The New Global Financial Regulation

Laura Tyson, S.K. and Angela Chan
Haas School of Business
University of California at Berkeley

Significant regulatory and institutional changes in financial markets often result from the lessons learned from financial crises. The Federal Reserve was established in 1913 in response to the lessons learned from the panic of 1907. The introduction of bank deposit insurance and the creation of the SEC and modern securities regulation were the result of the lessons learned from 1929 stock market crash and the runs on banks that followed. The International Monetary Fund and the World Bank were established in response to the lessons learned from the global financial market collapse and the collapse of trade and global production during the Great Depression of the 1930s. More recently, Japan overhauled its banking and securities regulations in response to the lessons learned from its 1990s banking crisis. Now in keeping with history, nations around the world are re-examining and reforming their regulatory systems and rules for financial markets in response to the lessons learned from the great credit crisis of 2008-2009.

The Lesson is Clear

Although the crisis had many causes, inadequate regulation and gaps in regulation were among the most significant. The lesson is clear: individual nations must bolster the supervision and regulation of their financial institutions and financial markets. Some regulations, like liquidity and capital requirements for banks and non-bank financial institutions, must be strengthened and off-balance sheet transactions to avoid such requirements must be eliminated. The Obama Administration has proposed that new authority be given to the Federal Reserve to supervise both banks and non-bank financial institutions that are big enough and interconnected enough to pose a threat to financial stability. The Obama plan also calls for higher capital requirements for all financial firms, including those that have not been subject to such requirements before. According to the plan, firms judged to be large enough and interconnected enough to pose systemic market risk would be subject to even higher capital requirements. Some critics have argued that this approach is insufficient and that firms judged to be too big or too interconnected to fail should be declared too big to exist and should be broken up into smaller firms. Similar proposals for tougher supervision and higher capital requirements related to size and risk and similar questions about how to regulate firms that are too big to fail are being discussed in Europe as well.

In both the US and Europe, there is also agreement on the need for a new macro prudential regulator charged with the responsibility of monitoring systemic risk. The EU has announced the creation of a new EU risk council of national regulators to be chaired by the European Central Bank, with input from national central banks and national regulatory agencies. The council will be charged with monitoring systemic risk, providing early warnings and making policy recommendations. But policy making power will reside at the national level. The Obama proposal also relies on a new council of regulators chaired by the Treasury to identify emerging systemic risk and improve interagency cooperation in policy making to reduce such risk when necessary. Policy making power will reside with the regulatory institutions that are represented in the council.

Policy makers on both sides of the Atlantic and throughout the G20 also concur that national regulation should be extended to non-bank financial institutions and new financial instruments that have not been regulated before.

Between 2002 and 2008, both capital under management in unregulated financial institutions like hedge funds and new financial products like credit default swaps, CDOs and other complex derivative products exploded in size and global reach. As a result of these developments, a significant and growing share of global credit markets was not subject to transparent reporting requirements and regulatory supervision. By 2007, unregulated non-bank financial institutions – so-called shadow banks – accounted for about half of the US credit market.

The Obama plan addresses the resulting gap in regulation in several ways: by giving the Federal Reserve supervisory authority over all firms that could pose a threat to financial stability; by establishing capital and prudential standards for all financial firms; by regulating all over the counter derivatives; by requiring that both issuers and originators retain an interest in securitized loans; and by requiring advisers of hedge funds and other private pools of capital to register with the SEC. Even this comprehensive set of proposals may not go far enough. For example, the Obama plan requires issuers to retain only a 5 % interest in the securitized assets they create, and this is not likely to be sufficient to deter the issuance of risky assets because of the huge financial returns enjoyed by the issuers. Many critics believe that the proposed regulations for credit default swaps are also too weak, arguing that such instruments should be tightly regulated and that their exemption from anti-gambling laws should be removed. Although the Obama plan requires standard over-the-counter derivatives to be traded on an exchange, it only requires that a clearing house be established for customized one-of-a-kind derivatives and credit default swaps and it does not attempt to diminish their use.

