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FINANCIAL REFORM AFTER THE CRISIS: AN EARLY ASSESSMENT*

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Highlights

- This paper takes stock of global efforts towards financial reform since the start of the financial crisis in 2007-08, and provides a synthetic (if simplified) picture of their status as of January 2012. Underlying dynamics are described and analysed both at the global level (particularly G-20, International Monetary Fund and the Financial Stability Board) and in individual jurisdictions, together with the impact the crisis has had on them. The possible next steps of financial reform are then reviewed along several dimensions including ongoing crisis management in Europe, the new emphasis on macroprudential approaches, the challenges posed by globally integrated financial firms, the implementation of harmonised global standards and the links between financial systems and growth.

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1 Introduction

Financial reform has been a core dimension of the initial global policy response to the financial turmoil of 2007–2008. At the first G-20 summit of heads of state and government in November 2008, more than four-fifths of the action points in the final declaration were about financial regulation (Rottier and Véron, 2010b). Obviously, the crisis is not over at the time of writing, and the cycle of financial reform it triggered is very far from complete. But it can be said confidently that the crisis has been transformational for financial regulatory policy, at least in the United States (US) and Europe[1].

One of the key lessons of the crisis is the close interdependence between the detailed features of financial systems and macroeconomic outcomes. Thus, the tight separation of financial and macroeconomic issues, which is entrenched both in academia and in the policymaking community, needs to be overcome. Initiatives to better analyse 'macrofinancial' linkages and to conduct 'macroprudential' policy have mushroomed since the start of the crisis, although they generally fall short of a fully joined-up framework. From this perspective, the focus of this chapter is financial regulation in an old-fashioned sense, understood as a cluster of interrelated policies designed to ensure the proper functioning and integrity of financial systems. This scope includes public regulation and supervision of bank capital, leverage, liquidity, and risk management; control of moral hazard and financial industry incentives; protection of the customers of financial services; and the regulation of capital markets. Other reform areas such as capital-flow controls, prevention of money laundering, and the taxation of financial activities can overlap with this agenda, but are not considered here part of it in a strict sense.

The general impetus of financial reform as a reaction to the crisis, in the US and Europe, has been toward more regulation, or re-regulation. This is admittedly too simplistic a generalisation: this policy area is multidimensional and cannot be reduced to a simple choice between less or more regulation. Nevertheless, there was a clear turning point in 2008 with the renewed realisation that financial systems, including banking systems, could not be left to their own devices, both because of the large potential economic cost of financial crises and because public expenditure is often a key component of their resolution. This age old wisdom was neglected in the preceding decade in both the US and Europe, for different reasons, more than in the rest of the world, including Australia, Canada, Japan, and emerging economies.

Financial regulation is a complex thicket of highly technical policy challenges, often subject to the use of mutually incomprehensible jargons even as they are mutually interrelated. The devil is generally in the details, and elegant quantitative modeling of policy trade-offs is rarely available. Analytical frameworks tend to be similarly fragmented across different academic silos, including economics, financial research, accounting, political science, and sociology. From an economic research perspective, this is a less mature field than other policy areas such as fiscal, trade or labour policies. Hopefully, the crisis itself will result in new avenues for research, the results of which might start to become available in a few years' time.

[1] The sequence of financial events that started in the summer of 2007 and is still unfolding at the time of writing has been referred to under various monikers including the subprime crisis, the late-2000s financial crisis, the Great Recession, or the global financial crisis. As none of these is fully satisfactory or has been universally adopted, we simply refer to this sequence in this chapter as "the crisis."

The first section of this chapter examines the dynamics of financial reform as they have unfolded since the start of the crisis. The second and last section looks at the forthcoming challenges and future prospects.

2 The dynamics of financial reform

Systemic financial crises frequently result in major financial regulatory initiatives. The US is a typical example: the key historical milestones of US financial regulation before the current crisis were the creation of the First Bank of the United States in 1791, as a consequence of the states' difficulties repaying the debt from the War of Independence; the creation of the Second Bank of the United States in 1816 in the wake of the inflation and financial difficulties associated with the war of 1812; the Legal Tender Act of 1862 and National Banking Acts of 1863 and 1864 to deal with the challenges of financing the Civil War; the Federal Reserve Act of 1913 in the aftermath of the banking crisis of 1907; the New Deal legislation, particularly the Securities Act of 1933, the Banking (Glass-Steagall) Act of 1933, and the Securities Exchange Act of 1934 after the Wall Street crash of 1929 and the banking panic of early 1933; the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991 as a reaction to the Savings and Loan crisis; and the Sarbanes–Oxley Act of 2002 after the Enron collapse and a string of other financial reporting scandals. Similarly, in Japan much of the current financial policy framework was introduced in the late 1990s and early 2000s following the financial turbulence that accompanied the country's 'lost decade'.

