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The G20 and the Challenge of International Financial Re-regulation

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Summary

The crisis, it is now widely accepted, means that markets failed. Meeting for the first time in Washington in November 2008, the G20 embarked in a ride of re-regulation. Months of negotiations later, it dramatically appears different to agree on principles and broad objectives, and to write and enforce rules and commitments. Toronto, the fourth G20 summit, delivered few tangible progresses. The paper first discusses the fundamental reasons why international convergence of financial regulations is difficult in a multipolar and heterogeneous world. Nevertheless, the prevention of systemic risk and the reinforcement of bank regulation and supervision have made significant steps forward and will testify in Seoul of successful actions following the G2O decisions. This exemplifies what we call "workable convergence". For the future, the agenda will raise more treacherous questions like the treatment of SIFIs and derivatives. Views could be even more confrontational regarding the convergence of accounting standards and the activity of investment banking. The conclusion discusses the chance to make the financial system safer and calls for the Seoul summit not only capitalizing on existing results but giving a fresh momentum to improve the convergence of international financial standards.

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Contents

INTRODUCTION ... 3

WHAT'S THE MATTER WITH FINANCIAL MARKETS FAILURES? ... 5

THE TRADE-OFF BETWEEN RISK AND REWARDS ... 7

DON'T EXPECT PURE AND PERFECT CONVERGENCE OF INTERNATIONAL RE-REGULATION ... 9

EUROPE IN A MULTIPOLAR FINANCIAL WORLD ... 11

A STRONGER BANKING SECTOR ... 13

PREVENTING SYSTEMIC RISK ... 16

A SAFER FINANCIAL INDUSTRY? ... 18

EXTENDING CAPITAL INTEGRATION AND PREVENTING FUTURE CRISES ... 20

THE TASK AHEAD FOR THE G20 ... 23

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Introduction

Toronto, the fourth G20 summit, delivered few tangible progresses in the field of financial regulation despite the fact that this is possibly the most important part of the agenda of those meetings since their beginning. Following the collapse of Lehman Brothers in September 2008, the word was that "the global problem raised by the financial crisis had to find a global solution". Leaders agreed that a reinforcement of regulations, their global harmonization and their strict enforcement were necessary to bring more stability to the financial sphere. Among the 47 items mentioned in the Washington communiqué, not least than 38 were devoted to detail the main aspects of this new would-be international financial regulation.

In the spring of 2010, many of those issues looked seriously entangled. Just to recall the mood in Toronto, the negotiations of the Basel committee regarding bank regulations were stagnating, the deadline for accounting standards convergence had just been postponed and no agreement could be concluded regarding an internationally coordinated taxation of banks. Not to speak of a vanishing European voice due to the chaotic answer of the eurozone to its sovereign debt crisis. While the final communiqué in Toronto repeated previous commitments, the statement also recognized that "countries should be free to examine a range of policy approaches". Does this comeback to national solutions mean that the G 20 is already *passé*?

What a difference two years make! When meeting in Washington and London, leaders clearly had to manage pressing and common challenges and they did that successfully. Now, as President Sarkozy observed in a speech devoted to the future French presidency, the G20 faces a bifurcation. Either the G20 continues as a crisis management instrument or it makes a significant step forward into effective policy coordination. This cannot mean pure and perfect convergence in the ongoing process of re-regulation. "One size fits all" does not work for fundamental reasons. What we should ambitiously work for is a "workable convergence". Will the re-regulation process now at work in the US as well as in the EU deliver a better regulation or fall either into complacency or overregulation? Are those reforms sufficiently converging on both sides of the Atlantic?

The paper is organized as follows. Starting from market failures in the first section, I emphasize in the second one the trade-off between financial risks and rewards. I explore next the conditions of international convergence in a multipolar world with a special emphasis on recent European decisions. The prevention of systemic

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risk and the reinforcement of bank regulation and supervision are then commented as the feasible progresses following the G2O decisions. For the future, the agenda will raise more treacherous questions like the treatment of SIFIs and derivatives. Finally we discuss alternative views regarding the convergence of accounting standards and the level playing field for investment banking and other capital markets intermediaries. The conclusion discusses the chance to make the financial system safer and calls for the Seoul summit not only capitalizing on existing results but giving a fresh momentum to the global re-regulation process.

