

Summary

A host of regulatory reforms are under way to make the financial system safer, and the reforms are aimed in the right direction: to make markets and institutions more transparent, less complex, and less leveraged. The chapter uses these qualities, among others, as normative benchmarks and adds value by providing new measures of financial intermediation structures and an early assessment of whether the financial system is headed in a safer direction. The same framework can be used for further evaluation when the crisis subsides. The chapter also takes stock of the host of regulatory reforms and their status with regard to implementation, and indicates where further effort is still needed.

Most reforms are in the banking sector and impose higher costs to encourage banks to internalize the costs of certain risky activities. Basel III requirements for more and better-quality capital and liquidity buffers should enable institutions to better withstand distress. Banks will likely adjust to the new costs in various ways, some of which may not have been intended. The new banking standards may encourage certain activities to move to the nonbank sector, where those standards do not apply. Alternatively, big banking groups with advantages of scale may be better able to absorb the costs of the regulations; as a result, they may become even more prominent in certain markets, making these markets more concentrated.

Although the intentions of policymakers are clear and positive, the reforms have yet to effect a safer set of financial structures, in part because, in some economies and regions, the intervention measures needed to deal with the prolonged crisis are delaying a “reboot” of the system onto a safer path. These intervention measures are rightly aimed at preventing a collapse of the financial system and supporting the real economy, but they can also provide time to allow damaged financial systems to recover. The findings suggest, however, that despite improvements along some dimensions and in some economies, the structure of intermediation remains largely unchanged. The data suggest that financial systems are still overly complex, banking assets are concentrated, with strong domestic interbank linkages, and the too-important-to-fail issues are unresolved. Innovative products are already being developed to circumvent some new regulations. These same traits have been linked to the crisis, suggesting financial systems remain vulnerable. The good news is that there do not appear to have been serious setbacks to financial globalization (despite reversals from some crisis-hit economies); however, this also means that in the absence of appropriate policies, highly integrated economies are still susceptible to harmful cross-border spillovers.

Despite much progress on the reform agenda, reforms in some areas still need to be further refined by policymakers. These areas include a global-level discussion on the pros and cons for direct restrictions on business models; monitoring, and a set of prudential standards if needed, for nonbank financial institutions posing systemic risks within the so-called shadow banking sector; careful thought on how to encourage the use of simpler products and simpler organizational structures; and further progress on recovery and resolution planning for large institutions, including cross-border resolution to help secure the benefits of financial globalization. Finally, the success of the current and prospective reforms depends on enhanced supervision, incentives for the private sector to adhere to the reforms, the political will to implement regulations, and the resources necessary for the task of making the financial system simpler and safer.