In the European Union (EU), a distinct driver of financial reform in the two decades preceding the crisis was the effort to create a single market for financial services, particularly after the introduction of the euro in 1999. Landmark corresponding pieces of legislation include the 1989 Second Banking Directive, which encouraged the creation of cross-border branches; the 1993 Investment Services Directive, which established a single 'passport' regime for investment banking operations throughout the EU; the 2002 Regulation on International Accounting Standards, which paved the way for the EU's adoption of International Financial Reporting Standards (IFRS) in 2005; the 2004 Markets in Financial Instruments Directive (MiFID), which broke the monopoly of national stock exchanges and established the basis for EU-wide competition among trading platforms; the 2006 Capital Requirements Directives, which transposed the Basel II Accord and paved the way for a harmonised regulatory framework for bank capital requirements; and the 2009 Solvency II Directive (the preparation of which started long before the crisis), which established a parallel capital regulation framework for insurance companies.

EU harmonisation efforts have themselves been a powerful stimulant or enabler for global regulatory projects. The two most prominent pre-crisis examples in this respect are IFRS and the Basel II Capital Accord. In the case of accounting, the EU's decision to adopt IFRS, made at the political level in 2000, finalised through the above-mentioned 2002 regulation and implemented in 2005–2006, was the trigger for their subsequent adoption by a significant number of jurisdictions that now represent about half of the aggregate market capitalisation of large companies worldwide (Véron, 2011). In the case of Basel II, the EU was instrumental in the negotiation of the accord in the first place, and was among the first to implement it with the adoption of the Capital Requirements Directives and subsequent rulemaking in individual member states. According to the Basel Committee on Banking Supervision, by September 2011, implementation of the Basel II Accord was complete in 21 of the committee's 27 member countries, with at least two more countries planning to join in 2012 (BCBS, 2011b).

Since the start of the crisis, financial reform has resulted from a sometimes complex and iterative combination of discussions and initiatives, at both at the individual jurisdictions and international levels.

2.1 *The G-20*

The emergence of the G-20 as the 'premier forum for [...] international economic cooperation'[2] is a significant development that crystallised in the first few weeks following the collapse of Lehman Brothers and the ensuing wholesale market panic (Price, 2009). The G-20 format traces its origins back to the aftermath of the Asian crisis of 1997–1998, but it was adopted as a forum for meetings of heads of state and government only in 2008. G-20 summits have been held in Washington (November 2008), London (April 2009), Pittsburgh (September 2009), Toronto (June 2010), Seoul (November 2010), and Cannes (November 2011). In the area of financial regulation, the G-20's impact can be observed in two ways.

First, the inclusion of large emerging countries into the 'premier forum' of political leaders has triggered parallel expansion or rebalancing of most of the global financial authorities that play a role in financial regulation. This included the April 2009 transformation of the Financial Stability Forum, which like the G-20 was created in 1999 following the Asian Crisis, into the Financial Stability Board (FSB) and the expansion of its membership from 11 countries (eight Western countries plus Japan, Hong Kong and Singapore) to 24 countries, of which 10 are emerging economies in addition to Hong Kong, Singapore and South Korea. Similarly, in March 2009, the Basel Committee for Banking Supervision expanded from 13 member countries (all developed economies) to 27 (of which 10 are emerging economies, plus Hong Kong, Singapore and South Korea). The Committee on the Global Financial System, also in Basel, expanded at the same time from 13 to 22 countries including Brazil, China, Hong Kong, India, Mexico, Singapore and South Korea. The Monitoring Board of the IFRS Foundation, which oversees IFRS standard-setting by the International Accounting Standards Board (IASB), was initially established in January 2009 with only the US, the EU and Japan directly represented, but the addition of large emerging economies is actively under consideration at the time of writing (Monitoring Board, 2011). Perhaps most prominently, the International Monetary Fund (IMF) in December 2010 adopted a significant realignment of its quota shares resulting in the presence of the four largest emerging economies (Brazil, China, India and Russia) among its ten largest shareholders.

Second, beyond its impact on the landscape of global financial institutions, the G-20 launched a series of individual initiatives in the area of global financial regulation. As previously mentioned, this was particularly the case during the first G-20 summit in Washington, in which 39 out of 47 items in the final declaration were about financial regulation in the sense used in this chapter. The specific impact of the G-20 in this field is not easy to assess precisely. Some initiatives were given G-20 endorsement but would probably have gone ahead anyway. In other cases, the G-20 set deadlines

[2] Final declaration of the G-20 Summit in Pittsburgh, September 25, 2009.