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What's The Matter with Financial Markets Failures?

The crisis has put to the forefront a number of pitfalls in financial markets, behaviors, remunerations, regulation and supervision. A few words about our understanding of the crisis are useful to set the stage. There is a relative degree of consensus between the two sides of the Atlantic regarding the origins of the crisis which can be most easily encapsulated in two words, "excessive leverage"; how did we arrive at this debt disaster?

First, there were macroeconomic causes: monetary policy has been too lax for too long; global imbalances have canceled any sense of discipline and allowed unlimited accumulation of debt. Second, there were micro-economic causes, financial innovation and lax supervision, followed by a series of secondary causes: ratings agencies, pro-cyclical accounting standards, unregulated monolines, excessive profitability targets, wrong incentives and so forth.

Markets failed, that is now broadly accepted: financial deregulation and ineffective supervision figure among the casualties of the crisis. For two years now, we have been asking "what was it about the financial system that wasn't self correcting"? Emphasis in the answer can be put along two axes; these are seemingly analytical nuances but they have very important policy consequences.

Many understand the wreckage as a failure of systemic nature: too much pro-cyclicality, inadequate oversight, ideology of self-regulation. The size of the financial industry has grown too large; a smaller and safer industry would be in the interest of a more stable growth. The future belongs to stronger regulation and supervision backed by rigorous macro-economic policies oriented towards medium-term sustainability. If not offering a definitive solution, this would clearly have a key role to bring back finance to discipline.

Other, less risk-adverse, are mainly pondering a broad failure of judgment which has been amplified by the failure of supervision. It is in the human nature that banks skillfully learnt to play the system! Trying to eradicate failings of human nature could prove more damageable than useful: regulation expose to serious unintended consequences. There are good reasons to think that the expansion of finance remains one of the better engines of economic growth; at the end of the day, risk-taking is the very source of economic progress and should not be discouraged.

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Answering to a broad and bitter anger from the public, the G20 summits had no opportunity to ponder these nuances which are not only analytical but also cultural nuances; leaders had to act bravely and co-operatively. In terms of broad principles, they embarked for a ride of re-regulation. Months of negotiations later, it appears how different it is to agree on principles and broad objectives, and to write and enforce rules and commitments. The uncomfortable truth is that regulation is not a straightforward avenue.

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The Trade-Off between Risk and Rewards

"Financial regulation" usually indicates a cluster of interrelated policies aimed at insuring a proper functioning of the financial system. Part of these regulations are, or should be, similar to those enacted in other industries regarding the protection of consumers, the safe design of products or the supply of appropriate information to the public. But finance is different in very important aspects. International financial regulation does not obey the same logic as the one for example embedded in international trade agreements and institutions. "Free trade is good" and has been (within regulatory limits exemplified by food security concerns) pursued as such; but what about finance? Capital flows as well are good but finance regularly triggers crises: more than trade, finance needs rules. There is an underlying tension beneath financial liberalization. Free trade means going forward on a linear axis, free capital movements immediately expose a trade-off between risks and rewards. Getting a financial international agreement is much more demanding than liberalizing trade.

Until the '70s, financial regulation developed almost exclusively at the national level. The first big pieces of international regulation started with the work of the International Accounting Standards Committee in 1973 and of the Basel Committee on Banking Supervision in 1974. A coordination among securities regulators developed as of 1983 under the auspices of the International Organization of Securities Commissions. Finance ministers and central bankers developed their cooperation according to different formats (G5, G7, G10 and finally G20 in 1999); also in 1999 the Financial Stability Forum was inaugurated and the IMF asked assessing national and supervisory frameworks trough the Financial Assessment Program. Looking to the results, this program, despite its apparent activism, proved dramatically inefficient to detect and prevent a global systemic crisis. Does that mean that international financial regulation is inevitably lagging the course of the real financial life?

