decisions (embedded in the EU framework)	Side with voices of prudence that seek to limit excessive credit booms (beyond average credit growth over a sustained period).
	Dynamic Loan Loss Provisioning	Under discussion at IASB and FASB, which will result in different standards for US and other banks	Make sure that differences between IASB and FASB do not prevent effective and counter-cyclical loan loss provisioning

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Policy Note: The case for development banks

In recent years, specifically, since the 2007/8 crisis, the value of development banks, both nationally and internationally, to help implement and finance development strategies and visions (by funding both the public and private sector) has received greater support. It is also interesting that the role of development banks has not just been highlighted as important in developing and emerging economies, but also in developed ones. In particular, the European Investment Bank (EIB) has played a prominent role in the provision of liquidity and long-term financing during the European debt crisis, as private lending fell. It has just had its paid-in capital doubled, as European Union countries contributed an additional Euro 10 billion of capital to allow it to increase lending further, as proposed in Griffith-Jones and Kollatz (2012).

At a national European level, Germany's public development bank, KfW, now the second largest commercial German bank, has played a very positive role in increasing lending counter-cyclically – for example, to small and medium-sized enterprises – during the crisis, as well as funding on a significant scale key sectors, such as investment in renewable energy production. In many developing countries, like Brazil, (BNDES), China and India, but also countries from South Korea to Chile, development banks have played a role at the national level in providing counter-cyclical financing during the crisis, as well as supporting long term development strategies. Indeed, Brei and Schlarek (2013) provide robust empirical evidence (based on data for 764 major banks in 50 countries for the 1994-2009 period, that government owned banks increase lending, during crises, relative to normal time, while private banks reduce lending.

There are thus four valuable functions that seem crucial for national, regional and multilateral development banks: a) providing counter-cyclical finance, when private flows fall, especially for supporting investment; this long term finance supplements the liquidity provided by public institutions like the IMF or Central Banks b) supporting productive development, within a vision of national development; much of the East Asian development was initially funded in strategic sectors by public development banks c) mobilizing broader resources, for example by leverage and blending[10] and d) financing public goods, such as mitigation and adaptation to climate change. Here the role of development banks, for example in funding renewable energy investment can be crucial (see Spratt, Griffith-Jones and Ocampo, 2013, for a detailed discussion of different roles that international development banks, such as the World Bank, can play in catalyzing investment in renewable energy in low-income countries; such investment will be most effective, if coordinated with national development banks).

Finally, development banks in capital-importing developing countries could provide a vehicle to absorb some of the excess savings that exist in other parts of the world. Such funds could be transferred in a way that is long-term and predictable rather than short-term and volatile.

[10] As a case in point, the paid-in capital of the EIB is being increased by Euro 10 billion; this will allow an increase of at least Euro 60 billion of EIB lending from funds raised on the capital markets and as there will be private co-financing, e.g. via commercial banks or via investors, this will lead to total additional financing of at least Euro 120 billion, implying a leverage of 12 for the public funds allocated as paid-in capital.

This could help reduce the negative impacts on developing countries of the volatility of international private sector financing. Counter-cyclical development bank expenditure in developing countries could thus help compensate for the volatility of private sector flows.

In other words, a well-designed financial system needs good public development banks to provide counter-cyclical finance, but also to provide long-term funding in normal times, as well as finance for small and medium-sized enterprises, where and when they are insufficiently financed by private banks. It is also crucial to help finance investment in the green economy, especially where important externalities are not reflected in commercial returns.

Incomplete financial and banking markets or gaps need to be filled by public development banks. Where the invisible hand does not work or even exist, the visible hand must act, to provide necessary funding to the real economy; an important pre-condition is that it should do so efficiently. Civil society should lobby for the establishment of such banks where they do not already exist, as in Greece and Ireland, and in the UK (where the Labour party is proposing a British Investment Bank), as well as in many developing countries; NGOs should lobby for expanding and improving them in countries where they are too small or not effective enough. This is a positive agenda, which is not sufficiently emphasized by progressive economists and NGOs and it needs to be stressed far more; which complements the also important need to properly regulate the private financial sector so it does no harm to the rest of the economy, which is the focus of the main paper. We will return in greater depth in a future paper to the important issue of development banks.

Therefore, development banks have a key role to play in a new financial architecture, both national, regionally and multilaterally.

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