that the authority of the heads of state and governments effectively made binding. This was seen in the negotiation of the Basel III accord on bank capital, leverage, liquidity, and risk management, which was published in 2010 after less than two years of negotiations, compared to its predecessor (Basel II) which took six years to complete. In other cases, however, the G-20 set deadlines that were not met, and it is unclear to what extent it had an actual impact on the related work of specialised global financial authorities. For example, the Pittsburgh Summit declaration included a call for the IASB and the US Financial Accounting Standards Board (FASB) to complete their convergence program between IFRS and US Generally Accepted Accounting Principles (GAAP) by June 2011; in the Toronto and Seoul summit declarations, the same aim was mentioned, but with the completion scheduled before the end of 2011; and the Cannes summit declaration acknowledged that even this delayed schedule would not be met by the standard-setters. Rottier and Véron (2010a) suggest that the success of the G-20's financial regulatory initiatives is highly dependent on — by decreasing order of effectiveness — whether their implementation was entrusted to treaty-based international institutions, to other global standard-setters, to the FSB as coordinator of individual jurisdictions, or to individual jurisdictions directly.

2.2 *The IMF and the FSB*

While the G-20 is by its very nature a political body, the coordination of the global financial regulatory agenda during the crisis has been mostly the joint preserve of the IMF and FSB, these being "the principal institutions of governance of the global financial architecture" (Schinasi and Truman, 2010). The IMF has played a significant role through its Financial Sector Assessment Program (FSAP). The FSAP, which is conducted by the IMF alone in developed economies and jointly with the World Bank in developing and emerging economies, is a comprehensive assessment of a country's financial-sector stability (and for developing and emerging economies, also of its financial development). In September 2010, the FSAP was made a more regular feature for 25 jurisdictions,[3] for which the assessment will be renewed at least every five years. This meant an end to the de facto exception under which some large countries escaped the scrutiny of the FSAP until the crisis: the first FSAP of the US started in June 2008 and was completed in July 2010; and the first FSAP of China started in August 2009 and was completed in June 2011.

The FSB's role is multifaceted and still, to a large extent, a work in progress. It has set up numerous working groups and coordinates work on multiple fronts, often at the explicit request of G-20 leaders. However, the actual work of standard-setting and rulemaking generally remains at the level of specialised global authorities. One case in point is the FSB's report on the 'shadow banking system', published a week before the 2011 G-20 summit in Cannes (FSB, 2011a). Many of this report's recommendations are addressed not to individual jurisdictions but to global bodies that are FSB members, particularly the Basel Committee and IOSCO. Such patterns mean that assessing the FSB's contribution to the policy process is far from straightforward. In some cases, the FSB's work can be little more than reporting initiatives of its members into which it has had essentially no input; in other cases, FSB leadership is essential for pressing other bodies into taking action. In practice, there appears to be a continuum of situations between these two extremes.

[3] Australia, Austria, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, Italy, Japan, India, Ireland, Luxembourg, Mexico, the Netherlands, Russia, Singapore, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

2.3 *Individual jurisdictions*

The pattern of financial reform initiatives has been extremely different from one jurisdiction to another, notwithstanding the coordination efforts deployed in G-20 summit and FSB initiatives. Multiple factors converge when explaining the differences of approach, including longstanding variations of institutions, culture, and economic structures, as well as different patterns of impact of the crisis itself.

The US has had a comparatively linear sequence of crisis management and resolution, legislative debate and decision, and implementation of new legislation by specialised authorities. Following the ad hoc rescue of Bear Stearns (March 2008), the *de facto* nationalisation of Fannie Mae and Freddie Mac (early September 2008) and the collapse of Lehman Brothers and the rescue of AIG (mid-September 2008), the US introduced the Troubled Asset Relief Program (TARP) as the main instrument of the executive branch's crisis management strategy through the Emergency Economic Stabilisation Act, enacted on October 3, 2008. After the November 2008 elections and change of administration in January 2009, the phase of crisis management and resolution was essentially completed with the publication on May 7, 2009, of the results of the Supervisory Capital Assessment Program (commonly referred to as 'stress tests') which imposed significant capital-raising requirements on ten out of nineteen participating banks. This step marked the beginning of a gradual normalisation of financial conditions. Smaller bank failures, as reported by the FDIC, peaked in the third quarter of 2009 and have been on a downward trend since, even though their numbers remain high. The US Federal Reserve gradually phased out its exceptional liquidity provision, and the main corresponding program, the Term Auction Facility, expired in March 2010. This sequence of crisis management initiatives was followed by more than a year of legislative debate, from the publication of the administration's blueprint for financial reform in mid-June 2009 (US Treasury, 2009) to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. Thereafter, individual authorities started a protracted phase of rule-making on the basis of the parameters set by the Dodd-Frank Act, a process that is still ongoing at the time of writing.