One point, frequently made by the activists of financial liberalization, is that financial regulation today has weaker foundations than say trade or macroeconomics because it only recently turned as a major policy concern. This is half-truth. Liberalization, the major policy concern in finance during the last decades, has been backed by a very strong theoretical argument, efficient market theory. Huge efforts have been made to turn academic research into policy recommendations. Where the idea of "a soft regulation" of finance does comes

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from, where the idea of “transferring risks to those most able to bear them” does come from, where the idea of relaxing capital standards because financial institutions were “more able to gauge risks than before” does come from if not from a powerful conceptual framework turned into an ideological and political force?

That government intervention is harmful, that fair value is the quantitative incarnation of reason and that securitization is the secret of risk evaporation have never been a result of science, they are one side of economic realities which had been for a period of time carefully manufactured into sort of a religious belief. Now, we have to live with the legacy of this faith-based strategy. The trade-off between risks and rewards had been grossly tilted towards the minimization of risks and the overvaluation of rewards; it is time to choose another point on this trade-off, but which one? Market failures are well recognized but governments are poorly equipped to back their efforts towards financial re-regulation. The efficient market theory brilliantly inspired a homogeneous vision of global finance, it is now broken; without the equivalent theory for a time of re-regulation, the world we inherit is heterogeneous.

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Don't Expect Pure and Perfect Convergence of International Re-Regulation

History suggests that international regulatory harmonization could be a (relatively) simple task in one situation: when one country plays a prominent role, when financial activity is described according to a consensual view and when the policy recommendation is to dismantle obstacles to the free circulation of capital. After the 30s, the US initially enjoyed a global leadership with innovations like deposit insurance, securitization or accounting standards enacted by the Roosevelt administration and subsequently adopted in other countries; reversing the trend, the US powerfully acted during the last 3 decades to extend the use of financial innovations, to broaden the horizon of global finance and to oppose foreign proposals to reduce its procyclicality. This period is over not only because the crisis has its origins in the US but for a more fundamental reason. In a world which is becoming multipolar, it's time to think more seriously about the difficulties of international policy cooperation.

The world is no more the bipolar one of the Cold War neither the brief unipolar moment which followed the fall of the Berlin wall. "Multipolarity", for sure, is a suggestive word rather than a rigorous analysis but the word undeniably captures something important. By the way, the G20 has precisely been celebrated for bringing the global summits in line with the present geopolitical realities. What about the implications of multipolarity for finance? The geography of modern finance has been organized following a London/New-York axis; Germany and Japan became first class industrial powerhouses but never dislodged – and never tried to dislodge- the Anglo-American financial preeminence. This preeminence certainly remains but things are now evolving into a much more complex canvas.

First, the center of gravity of global finance is moving eastward. The share of emerging countries among the top 100 listed banks has surged from practically nothing to one third of the world total, a significant part of it reflecting the rise of Chinese institutions. A similar picture emerges when looking at global financial centers among which Hong Kong, Singapore, Tokyo (and Shanghai tomorrow) rank at the top of the league. The combination of deleveraging in the west and wealth accumulation in Asia will certainly reinforce this trend. This does not still translate into Asian countries playing a major role in the global financial policy debate. Emerging economies are

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considering the financial crisis as a western mess, they are not re-regulating in the western style but rather withholding their cards, and that does not contribute to make the world of global finance flat.

Second, continental Europe is looking for emancipation. Its financial culture, its financial structures are different from those of the City or of Wall Street. A distinguished observer of European financial realities recently characterized Europe as the combination of a port, the city of London, oriented towards the ocean and a vast hinterland, continental Europe, both being strongly inter-connected. In many aspects, continental Europe only reluctantly adopted the mantra of self-regulated efficient markets, think to the harsh words of German officials going so far as to qualify American bankers as “locusts”. More importantly, Europe appeared disarmed when facing the financial crisis. A more unified financial single market had been recognized for years as a desirable goal but despite the creation of the euro action remained timid and delayed due to conflicting national interests. After the crisis, under public anger, inaction was no more an option.

