

Everyone agrees on reforming the governance of financial markets, but who will do what remains unclear



A Tangled Web

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THE financial crisis sweeping the world has brought into sharp focus serious weaknesses in how today's global financial markets are governed. Since the 1970s, the world's financial markets—dominated by the institutions of mature markets—grew exponentially, much faster in fact than any other global markets.

The expansion was driven by the mutually reinforcing forces of deregulation and financial innovation. Banks played a central role in this sharp, sustained expansion and progressive internationalization, but capital markets and the trend toward securitization also helped transform finance.

What didn't grow—or rather couldn't keep up—with the proliferation of these markets were the institutions and structures that over-

see them by setting and implementing regulations. There remained a gnawing gap between market activities and regulatory scope, especially in relation to mature markets.

The current financial crisis has dramatically revealed how these regulatory weaknesses have hurt the global economy and highlighted the need for global approaches to regulating global markets. Treated until the 1990s as only one—and an arcane one at that—aspect of the broader agenda of global economic governance, financial market reform is now universally recognized as a central and urgent global priority. But although there are many reform proposals, there is no agreement as yet on how much reform is needed, who will do what, and how international cooperation will be coordinated and enforced.

Photo shows the headquarters of the Bank for International Settlements in Basel, Switzerland.

Financial markets evolved—rapidly

Until the early 1980s, national financial systems were bank dominated, relatively tightly regulated, and with limited international exposures. Starting with the modest issuance of eurobonds during that decade, cross-border financial flows and linkages started to expand dramatically. And although the 1980s debt crises arrested the integration of developing countries and the 1990s financial crisis severely hurt some emerging markets, these crises had little impact on the evolution and expansion of global financial markets.

Led by the rapid growth in international banking, global financial markets continued to boom—from just \$0.1 trillion in 1970 to \$6.3 trillion in 1990 and to a massive \$31.8 trillion in 2007. This was accompanied by a consolidation of the international banking industry—a result of a wave of cross-border mergers and acquisitions. Banks entered areas of activity that had previously been the preserve of non-bank institutions (such as underwriting, asset management, investment banking, and proprietary trading), blurring distinctions between banks and other financial institutions and leading to a “shadow banking” system with large segments of bank activity outside the perimeters of regulation. And rapid growth of complex securitized products, such as credit derivatives, sharply increased banks’ leverage and masked underlying risks. The credit derivative market—which was insignificant in 2001—grew to about \$50 trillion by 2007.

Asian crisis set alarm bells ringing

The 1997–98 Asian crisis triggered a range of initiatives to reform the architecture of the international financial system (see box) and thereby reduce the likelihood and costs of future financial crises and cross-border spillovers.

In the immediate aftermath of the crisis, working groups (the so-called Willard groups) were set up, drawing on poli-

cymakers from 22 developed and emerging market countries as well as the international financial institutions (IFIs) to identify reform priorities in the areas of transparency, strengthening of financial systems, and resolving international financial crises.

Subsequently, in 1999, the leading industrialized countries in the Group of Seven (G-7) asked Hans Tietmeyer, then governor of the Bundesbank, to consider options to strengthen the institutional arrangements for global coordination. Tietmeyer submitted a report proposing one forum of finance ministers and central bank governors, and another of policymakers, regulators, the IFIs, and the apex bodies of standard setters, regulators, and supervisors. These recommendations led that year to the establishment of two institutions that are now in the spotlight—the *Group of Twenty* (G-20) industrialized and emerging market nations and the *Financial Stability Forum* (FSF) that links financial authorities in major economies with regulatory bodies and IFIs.

Since its inception, the G-20 has served as an important forum for dialogue between the developed and major emerging markets on the global economic and financial agenda, including on the reform of the international financial architecture.

The FSF, which is supported by a small secretariat in the Bank for International Settlements (BIS), was aimed at bringing together senior representatives of national financial authorities, IFIs, and international regulatory and supervisory groups to focus on systemic risks in financial markets and on ways to address them. Its membership is highly tilted toward G-7 countries, each of which is represented by three senior officials from its respective treasury department, central bank, and supervisory authorities. Australia, Hong Kong SAR, the Netherlands, and Singapore are also represented, though only by their central banks.