In the EU, there has been no similar sequence, and crisis management and legislative reform have both been continuous processes with overlapping consequences. Successive rounds of stress tests were completed in September 2009, July 2010 and July 2011 but have not resulted in the return of trust in the European banking sector, and from late 2009 onwards the difficulty has been compounded by sovereign credit fragility affecting first Greece and then Ireland, Portugal, Spain, Italy and others. Simultaneously, the European Commission's Internal Market Directorate-General (DG MARKT), which oversees financial regulation at the EU level, has actively proposed new legislation in multiple areas: capital requirements (proposed in October 2008, adopted in various steps in 2009), deposit insurance (proposed in October 2008, adopted in March 2009), rating agencies (proposed in November 2008, adopted in November 2009), hedge funds and private equity (proposed in April 2009, adopted in June 2011), revision of capital requirements (proposed in July 2009, adopted in November 2010), new EU-level supervisory authorities (proposed in September 2009, adopted in November 2010), revision of credit rating agencies (proposed in June 2010, adopted in May 2011), revision of deposit insurance (proposed in July 2010, discussion ongoing), market infrastructure (proposed in September 2010, discussion ongoing), revision of capital requirements (proposed in July 2011), revision of the 2004 directive on markets in financial instruments (proposed in October

2011), revision of 2003 directive on market abuse (proposed October 2011), another revision of credit rating agencies (proposed November 2011), and framework for bank crisis management and resolution (forthcoming), to name only the most prominent pieces. Inevitably, the fact that so many different pieces of legislation are debated and decided upon while the financial crisis continues raises risks of legislative inconsistency and of short-term considerations prevailing over longer-term ones.

Moreover, in the EU important financial legislation is also set at the national level, under various patterns of coordination with EU-level legislative initiatives. This has been particularly the case with moves to introduce special resolution regimes for troubled banks, on the model of FDIC-managed receivership, which did not exist in most European countries until the crisis. The UK, Germany, Belgium, Ireland, Sweden and other EU member states have adopted such legislation, well in anticipation of any European Commission proposal in this area. The UK has distinguished itself with a more in-depth debate on banking structures than its EU peers through the Independent Commission on Banking chaired by John Vickers, which delivered its final report in September 2011 (ICB, 2011). Likewise, the imposition of new taxes or levies on the financial sector has been the preserve of individual member states, even though the possibility of an EU-level or Eurozone tax on financial transactions is being actively debated at the time of writing.

Beyond the EU and the US, Switzerland stands out for its decision to demand capital requirements for its largest banks, which go well beyond the minimum set by Basel III, which itself is tougher than Basel II. This is ostensibly linked to the discovery in 2008 of major risk-management shortcomings at UBS, which had a durable impact on Swiss public opinion. Other jurisdictions, including Canada, Australia, and countries in Asia, the Middle East, Africa, and Latin America, were generally less impacted financially by the crisis. Their financial reform initiatives since 2007, if any, have generally not risen to a level of prominence comparable to those in the US, the EU and Switzerland.

2.4 *Crisis-induced shifts*

In comparison to the preceding two decades, the crisis has induced shifts in the interplay between the public and private sectors, between political and technical factors, between the global and jurisdictional levels, and between developed and emerging jurisdictions. Generalisations are difficult in this analysis because reform dynamics vary widely across specific issue areas and jurisdictions, before and after the start of the crisis. Nevertheless, a few trend changes can be identified at a general level.

First, the crisis has marked a relative retreat of the private sector's influence over the financial policy process. At the global level, this change is perhaps best exemplified by the contrast between Basel II and Basel III. The negotiation of Basel II was, to a significant extent, a collaborative exercise between large banks, partly through the agency of the Washington based Institute of International Finance (IIF) and the Basel Committee and its members. The Basel II Accord ended up giving wide discretion to banks to assess the riskiness of their asset portfolios, under the control of supervisors (Tarullo, 2008). By contrast, Basel III was an initiative of the supervisors and the Basel Committee secretariat under close monitoring by G-20 leaders, and resulted in a partly public — and at times bitter — controversy between the Committee and the IIF over the assessment of the Accord's macroeconomic consequences (BCBS, 2010a; IIF, 2010). Similarly, in some jurisdictions, including the US, UK and

Switzerland, and at the EU level, financial reform initiatives elicited a level of opposition from the financial industry without equivalent in recent memory. Among other episodes, this shift was illustrated when JP Morgan Chase CEO Jamie Dimon described the Basel Committee's proposed capital surcharges on Global Systemically Important Banks as 'anti-American'[4], or when the Director General of the Confederation of British Industry, John Cridland, referred to the proposals of the UK Independent Commission on Banking as 'barking mad'[5]. This is not an absolute shift: there were instances of autonomy of public financial policymaking from the private sector before the crisis, including the US Sarbanes-Oxley Act of 2002; and there are examples of private-sector capture of the policy process since the crisis started, such as when the European Commission in October 2008 forced the IASB to amend its IAS 39 standard on financial instruments to help banks escape the early recognition of crisis-induced losses, or when the US FASB eased its criteria for asset impairment in early 2009 under pressure from Congress. There are also many grey areas. Nevertheless, the general trend so far appears to have been a sharp reduction of the private sector's influence over the financial policy process.