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Europe in a Multipolar Financial World

For the EU, the clouds of the spring 2010 have cleared. After months of delay, due to the political bickering following the installation of a new Parliament, of a new Commission and of new European institutions, lawmakers and governments finally agreed in September to a radical overhaul of the patchy system of financial oversight which should be definitively endorsed by January. Besides the creation of a Systemic Risk Council (described in the following section), the new regime will rely on three new European Supervisory Authorities for banks (located in London), markets (in Paris) and insurance (in Frankfurt). This decision is a new example of a European tradition to use every crisis as an opportunity: the creation of such agencies was considered as necessary to really organize European wide financial activities but opposed by national governments. Their creation out of three pre-existing pan-european committees is a logical consequence of the crisis. On paper, the supervisory structure is a wise balance of national and EU-wide responsibilities. The main task of European agencies will be to set standards and rules, day-to-day supervision remaining with national authorities. Which are the differences with the past?

The new ESAs are formal European institutions made up of the heads of the 27 national supervisors; they will make their decisions by simple or qualified majority voting even if they certainly extend the tradition of the previous committees to work mainly by consensus so as to bring everyone on board. The ESAs will have binding powers in certain circumstances in particular in case of "emergency situations" but they cannot enforce decisions that have budgetary implications: if facing a financial crisis, the market-authority could temporarily ban certain products but the banking-authority could not order a bail-out. The size of the agencies will be modest (say 100 people for each as compared with 3000 for the British FSA) and they willingly will depend from significant member states input. All this is a sensible, harmonized rule-making process which is an important piece definitely needed for a better functioning of the European financial industry and markets; it is also a subtle shift of power to Brussels.

Multipolarity eventually changes the behavior of the main actors. A multipolar world is one where you simultaneously face asymmetry between the west and the rest and between the US and the EU. In its previous phase, for example, EU institutions were instinctively working on the basis of free-market and internationalist

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considerations because these were the drivers of intra-European harmonization. The dynamics are changing as more political objecttives are now, as everywhere in the world, fed into the debates; this in particular reflects the increased role of the European Parliament. This European reaction is a striking demonstration of what we have to expect when entering a heterogeneous and multipolar world. The G20 is not the expression of a global political constituency; beyond the summits, decisions are made in Washington, Beijing, Brussels and other capitals where, as we know, "all politics is local". Re-regulation lies in the hands of domestic constituencies; this inspires a widespread reluctance to delegate formal powers to a supra-national level. Differences in the financial industry structures also make uniform rules meaningless and unreachable. There is nothing like an ideal harmonization of legislations, the G 20 has to engineer a "workable convergence": two years after the Washington G20 meeting, two major changes of the financial landscape can be successfully endorsed as of the Seoul summit.

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A Stronger Banking Sector

The crisis has demonstrated the importance of strengthening the resilience of the banking industry by implementing tougher rules on capital and liquidity. The package prepared by the Basel Committee has been delivered in time after detailed consultations. It is very comprehensive and addresses these issues by improving the level and quality of capital for credit institutions as well as developing a framework for liquidity risk. The main elements of the proposal – which is to be adopted at the Seoul summit- are: first, to improve the quality of capital constituted especially under tier 1 and to introduce capital buffers to increase the loss-absorption capacity of banks; second, to rely on a non-risk-based leverage ratio as a supplementary measure to the Basel II risk control framework in order to curb excessive balance sheet growth; third, to introduce a range of measures like forward-looking provisioning intended to mitigate the inherent procyclicality of the financial system. Does all this rise to the challenge?

Heated debates have flourished with regard to the impact of the proposed rules on financial institutions and on the real economy. The industry loudly cried folly and emphasized the depressive consequences these exaggeratedly pressing rules would have on credit distribution and growth. This argument seems to fit with a recovery which is a polarized one: robust for the large-corporate sector but fragile for small business and households. Corporate debt markets severely suffered during the recession but have recovered as credit spreads have narrowed; by contrast, small business continues to face difficulties and frequently resent an inadequate access to credit.

Quantitative studies have been conducted in order to assess the impact of the proposed rules; they didn't produce a complete consensus but it seems fair to say that disinterested observers thought that the impact was clearly exaggerated by the industry, that the effect on price would be moderate (1/4%) and their consequences on growth limited and finally more than offset by the benefits of greater systemic stability. And finally, banks have been given until 2019 before the new rules apply in full force – an extraordinarily extended period of time for this transition! The argument of the industry must also be considered the other way. In the recent past, "easy credit availability" has constantly fueled rhetoric in favor of light capital requirements which in turn meant a more leveraged banking sector: this was the beginning of the very sloppy argument which made us believe that a global financial industry as big as possible

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was indispensable for the future growth of the world. The argument cannot be considered anymore as common wisdom!