A web of regulators

The oversight of global financial markets evolved over time, reflecting changes in international financial markets, but the gap has continued to grow between the scope of regulation and the activities of financial markets. The *Bank for International Settlements* (BIS), established in 1930, is the central and the oldest focal point for coordination of global governance arrangements. Its 55 members comprise central banks of advanced economies and an increasing number of emerging markets.

The main power behind the BIS is the *Group of Ten* (G-10) nations, comprising finance ministers and central bank governors of 10 advanced economies. The G-10 has established important committees, with secretariats in the BIS, that play key roles in their respective areas. The Basel Committee on Banking Supervision has served as the standard setter on bank supervision; the Committee on Payment and Settlement Systems on payment, clearing, settlement, and related arrangements; and the Committee on the Global Financial System on identifying and assessing potential sources of stress in global financial markets as well as measures that promote stability in emerging markets.

The BIS also houses the secretariat of the *International Association of Insurance Supervisors*, which represents insurance regulators and supervisors of some 190 jurisdictions in nearly 140 countries, accounting for 97 percent of the world’s insurance premiums, as well as the *Financial Stability Forum*.

The *International Organization of Securities Commissions*, which is not linked to the BIS, has 109 members and covers 90 percent of the global securities markets. Another important body, the *International Accounting Standards Board*, has oversight of formulation and agreement on international accounting standards.

At present, accounting practices and credit rating agencies are not covered or overseen directly by any global regulatory body, although indirect regulation is enforced by financial regulators.

Other standard setters and global cooperative forums include the *IMF*, which is responsible for monetary and financial transparency codes; the *OECD*, which sets the standards and good practices for corporate governance; and the *World Bank* and *United Nations Commission on International Trade Law*, which have jointly developed a standard on insolvency regimes and creditor rights.

The FSF has been the main mechanism to link the growing array of institutions involved in global financial governance and to carry out technical work on cross-cutting topics that were high on the global agenda—global standards and codes, highly leveraged institutions, offshore financial centers, and deposit insurance systems. It established a systematic inventory of work across the IFIs and the supervisory and regulatory groupings, and has also provided a forum to assess and review financial market developments and potential risks.

In addition to the FSF, much of the work and attention of the IMF between 1997 and 2003 was devoted to initiatives to bolster the international financial architecture (such as the launch of the joint IMF–World Bank Financial Sector Assessment Program and Reports on the Observance of Standards and Codes as well as the aborted Sovereign Debt Restructuring Mechanism).

All of these efforts were skewed toward emerging markets; they did not focus on the underlying vulnerabilities in mature markets. Indeed, they assumed that mature financial markets were already robust and there was little value in enhancing the oversight of these markets. Efforts to extend regulation to systemically important segments in advanced economies, such as hedge funds, also met with resistance from some major countries and market participants.

Current crisis has exposed deep flaws . . .

The current financial crisis has provoked a major rethinking of the role of financial markets and the failures in their governance, particularly in advanced economies. Many have argued that the role of financial markets has expanded beyond what it should be—a means rather than an end—and the unbridled globalization of financial markets has left countries and citizens vulnerable to the markets' inherent vagaries. Although such reflections—especially on what went wrong and what can be learned from the crisis—are ongoing, three core sets of failings can be identified, with implications for future reform.

First, the crisis has underscored fundamental weaknesses in the functioning of financial markets. The problems of informational asymmetries, moral hazard, and principal agency in financial markets are well known, but the crisis has exposed weaknesses in corporate governance (linked partly to the nature of executive compensation), loan origination, and underwriting standards that border on fraud. It has also shown how new financial instruments and their growing complexity (typified by new securitized products such as credit default swaps) have amplified procyclicality and masked the underlying risks. The two important pillars of market correction—risk management by financial institutions and market discipline—have not worked either.

Second, there was a broad-based failure in the regulation of financial markets. Despite the emphasis on capital adequacy, capital regulation was imposed in a way that allowed the buildup of significant leverage and promoted procyclicality. In addition, the fragmentation of regulation, especially in the United States, contributed to regulatory arbitrage and greater risk taking, as did the fact that large systemically important segments—such as hedge funds and the special investment

vehicles created by banks—were outside the scope of prudential regulation.