Second, within public policy decision-making there has been a general shift toward more politicisation. Policy issues that were previously the preserve of a narrow community of technicians and practitioners have tended to climb up the agenda and be directly affected by the political concerns of elected officials. For example, accounting issues have repeatedly been discussed at length among G-20 leaders, and featured prominently in political discourses, such as French President Nicolas Sarkozy's first speech at the World Economic Forum in Davos, which contained no fewer than seven references to accounting standards (Sarkozy, 2010). The crisis has elevated financial issues to matters of concern for the general public, as the Occupy Wall Street movement of 2011 in the US and similar initiatives in Europe have shown. Even though it is generally difficult to disentangle the influence of political and technical concerns in the policy process, there is little doubt, for instance, that the restless opening of multiple regulatory fronts by the European Commission successively on hedge funds and private equity, credit rating agencies, remuneration policies, short-selling, regulation of audit firms, and the introduction of a Financial Transaction Tax, responds in part to a politically motivated urge to act, even though the Commission's civil servants have duly produced a technical rationale for each initiative. The evidence of past failures of oversight or excessive regulatory forbearance, such as the US Federal Reserve's failure to properly supervise mortgage originators, the UK Financial Services Authority's inability to anticipate the bank run at Northern Rock, or German supervisors' tolerance of large Irish-based off-balance-sheet conduits at since-failed banks IKB, SachsenLB or WestLB, has also diminished the autonomy of financial authorities. Financial regulators and supervisors, like central bankers, have acted under the general public's eye since the start of the crisis to an extent that was rarely seen in the previous era.

Third, the crisis has affected in multiple ways the boundaries between global and local financial policymaking, even though this transformation cannot be described as a uniform trend. On the face of it, the creation of the G-20 has appeared, at least initially, to be a significant shift toward the empowerment of global decision-making in the financial regulatory area. Many political leaders,

[4] Stephen Mangan, "Jamie Dimon, CEO of JPMorgan Chase, Calls International Bank Rules 'Anti-American,'" *Reuters*, September 11, 2011.
[5] Elizabeth Rigby, "Rush to ringfence banks 'barking mad,'" *Financial Times*, August 29, 2011.

particularly those from large Western European countries, heralded the need to define 'global solutions' to a crisis that was described as a 'global problem'. Indeed, the G-20 agreements to adopt the Basel III accord or to move the clearing of over-the-counter derivatives to central counterparties, even though they are not yet fully implemented, were landmark instances of international joint regulatory action with few precedents in the preceding two decades. However, there have also been crisis-related setbacks in terms of the regulatory underpinnings of global financial integration. This particularly applies to the European Commission, which was a determined champion of global regulatory harmonisation throughout the 1990s and 2000s but has shifted markedly since 2008 towards a more unilateralist stance in many areas. At play has been the fact that it is intrinsically more difficult to achieve international regulatory convergence in an era of financial reregulation than in an era of liberalisation (Rottier and Véron, 2010a). The UK Independent Commission on Banking's suggestion to 'ring-fence' the retail operations of international banks is another illustration of the way the crisis is shifting the limit between globally integrated and jurisdiction-specific regulatory and supervisory approaches.

Fourth, the crisis has accelerated the transition from a western-dominated financial world toward a more globally-balanced one in which large emerging countries play an increasingly significant role, with consequences for financial regulation that remain difficult to predict. To various degrees, the memberships and/or governance structures of the IMF, the FSB, the Basel Committee and other committees hosted by the Bank for International Settlements, and the IFRS Foundation, have been or are being expanded to include large emerging economies. It will certainly take time for this to translate into a rebalancing of these authorities' senior leadership. IOSCO gave itself a non-Western head in April 2011 with the selection of Brazil's Helena Santana as its chair, but most post-crisis senior appointments have gone to westerners. At the IMF, Christine Lagarde was appointed Managing Director in June 2011. At the Basel Committee, in June 2011 Australia's Wayne Byres was appointed Secretary General, Sweden's Stefan Ingves Chairman, and Britain's Mervyn King Chair of the Group of Governors and Heads of Supervision. At the IASB, the Netherlands' Hans Hoogervorst was appointed Chair in October 2010 (effective in July 2011), and France's Michel Prada's appointment as Chair of the IFRS Foundation's Trustees was announced in December 2011. At the FSB, Canada's Mark Carney was appointed Chair in November 2011. And the next president of the World Bank, to be appointed in 2012, is expected to be an American. Plainly, the shift from G-7 to G-20 has not yet translated into these selection processes, and the same is true at less visible levels: for example, half of the FSB's member countries are emerging economies, but the vast majority of its working groups and task forces are headed by westerners. It appears likely that the wider diversity of participants should gradually result in leadership roles being taken by emerging economy representatives, at least in some areas. Even so, it remains to be seen how keen these new entrants will be to empower global financial authorities and effective international cross-border regulatory convergence, in absolute terms and in comparison with the western incumbents.

