Remaining Challenges in Strengthening Financial Systems

A View from Across the Atlantic

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Road Map

- Weaknesses revealed by the crisis
- G-20 key areas of reform
- Summary of reform progress so far (not good)
- US – some details and issues
- Europe – some details and issues
- Sum up

Take-Aways

- Reform efforts slow in US and dangerously slow in Europe.
- In US, financial system needs further strengthening and reforms.
- Dodd-Frank addresses some but not all crisis-related weaknesses and implementation very slow and incomplete.
- Moreover, need for re-thinking SIFIs benefits vs. costs.

Take Aways (continued)

- In Europe, financial system still fragile.
- Good ideas for, and some agreement on need for elements of European banking union:
  - Single supervisor (ECB)
  - ESM with conditional, direct bank recapitalization
  - Ultimately, a European resolution mechanism (or institution) with bail-ins to safeguard taxpayer
  - Harmonization of deposit (liability) insurance
- But, banking union slowed by national interests and politics (on recapitalization, on ESM, on single supervision, etc.).
- Who will lead Europe to European solutions?

What Went Wrong? Pre-Crisis Global Financial Architecture

Lines of defense	Sources of cross-border systemic risk			
	Global financial institutions	Global markets	Unregulated financial activities	Economic and financial policy mistakes
Market discipline and transparency	Partial	Primarily	Exclusively	Committee structures; peer pressure; lack of clarity and transparency
Financial regulation	National orientation with international cooperation on capital requirements	No formal regulation	No regulation	No explicit framework and ineffective coordination and cooperation
Microprudential supervision	National orientation with cooperation on best practices via Basel process	Not applicable	No supervision	International cooperation proved inadequate to supervise systemically important financial institutions
Macroprudential supervision	If systemically important	National market surveillance; IMF multilateral surveillance; FSF vulnerabilities discussions	Some via surveillance of national markets and financial institutions	National authorities and international cooperation failed to adjust macroeconomic and supervisory policies in advance of systemic pressures
Crises management and resolution	National legislation and orientation	National focus with some central bank cooperation and coordination	No framework	No framework and ineffective cooperation and coordination

G-20 for Reform Agenda

- Capital, liquidity, leverage and systemic-risk taxes
- Perimeters of financial regulation, supervision, and infrastructures
- Global money and financial markets
- SIFIs and the TBTF problem
- Crisis management, rescue and resolution
- Effective management of volatile capital flows

Where are we now?

- Reform efforts under way, but implementation incomplete and very slow.
- Basel III in limbo – too complex to implement – and delayed until 2019.
- US Dodd-Frank reforms in progress but too much delegated to regulators
- Euro Area finance fragile and needing reforms – especially with coming US QE phase-out
- Emerging markets under stress with outflows
- Dis-integration and de-globalization of finance

Dodd-Frank (DF) legislation addresses many weaknesses revealed by the crisis

- More restrictive capital, liquidity, and leverage regulations slated for 2019(!??).
- Prevents FED from using ‘unusal and exigent’ powers to rescue banks (as it did with AIG)
- Creates an ‘Orderly Liquidation Authority’ (OLA) to improve prospects for orderly resolutions of FIs.
- Enhances FDIC authority to resolve failing FIs via OLA
- Tighter regulation of OTC derivative markets
- Rationalizes the plethora of US regulators, for example by designating FED as SIFI supervisor
- Establishes macroprudential ‘Financial Stability Oversight Council’ for assessing systemic risks

But DF implementation slow

- DF delegated much of the reform to regulators (Fed, SEC, CFTC, others) that were arguably previously somewhat captured by financial industry.
- Volcker quoted as seeing DF implementation only half way completed some 3 years after enactment.
- Two measures of slow implementation:
  - As of early June 2013, 279 Dodd-Frank rulemaking requirement deadlines have passed. Almost two-thirds of these 279 deadlines (62.7%) have been missed! That is only 104 of 279 rulemaking requirements (or 37.3%) have been met on time with finalized rules.
  - Only 153 of 398 of the total required rulemakings (38.4%) have been finalized, while 128 (32.2%) rulemaking requirements have not yet even been proposed.