All in all, the Basel package represents a sensible compromise, offering elements of increased security without being heavily handed. There are nonetheless two troubling elements.

The first one is the basis of the argument itself. Higher capital requirements are necessary, are they sufficient to prevent future crises? This remains inconclusive for a simple reason, namely that the five largest US financial institutions subject to Basel capital standards that either failed or were forced into government assisted mergers (Bear Sterns, Washington Mutual, Lehman, Wachovia and Merrill Lynch) each had regulatory capital-ratios ranging between 12% and 16% before they were shut down; they not only respected the regulatory minimums but were rightly considered “well capitalized”.

Another aspect didn’t possibly raise sufficient scrutiny. Basel III, like its predecessor, allows the big and complex global banks to use their internal risk models as key determinants of capital requirements. There are two arguments of which one is flawed and the second dramatically flawed. First, “banks are more than regulators able to devote more resources to sophisticated methods”; true enough, but at what price for the quality of supervision? Second, “banks have a strong incentive to get the exercise right”; we now know how fragile this assumption is, especially for the most audacious and risk-prone institutions. In sum, there are good reasons to think that risk modeling methods are better than they were; but there are more reasons to be skeptical that the basic flaws and bias have been corrected. The committee concluded that the benefits outweigh the costs… and above all that there were no clearly superior approach.

The Basel committee has, in short, concluded a complex agreement in a short period of time, good news for its future work. The compromise, with the above mentioned limits, offers the chances of a level playing field even if several countries, among them the US or Switzerland, could find it not demanding enough. This would be sort of a reverse controversy seeing the US willing more stringent regulations than continental Europe! Some will conclude that, in the current context, harmonization efforts might only lead to weak global standards: this is unnecessary cynical an argument. Anyway, the Congress will always follow its own way – and the adoption of any Basel agreement in Washington remains an open question. With many others, I would finally consider the Basel proposals as example of a workable convergence.

On top of that, it is possible to argue that many aspects of financial stability policy can be effectively tackled at national (or regional) level. The international activity of large banks is typically less than one fourth of their total business, Europe being an exception due to the perspective of financial single market and consequently to a higher level of cross border integration. Outside Europe,

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it is not clear that even multinational groups require internationally uniform supervision. BNP Paribas, CITI, HSBC or Santander illustrate that international synergies can arise from the leverage of technological know-how or better customer-relationship management even with locally capitalized and funded retail subsidiaries which are subject to slightly different supervisory standards.

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Preventing Systemic Risk

The financial crisis has demonstrated that safe banks were a necessary but not sufficient condition of a safe financial system. Deep and complex interconnections between financial intermediaries are the source of risks of systemic nature. The key to preventing financial crises is the establishment of a process to identify and monitor these vulnerabilities that threaten financial stability. It is easy to remember in the past decades a lot of situations – Mexican and many other debt crises, savings and loans, dotcom or housing bubbles- where such a process would have been more than desirable. Briefly said, the historical record is not encouraging in this regard. Could it be different this time? Should we prove irremediably naïve, we are tempted to think that the short answer is yes. The true question relates to political will but the task is not unmanageable, the idea of weaknesses accumulating before the crisis being, at least for now, widely shared. These imbalances and risks have first to be recognized – rather than denied as we have too frequently witnessed during the last decade; they have thus to be calibrated in terms of their potential adverse effect on the economy, this is both more important and more difficult. This process is a continuous one of information gathering, technical analysis and synthetic assessment. It should be systematic in nature, comprehensive and monitoring both the macro- and micro-aspects. We have witnessed a political will to meet these challenges. Are EU and US reforms appropriately designed? Will they prove up to the task?