3 Challenges and outlook

It is far too early to present a settled picture of post-crisis financial reforms and their impact on the global financial system. Huge challenges remain and it is still unclear how they will be met. First and foremost, the crisis has not yet been resolved, and the interaction between crisis management and longer-term reform creates uncertainties of its own. Second, in spite of widespread calls for 'macroprudential' approaches, the interaction of financial-sector policy with other dimensions of economic policymaking remains largely unsettled. Third, how to effectively regulate cross-border financial firms remains a fundamentally unsettled question. Fourth, other reforms will be difficult to implement in an internationally consistent manner, raising concerns about the possible fragmentation of the global financial space. Fifth, the reforms will affect the financial system's contribution to economic growth in multiple ways, which on the whole remain poorly understood.

3.1 *Ongoing crisis management*

The most obvious uncertainty is that the financial crisis is far from over. Although it was partly overcome in the US in 2009, it is still worsening in Europe and could again spill over to other parts of the world. This creates a triple risk of forbearance, populism, and irrelevance.

Concerns about financial instability in jurisdictions where the financial crisis remains unresolved, including much of continental Europe at the time of writing, can easily lead to excessive forbearance as has been the case in several past episodes of systemic banking fragility, such as in Japan in the 1990s. For example, large continental European countries such as Germany and France were widely reported as being reluctant to tighten the definition of capital and impose higher minimum capital requirements in the negotiation of the Basel III Accord and in the subsequent discussion of SIFI surcharges. Similarly, the first draft of the EU legislation transposing Basel III softens some of the Basel Committee's tightening of the definition of capital, and prohibits the voluntary application of higher capital requirements by individual member states. The same factor was at play when European policymakers forced the IASB in October 2008 to amend the IAS 39 standard on financial instruments and allow more flexibility in the classification of financial instruments by struggling European banks. This is especially important as the European Union prepares to introduce legislation on banking crisis management and resolution, for which a proposal is expected from the European Commission in early 2012. It is arguably impossible to eliminate moral hazard from banking sector policy frameworks, but it is arguably even more difficult to prevent it when such frameworks are prepared in a climate of systemic instability.

The risk of populism complements that of forbearance, and the two can be simultaneous. As the ongoing crisis creates a political demand for action, and action at a fundamental level is prevented by the bias towards forbearance, policymakers can be tempted to adopt a punitive attitude toward the financial sector, in response to popular perceptions rather than in-depth policy analysis. This has arguably been the case with initiatives, particularly in the EU, to put hard limits on the scope of remuneration practices in the financial industry and to impose specific taxation on aspects of financial activity. In certain cases, such impulses can be aligned with strategies of 'financial repression', namely the forced investment of domestic savings in government securities, or in other forms of repression of market mechanisms for price-setting and capital allocation, such as the attempts to discourage some forms of hedging against sovereign risk or to suspend the publication of credit rating decisions affecting troubled countries. Given the complexity of financial regulation, it can be difficult to disentangle such populist motivations from other drivers of financial reform. Nevertheless, they are likely to gain in prominence if the European crisis worsens and leads to more financial and economic dislocation.

Furthermore, embarking in long-term financial reform while a major financial crisis is still ongoing and unresolved creates a risk of irrelevance of the corresponding legislative and regulatory initiatives, to the extent that the eventual crisis resolution can be expected to usher in a new round of reform to ensure that 'it never happens again'. Examples in the EU are the successive rounds of amendments to the Capital Requirements Directive of 2006 (introduced respectively in October 2008, July 2009, and July 2011), or the three consecutive regulations to create a tighter legal framework for the activity of credit rating agencies (the first two were respectively finalised in November 2009 and May 2011, and the third set of proposals was published in November 2011).

Each of these three factors, in certain circumstances, can contribute positively to the quality of policymaking. Forbearance can be a rational calculation to minimise financial dislocation, even though it increases moral hazard. Populism can help assert the autonomy of financial reform against pressure from the financial industry. Successive rounds of regulatory reform can result in gradual improvements of the regulatory framework and correction of past missteps. But each of them can also easily have negative consequences in terms of the sustainability and efficiency of the financial policy framework.

3.2 *Macroprudential approaches*

Events since 2007 have revealed embarrassing blind spots in the pre-crisis understanding of the financial system by policymakers but also by the academic community. Thus, there has been an understandable drive to introduce a more comprehensive and joined-up approach to financial regulation. This has resulted in an emphasis on 'macroprudential' policies and institutions, using an expression developed well before the crisis by the Bank for International Settlements (Clement, 2010).