Third, the crisis has revealed major deficiencies in international coordination and cooperation. Surveillance by the IMF and the FSF has remained weak and incomplete, in large part because both institutions lack the building blocks of effective oversight of systemically important advanced economies. Even where the problem was well understood, as in the case of growing macroeconomic imbalances that contributed to the buildup of vulnerability, there was no agreement on responsibilities or means to enforce the necessary cooperative actions. As the recent crisis has shown, the IMF lacks the resources and instruments to respond aggressively to systemic instability, which also reflects differing opinions among its member countries on what the institution's role should be. And the imbalance in voice and representation of emerging and developing economies in the IMF, and even more so in the BIS and other standard-setting bodies, has undermined the legitimacy and effectiveness of global financial governance.

. . . leading to new reform proposals

The growing consensus on regulatory weaknesses has led to many reform proposals from different quarters. A common theme has been that the balance between regulation and laissez-faire needs to be restored in favor of prudential regulation that is countercyclical, comprehensive in its coverage of financial institutions, and global in scope and consistency.

These proposals emphasize, among other things, the need for (1) improved incentives for prudent risk taking through such steps as reform of compensation and greater risk sharing on the part of loan and securities originators; (2) much tighter capital regulation, with stricter limits on leverage and built-in stabilizers to prevent procyclicality and buildup of asset bubbles; (3) greater attention to liquidity supervision and funding risks; (4) better mechanisms for supervising large, complex cross-border financial institutions; (5) extending the scope of financial regulation to ensure that all systemically important institutions are appropriately regulated; (6) improved transparency and reduced systemic risks associated with derivatives and complex financial instruments through greater reliance on exchange-traded or electronic trading platforms rather than on over-the-counter derivatives transactions; and (7) ensuring that credit rating agencies meet the highest standards and avoid conflicts of interest.

Although there may be broad agreement on most of these elements, the devil is in the details. The views of those who propose much tighter regulation differ from those who rely on market discipline and believe in preserving room for financial innovation.

And who will do what?

This broad agenda for financial reform poses a range of complex questions, including who should be responsible for what, how gaps in the existing institutional architecture should be filled, and how international cooperation can be reinforced.

At the most ambitious end are proposals for entirely new institutions or approaches to regulation (especially of large cross-border institutions) implemented through a world financial organization, an international bank charter, and an international insolvency mechanism. If such new mechanisms do not materialize, there are proposals to create “colleges of supervisors” who would be collectively responsible for effective supervision. More generally, there is agreement on the need for improved cooperation and communication across regulators, given the national scope of regulation and the global nature of financial markets.

Given the importance of macrofinancial linkages in the buildup of vulnerability and resolution of crises, clarity in the roles of and enhanced cooperation between the FSF and the IMF have also come to the fore. Of even greater importance is fundamental reform of the IMF so that it can play a central and effective role in reducing the risks of financial instability and in crisis response. The IMF will need a major overhaul of its surveillance role, especially in systemically important countries and markets, as well as of its instruments and policies so that it can provide the necessary precautionary and crisis support to the full spectrum of members, it is endowed with a much enlarged pool of resources, and its governance is reformed to make it more accountable and representative. It is also time to revisit the role of the IMF in the inter-

national monetary system and in the new world of volatile capital flows. All this is not just about reform in Washington, but requires equally the commitment of all members to the cooperative nature of the institution.

Given the breadth, complexity, and political obstacles in reforming global financial governance, a steering group with sufficient political and technical clout is needed at the global level to drive the reforms. The G-20 is well placed to play this role since it brings together finance ministers and central bank governors from the most systemically important countries. The elevation of the discussion to the leaders’ level gives even greater political impetus and scope to take up cross-cutting issues.

While the G-20 can therefore play a constructive role, it cannot supplant the more universal and legitimate decision-making structures. In that regard, it will be important for the G-20 (and other related forums, such as the FSF) to be as inclusive as possible in their deliberations, and to defer to the appropriate institutions for ultimate decisions. In particular the International Monetary and Financial Committee and the Board of Governors of the IMF will need to play a key role, as will the United Nations, as the most universal body at the level of world leaders. ■

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