Credit should be at the moment given to the reforms adopted on both sides of the Atlantic. Prominent among other policy bodies, new institutions are created to face the unique nature of systemic risk. In Europe, the new actor is called a Systemic Risk Board, in the US, a Systemic Risk Council; both will comprise policy officials, central bankers, members from regulatory and supervisory bodies; the chair is held by the Central bank in Europe, by the Treasury in the US. There is a debate about the effectiveness of both arrangements. In both cases, participants represent different interests and are subject to different public and private influences; this is the nature of the game and consensus will not be easy to achieve. It can be argued that the US solution relying exclusively on federal officials, consensus once reached, each agency has the authority to implement decisions. Effective enough *if* consensus can be reached; the experience of the past decade invites to a cautious assessment in this regard. The EU Board is sometimes wrongly qualified as a “reputational body”, it has real even if less direct power than its American counterpart; but more importantly it is chaired by the independent and powerful ECB. The

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ECB already proved to be an important player in the middle of diverging views among member states.

In short, the distinctions between the American and European solutions to cope with systematic risk are of second order, the Board and the Council are reliable frameworks to track and prevent financial excesses. Experience suggests that coordination between the two will be satisfactory in case of “standard” financial turbulence. Things would be tenser if facing a more severe situation (another major banking crisis, a sovereign default threat, a mix of both, a divergence regarding the pursuit of quantitative easing…). In such a case, issues could be elevated to the G20 level. The final answer would depend on the degree of consensus regarding the risk-reward balance of the financial outlook and on the political will to act accordingly and cooperatively. There is no known solution, as we already witnessed in particular about the size of the stimulus package, to oblige convergence and overcome diverging political priorities regarding the use of budgetary and monetary rescue instruments.

The conclusion of the two previous sections is that, when meeting in Seoul in November 2010, the G20 and the financial bodies acting under its guidance will have reasons to consider having done a good, even if partial, job. Looking forward, is this a sufficient reason for hope? Or will the forthcoming summits face more treacherous issue? We now explore some of them.

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A Safer Financial Industry?

Another major systemic vulnerability of the system is the question of "too big to fail". In the US, several big financial firms, now called "Systematically Important Financial Institution" or SIFIs, faced insolvency. As the Lehman's failure demonstrated, this was posing a threat to the whole system. Government intervention was needed, as it had been the case in previous financial crises, but the government had not the tools to do the job. US authorities had to provide bridge loans to sponsor mergers, to extend Federal Reserve funding and to recapitalize these institutions with an unprecedented amount of taxpayer' money. Europe too faced similar risks in the UK and Ireland. On the continent, individual banks suffered, sometimes severely, without endangering the system.

The question raised by SIFIs is at the heart of modern finance; these institutions have grown in a way that put them outside the very logic of capitalism which is to reward success by profits and to punish failure by bankruptcy. There cannot be a proper functioning of the whole system if such an important part of the economy is able to withdraw itself from market discipline. Solutions have been debated and a report is to be submitted later to the G20 by the FSB. If capital requirements alone are not up to the task, what other solutions can be implemented?

The first piece is to ensure that governments have the special resolution authority to act so that there is an alternative to a massive bail-out of failing firms. This is now part of the Dodd-Frank bill in the US. One sensitive part of the scheme is to design the resolution process in a way that supports market discipline. Punish the failures mean the possibility of whipping out all the stakeholders, the shareholders first but also the management and creditors. Would these threats be sufficiently biting to discourage imprudent behaviors remains an open question. It would consequently be appropriate to have other tools. One of them is the obligation to prepare wind-down plans, also called living wills, which would assure the supervisor that a failure can be resolved without producing uncontrollable spillovers; another policy would be simply to impose explicit size limits. A powerful economic argument is backing this solution: there is no clear evidence that increasing size is always a source of improved efficiency. The debate should consequently be framed in a political economic context and raise the question of the excessive power accumulated by the SIFIs.

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By enormously extending the sources of moral hazard that this crisis has already seed, inaction regarding SIFIs would be a sure recipe to cook the next big crisis. Taking into consideration competitive or strategic considerations, one clearly sees that there is no national solution to the issue; confronting "too big to fail" could be one of the most important tests of the political will concentrated in the G20.