Perhaps the most visible consequence has been the creation of new bodies with a mandate to contribute to system-wide financial stability in most jurisdictions affected by the crisis. In the US, the Dodd-Frank Act of 2010 created a Financial Stability Oversight Council (FSOC), chaired by the US Treasury Secretary, and an Office of Financial Research with autonomous resources within the Treasury Department. In the EU, the string of institutional reforms known as the 'supervisory package', adopted in November 2010, created a European Systemic Risk Board as an autonomous EU institution hosted by the European Central Bank in Frankfurt and chaired by the ECB's President. In the UK, the Bank of England in 2011 established a Financial Policy Committee, pending forthcoming legislation that will specify this new body's exact role and mission. Similar bodies were created in France (Financial Regulation and Systemic Risk Council), Belgium (Committee for Systemic Risks and System-relevant Financial Institutions), and other jurisdictions. However, this list itself illustrates a diversity of views about the relationship between financial stability policy and the wider aim of economic and price stability, which is typically the preserve of central banks (White, 2012). In the UK, the macroprudential body is part of the central bank and chaired by the bank's governor, even though its membership is distinct from that of the Monetary Policy Committee. At the EU level and in Belgium, it is also chaired by the central bank's governor but is legally autonomous and includes representatives of multiple public entities. In the US and in France, it is chaired by the Finance Minister, suggesting further distance from monetary policy.

The macroprudential concept, as described by one of its early promoters (Borio, 2010), has a time dimension (how risk in the financial system evolves over time) and a cross-sectional dimension (how risk is allocated among financial-system participants at a given point of time). Beyond the institutional machinery, there are challenges in both dimensions. On the first, policies to adjust some financial regulatory instruments over the financial cycle in order to mitigate their pro-cyclical effect or to make them counter-cyclical remain tentative at best. Specifically, the Basel III framework envisages that regulated entities will be required to build up counter-cyclical capital buffers, but supervisory authorities may prove reluctant to take a stance on the shape of the financial cycle that could be proved inaccurate by future developments. The cross-sectional dimension has given rise to more follow-up, with the crisis-induced recognition that all financial firms have a potential impact on system stability, and that regulatory silos that separate the respective policy frameworks for depository institutions, insurers, investment funds, etc., can be irrelevant or even counterproductive from a systemic stability standpoint. This concern partly underlies the new processes for registration of long unregulated or lightly regulated actors such as private equity and hedge funds in both the EU (Alternative Investment Fund Managers Directive of 2011) and the US (Dodd-Frank Act).

The same concern also underlies the explicit designation of some financial firms as systemically important. At the global level, the FSB in November 2011 published a list of 29 Global Systemically Important Banks (G-SIBs) on the basis of criteria set by the Basel Committee (BCBS, 2011c). The FSB intends to enlarge that list in 2012 to include global systemically important non-bank financial institutions; additional capital requirements are expected to be applied to G-SIBs from 2016 onwards, on the basis of the update of the list to be published by the FSB in November 2014 (FSB, 2011b). At the level of individual jurisdictions, Belgium, as early as October 2010, identified 15 systemic financial firms, including four credit institutions, four insurers, three holding companies, and three entities of the Brussels-headquartered Euroclear securities settlement and custodian services group. In the US, the Dodd-Frank Act prescribes the FSOC to do the same, even though no such list has been published at the time of writing. Other individual jurisdictions will follow suit, but some may be reluctant to single out specific firms as systemically significant, partly out of concern about creating competitive distortions in the domestic financial environment, and also because of different perceptions about the specific risks associated with 'too-big-to-fail' financial institutions (Goldstein and Véron, 2011).

Beyond these two dimensions, macro-prudential concerns have also been invoked to justify controls imposed on external capital flows in order to mitigate the risks associated with 'hot money'. In particular, the crisis has triggered a reversal of the IMF's position on capital controls, which are now viewed as an acceptable tool of financial stability policy if correctly wielded (Ostry *et al.*, 2011). This illustrates the elasticity of the macroprudential concept and of its boundaries with, on the one hand, monetary policy run by central banks, and on the other hand, microprudential supervision of individual financial firms by prudential supervisors. While the crisis has clearly underlined the need to monitor not only individual regulated institutions but also the financial system as a whole, the best way to reach this objective is unlikely to become a matter of universal consensus in the short or even the medium term.

3.3 *Regulating multinational financial firms*

The crisis has brought a sense of urgency to another longstanding challenge: the resolution of the difficulties posed by multinational financial firms. These can shift risks across borders in ways that escape the oversight of national supervisors, as was illustrated by the concentration of risk in the London-based operations of AIG Financial Products, which precipitated the downfall of the entire AIG Group. Moreover, when such firms collapse, the absence of a centralised resolution process creates the scope for considerable uncertainty and cross-border contagion, a striking example of which was provided by the Lehman Brothers bankruptcy.