Greater Coordination needed

Another dramatic lesson of the global financial crisis is the interdependence of national and regional capital markets and the need for greater coordination and consistency in the national regulation of global financial companies. There were global systems for coordination in place before the crisis, for example, the Basel Committee and the Financial Stability Forum. But these systems had gaps, inadequate standards, weak compliance and no sanctions for countries whose national regulatory practices failed to comply with global standards. In the aftermath of the crisis, some observers are calling for the creation of a new World Financial Organization. The WFO would establish global principles for supervision and regulation, would use independent experts to assess national compliance with these principles, and would have the right to impose sanctions on countries that failed to comply. Since most G20 members are reluctant to cede their regulatory powers to a global organization and since there is disagreement about appropriate regulatory principles and practices, it is highly unlikely that a WFO will be created in the foreseeable future. In the meantime, the G20 has agreed in principle that the newly established Financial Stability Board should establish acceptable regulatory standards in a variety of areas and that the IMF should be given authority to assess whether national policies meet these standards. In the absence of common standards, global financial institutions will engage in regulatory arbitrage to find the weakest national regulators. In reaction to the global consequences of the unilateral decision by the US government to allow Lehman's bankruptcy, many G20 nations are also calling for a global agreement on processes to seize and wind down large non-bank financial institutions whose failures pose global systemic risk. The Obama plan proposes a US workout process for non-bank financial institutions patterned on the powers the FDIC already has to seize, work out and close down troubled banks. But the Obama plan is a national rather than a global one. So far, there has been little discussion of a global workout process or a method for making national workout processes consistent. As the head of the Bank of England recently quipped, we live in a world in which global financial institutions are global in life but national in death. Unfortunately, as the Lehman case demonstrates, a national death can have global consequences.

Although regulatory gaps and failures were clearly significant causes of the global financial crisis, they were not the only causes. A growing global savings glut in search of investments with higher yield also fueled the crisis. Indeed, the savings glut was a necessary albeit not a sufficient factor behind the crisis. Large current account surpluses in China, Japan, the Middle East and Germany reflected an excess of domestic saving over domestic investment. The excess savings were invested primarily in US financial assets, keeping US interest rates and global interest rates low, providing inexpensive loans to the US government and US households and funding a large and growing US current account deficit. To fuel their export-driven growth, the surplus countries relied on the US to borrow and spend irresponsibly. In the words of Martin Wolf, global growth depended on the US economy spending itself toward bankruptcy to provide adequate demand for global output. The savings glut reflected policy decisions in many emerging market economies to maintain undervalued exchange rates to promote the production of tradable goods and services. The expansionary monetary and fiscal policies in the US supported the demand necessary to absorb the savings and exports of the surplus countries. The policy decisions of both the surplus and deficit countries fueled the savings glut and the unsustainable macroeconomic imbalances that resulted.

The macroeconomic lesson of the global financial crisis is the need to strengthen the authority of the International Monetary Fund to monitor the macro policies of individual countries, including their exchange rate policies, and to recommend coordinated policies by individual countries to reduce global imbalances. A related lesson is that the IMF must have additional resources and streamlined procedures to provide emerging market economies with both emergency liquidity and longer term loans quickly and without stigma to borrowing nations. In the absence of adequate resources and generous lending facilities at the IMF, many emerging market economies have built large current account surpluses and reserves to shield themselves from the risks of sudden declines in private capital flows such as those that crippled many Asian and Latin American economies during the Asian financial crisis and those that have hammered many of the Central European economies during the current global financial crisis.

To strengthen the IMF's effectiveness in addressing macro imbalances and funding the borrowing needs of emerging market economies, the governance of the IMF must also be adjusted to reflect their growing role in the global economy. The leadership selection process must be opened to greater participation and membership on the executive committee needs to be updated and downsized. Both quotas and votes must be adjusted. Voting procedures should be changed to achieve a better balance between the interests of large and small countries. And the 95 % supermajority rule for substantial changes to the IMF's articles of agreement should be modified so that no country, large or small exercises a veto.

In addition to regulatory gaps and failures and the savings glut and unsustainable imbalances, errors in judgment and decisions, fueled in part by human greed and euphoria, have played a significant role in the current financial crisis and in the many other crises that have periodically engulfed financial markets since their inception. Recent evidence from behavioral economics and neuro-economics confirms that during extended periods of prosperity, market participants become complacent about the risks of loss –either because they underestimate these risks or their aversion to risk declines or both. MIT Professor Andrew Lo, a noted financial market economist, concludes that prolonged periods of growth and prosperity can induce a collective sense of euphoria and complacency among investors not unlike the drug induced stupor of a cocaine addict. Moreover, the financial liberalization that usually accompanies extended periods of prosperity means greater availability of risk capital, greater competition for new sources of excess expected returns, more highly correlated risk-taking behavior and a false sense of security derived from watching and imitating peers who engage in the same risky behavior with apparent success. This behavioral or "animal spirits" interpretation of the current global financial crisis means that no matter how well we design new regulations and institutions based on the lessons learned from the crisis, we cannot preclude future crises. The best we can do it to prevent a crisis of similar depth and breadth from occurring again for a very long time.