Markets as well can have a systemic impact if they are insufficiently transparent thereby leading to mispricing of risk and laying the basis for destabilizing adjustments; this was the case in the CDS market. Efforts to reform the CDS market are focused on making the market more transparent and reducing counterparty exposures. Consensus has emerged that over-the-counter markets need to be moved to central counterparties or be subject to additional requirements. Where such central clearing mechanisms existed before the crisis, payments flowed smoothly and defaults were handled well. Looking forward nonetheless, it is important to act carefully so that the benefits of multilateral counterparty netting are not offset by the concentration of operational risk inherent to such big institutions.

The future extent of securitization will crucially depend on how regulation is formulated. New regulations have already constrained some of the more complex products but securitization benefits for economic growth should be secured by creating a secure environment for long-term investors (insurers, pension funds and so on) which need to be convinced that abuses which occurred in the run-up to the crisis are definitely under control. Incentives should be designed in a way which promotes a stricter view of credit supply which implies originators keeping a significant share of these credits on their books. On the other side, would regulations too strictly be designed and applied, originators may well find un-economical to originate loans unnecessarily restricting the usefulness of securitization. Facing this trade-off, and with the benefits of the previous financial boom and bust, policy-makers should preferably err on the side of caution.

The two previous sections have suggested that the G20 when meeting in Seoul will rightfully commend the progresses made with the Basel capital framework and the systemic prevention schemes; it cannot stop at that point because other major sources of financial instability have not been corrected. Due to their global nature, the questions of Too Big To Fail and the organization of derivatives markets remain on the agenda and will not find a proper solution without a strong endorsement by the Leaders.

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Extending Capital Integration and Preventing Future Crises

The argument developed in this paper is that the world needs re-regulation to prevent the repetition of the crisis and that this policy has been and deserves to be powerfully promoted by the G20. This network (G20, IMF, FSB, Basel…) has the capacity to do a lot regarding the assessment of the financial outlook and the accumulation of systemic risks, to set authoritative standards and monitor the reason-nable convergence of regulatory practices and to fix the SIFIs and derivatives issues. On the other side, we have also recognized that re-regulation increases the risk of mutually incompatible policies that could be the cause of competitive distortions. This is why we should not expect a perfect convergence and be happy with what we called a "workable convergence". However, some crucial regulatory concerns can only be addressed at a global level as we diagnosed regarding the SIFIs. The future G 20 summits have a difficult task to push the re-regulatory agenda forward while ensuring the sustainability of financial integration. Will this process develop smoothly? Or will we see divergent views about the priorities?

The intrinsic logic of capital markets is to continue their process of global integration. Re-regulating banks will be a boost to capital markets and other non-banks financial intermediaries. Experience clearly suggests that these would be new sources of financial risks and instabilities. Extending the global capital market integration and preventing future financial crises could thus appear as conflicting goals and prove to be more difficult fields for delivering the fruits of a workable convergence. We will take two examples.

With banks more constrained, non-banks are bound to thrive. Lower leverage within the banking sector will likely result in greater demand from those able to do so to access credit trough capital markets. Because of higher capital requirements, risky credits will likely shift out of the banking industry to the non-bank financial system. Intermediation outside the banking system is going to grow and capital markets intermediaries will forcefully ask for the more extensive freedom of action to seize new profit opportunities. How will regulation adapt to oversee the risks in this sector? Financial institutions like private equity or hedge funds are similar to banks when considering high leverage and potential asset-liability mismatches. The industry will lobby policy-makers to agree that such risk-shifting is a condition of growth and that it is acceptable as long as it remains outside a well-protected banking system. However, it remains unclear

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how to avoid the development of another shadow-banking-system, operating under insufficient transparency and prone to building another form of systemic risk. Experience suggests there are no unbreakable borders between different parts of the industry. *Contamination* is a basic lesson of the previous crisis and it would be prudent to act accordingly. Non-banks should consequently be subjected to bank-like regulation and supervision. Another important question is whether these institutions should, and according to which conditions, be eligible to the same protections provided to deposit holders and to central banks' liquidity support. The answer to these questions depend, more than the ones discussed in the previous sections, on the very structure of the industry in different nations as will be manifest in the case of investment banking.