Main Problem: DF underwrites a SIFI status quo

- DF’s approach maintains the status quo of financial conglomeration, complexity, size, and inter-linkages – namely SIFIs and GSIFIs – and tries to impose more stringent regulations
- Outcome so far: US SIFIS and GSIFIs are now larger and more dominant, and systemic risk may not have diminished as desired.
- And: No reform of Fannie Mae/Freddie Mac – a major cause of the US crisis.

Will DF survive criticism?

- Volcker rule is not seen as enough for dealing with SIFI conglomeration and risk taking
- Congressional legislation being considered to separate SIFIs into separate specialized businesses
- Strong SIFI lobbying is delaying progress on reform of highly systemic interbank OTC derivative markets – repos, swaps, cds.

Bottom Line on DF

- Has not reduced size, complexity, and inter-linkages of SIFIs
- Has not reduced systemic risk potential
- OTC derivatives markets still source of potential systemic liquidity events
- Capital, Liquidity, and Leverage regulations have not yet been implemented and are slated for 2019 – as is Basel III
- Not yet clear it will prevent the next crisis; And may even contribute to the next crisis

European Reform Efforts
(brief overview)

- Banking union ‘first-best’ framework ensuring <u>Euro-Area</u> financial stability;
- Europe finance now a Nash-Cournot situation, implying banking union most likely a long way off;
- Moreover, banking union not a solution for current fragility/instability in European finance.
- Interim solutions are possible, however.
- Meanwhile, ECB central supervision could challenge fiscal sovereignty if supervision is effective.
- More focus on ‘who-does-what’, than on the ‘what’ – which is more important.
- Euro-area reforms should be mindful that finance is global.

Summary of Current Situation

- Agreement (Council Regulation) on central supervision at the ECB, but Parliament(s) want more power on appointment/dismissal of the Chair/Vice Chair of Supervisory Board. Passage of regulation expected in September 2013.
- Political agreement on a single resolution authority and a Directive expected this year.
- Bank resolution Directive is pending Ministers of Finance negotiations over national creditor-bail-in policy flexibility.
- No significant progress on the funding of resolution and the level of mutualization of losses, which is likely to be minimal.
- No political agreement on common deposit insurance; only harmonization is likely.

Alternative Interim Solutions?

- Yes, many.
- Example: Intermediate stabilizing solution could still be in place by end-2014 if
  - ECB becomes single supervisor as envisioned
  - Politicians create a more flexible and larger ESM capable of funding bank rescue and resolution
  - Fragile countries sign up for conditional ESM credit line with ECB-OMT liquidity backing

Stability vs. Sovereignty

- Sequencing: Banking union without greater fiscal union is fraught with political difficulties.
- Consider:
  - ECB as single supervisor declares a large French or German bank as not viable (or insolvent)
  - Bank will require rescue and resolution funding
  - ECB in effect imposes fiscal cost on bank's home/host countries
  - Will ECB be able to maintain independence of judgment?
- Solution: Move to fiscal integration or fiscal union more quickly.

‘What’ is more important than ‘Who’

- Too much focus on Who does What – ECB vs National authorities.
- Greater focus necessary on establishing more effective supervision:
  - For supervising domestic financial activities
  - For supervising cross-border activities
  - For assessing Euro-area sources of financial systemic risks and vulnerabilities
  - For assessing liquidity vs. solvency conditions
- The US and the UK need to do this too.

Finance is global

- Euro area is not operating in a vacuum.
- US and UK have regulatory reforms underway, though incomplete and uncertain final outcome .
- Euro area reforms should be mindful of reforms elsewhere or risk:
  - Loss of global competitiveness (but to achieve greater stability)
  - Migration of risks to least regulated environment, with implications for global systemic risks

Need for Global Reforms

- Legal/enforceable cross-border surveillance mechanisms for encouraging macro-economic and macro-prudential policies to prevent crises
- Legal/enforceable crisis management and resolution mechanisms for dealing with cross-border stability problems;
- Bigger and broader global financing mechanisms (a global balance sheet) with clear ex-ante burden sharing mechanisms to support crisis rescue, management, and resolution – more highly empowered/independent IMF, WB, and WTO.
- Europe is a microcosm of these global challenges and could lead the way if banking union is successful.

Impediments to Global Reforms

- Current state of economies and financial systems.
- Narrow policy focus on entrenched national economic and political interests.
- Perpetuation of strong financial lobbying pressures (or legal forms of ‘corruption’).
- Lack of global leadership by advanced-country heads of state.

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