Contrary to the traditional business of banking, the activity of non-banks and investment banks being more internationally integrated they need more uniform rules. This issue cannot be treated independently of the structures of the financial industry and of the politics that framed those structures. In the US, the Glass-Steagall Act reacted to the anger of those whose savings had been ruined by greedy bankers and decided the separation of retail and investment businesses. This theme has made an important come-back with the so-called Volcker rule. There is reluctance in Europe -where the structure of the industry is based on the concept of "universal banks"- to follow the same route. In this debate, Europe is being of trying to protect its champions; there are much more serious reasons. The recent crisis eventually suggests that the Glass-Steagall style regulation offers only a weak protection since the excesses of the shadow banking system and of the investment banks have been powerful enough to draw the whole system into the abyss. It can even be reasonably argued that the separation of investment banks is radically counter-productive because they are offered the greatest latitude of action since their supervision only relies upon a market-authority like the SEC. That proved radically inadequate not only because the SEC was insufficiently staffed or in some cases captured by the industry but because the surveillance of complex financial institutions cannot be exclusively bestowed upon the market authority. On top of that, there is an element of irony in the fact that the surviving US investment banks only survived the crisis thanks to their rapid transformation into financial holdings thus opening the umbrella of the Federal Reserve. It is audacious in such a context to argue that the European investment banking business located within universal banks enjoys a competitive advantage; the truth is the reverse, without public rescue, American investment banking would have disappeared and be ready for a refreshing start from scratch. The separation of investment banking, in short, has a low appeal in Europe and there is little to recommend convergence at all price on this issue.

Second, capital markets need consistent financial information, this is a clearly desirable goal but this could also fuel a serious

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transatlantic rift. First, a lot of issues deserve to be taken into consideration by the G20 and its regulatory network and could be other examples of a workable convergence. Current risk-disclosure practices could certainly be improved; lessons could for example be drawn from the stress-tests conducted both in the US and the EU and these exercises integrated into a more coherent framework. The public supervision of rating agencies remains very much unconvincing; that calls for new initiatives which should be as converging as possible. Surprisingly, audit firms have remained out of the radar screen despite the fact that the Sarbanes-Oxley Act produced a transatlantic uproar after granting extraterritorial competence to US authorities; designing a stronger international body should be part of the agenda. This said, everyone knows that a more painful hurdle lies on the way towards a "better" financial information, fair market value at all price. There is no issue where the theme of pro-cyclicality is more provocative. Prematurely recognizing unrealized capital gains, it can be said, is the mother of all financial excesses. There is no issue where the intellectual candor of a financial body has been more deeply and systematically captured by the industry. Raising the lessons of the crisis, the London summit took the initiative to ask the IASB and the FASB for delivering convergence of their standards in June 2011; this hope has been (indefinitely?) postponed by the FASB. There are few reasons to believe that Europeans would accept to converge at a price which would be a come-back to what is considered as a key ingredient of the crisis; convergence of accounting standards is a worthy objective as long as the content and quality of the standards are designed to increase convergence, not volatility. Could this turn into another real transatlantic divergence?

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The Task Ahead for the G20

Two years on, international re-regulation has not gone as far as many, overwhelmed by the crisis and subdued by the strong wording of the G20 original communiqués, had expected. The danger of over-reaction has definitely been kept off. Today, investment banks and investment bankers are back at the top, profits and bonuses, courtesy of public policies, not of "talent", are booming, the non-financial economy continues to suffer. Has the chance to make the system safer been lost? No, it would be premature to conclude that the process has gone into complacency. Governments and regulators have started to do some of the things that might have averted the previous crisis. The pledges made by the initial G20 have had a reasonable success given the obstacles to co-ordinated action in a multipolar and heterogeneous world. Governments have also been cautious not to worsen the perspectives of a weakened financial system. But many of the basic mechanisms which concurred in the financial meltdown have remained untouched and much more clearly remain to be done. The regulatory process certainly goes step by step, governments and central banks have not lost the memory of the crash and its consequences on their budgets and balance sheet; far from seeing the financial industry as "God in action", the public could easily call for more action. To avoid the risk of irrelevance, the G20 has not much choice and must go further: derivatives, "too big to fail", the shadow banking system, accounting standard. The G20 has not lost his *raison d'être* and must push his agenda as far as convergence is feasible. This will not occur without a new political impetus.

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