This challenge relates to an emerging policy debate about the structure of financial firms, in which the UK has taken an early lead with the consultations and conclusions of the Independent Commission on Banking chaired by John Vickers (ICB, 2011). The ICB's most prominent recommendation is to ring-fence the domestic retail activities of UK financial firms in order to more easily separate them from international wholesale activities in the event of a crisis. This raises the possibility of protecting depository operations from the knock-on effects of international financial failures. However, it does not tackle the problem posed by cross-border failures of pure wholesale operations, as was the case with Lehman Brothers.

The FSB has attempted to foster coordination of contingency planning and resolution efforts for global systemically important financial institutions, and has initiated the development of common processes and tools by national supervisory and resolution authorities (FSB, 2011b). However, the European experience suggests caution over the operational relevance of such coordination efforts. When the Fortis financial group collapsed in late September and early October 2008, in particular, pre-existing arrangements among national regulators, enshrined in memorandums of understanding and other non-binding endeavors to promote constructive cooperation, were largely swept away by the urgency of the situation and the national mandates and accountability frameworks of the main public authorities involved. Some policymakers such as Liu (2010) have suggested the possibility that more binding international approaches to addressing this challenge should be considered, possibly through international law. However, such approaches remain likely to give rise to significant political resistance and are therefore widely considered as being no more than a remote possibility.

3.4 *Consistent implementation of global standards*

While the supervision and resolution of international financial firms is an area in which cross-border interactions are particularly difficult to manage, the comparably less intractable aim of consistency in implementing standards agreed at the global level is not itself assured of being satisfactorily met. This carries risks of competitive distortions, regulatory arbitrage, and to some degree, fragmentation of the international financial space.

A prominent case is the forthcoming implementation of the Basel III Accord (BCBS, 2011a and 2010b), which tightens the definition of capital and raises capital requirements (with a phased introduction to be completed in 2019); introduces a maximum Leverage Ratio (mandatory from 2018); and ushers in liquidity requirements for banks to withstand liquidity stress over periods of one month (Liquidity Coverage Ratio, to be introduced in 2015) and one year (Net Stable Funding

Ratio, to be introduced in 2018). The G-20 leaders endorsed Basel III at the Seoul Summit in November 2010 and committed to implement it in their respective jurisdictions. At the time of writing, most jurisdictions are still at a relatively early stage of this process, but concerns have already emerged about the consistency of implementation in jurisdictions including the EU, where the proposed legislation (fourth Capital Requirements Directive and Capital Requirements Regulation, adopted by the European Commission on July 20, 2011) diverges from Basel III on some aspects of the definition of regulatory capital. Conversely, there are widespread doubts in Europe about the extent to which Basel III will be implemented by the US.

Comparable concerns exist about accounting standards, with the difficulty of maintaining consistent endorsement and implementation of IFRS as more jurisdictions decide to adopt them. While the IFRS Foundation tries to promote the universal use of all IFRS, some jurisdictions including the EU and to a greater extent China and India, have adopted standards that vary from IFRS in ways that can have significant impact for some issuers, resulting in what can be described as 'IFRS dialects' (Véron, 2011). The US has not yet determined its position on eventual IFRS adoption, but is likely to include a strong 'dialectal' component as well. If such dialects multiply, the risk is that the central promise of IFRS, namely the cross-border comparability of corporate financial statements, will not be delivered.

3.5 *Financial systems and growth*

Finally, one of the most open questions of all is how the post-crisis financial reform agenda might affect the ability of the financial sector to contribute to overall economic growth. This issue too has multiple dimensions.

As mentioned above, the consequences of tighter capital requirements on economic growth has been a matter of heated controversy in the context of the preparation of Basel III, with a stark contrast between simulations conducted by the financial industry that predicted a devastating effect of the proposed rules on future output (IIF, 2010), and those of the supervisory community that forecasted a much milder impact (MAG, 2010 and BCBS, 2010a). Ultimately, the G-20 leaders implicitly endorsed the Basel committee's more sanguine assessment when they adopted Basel III at the November 2010 Seoul Summit.

However, this quantitative argument fails to capture the complexity of the impact of financial reform on growth. In most countries, in the developed world at least, large companies have fairly easy access to international capital markets, and their funding conditions are not overly affected by domestic regulatory frameworks. Smaller companies and other borrowers, by contrast, including younger firms which have the greatest growth potential (Haltiwanger *et al.*, 2010), have no such access, and their ability to mobilise external finance is likely to be most affected by financial reforms. What is at stake is not just the aggregate volume of credit, but how this credit is allocated by heterogeneous intermediaries towards heterogeneous firms and other borrowers. Regulated banks are only one part of this picture, which includes the loosely defined 'shadow banking system' (FSB, 2011a) and interacts with the broader economy in ways that existing economic models generally fail to describe comprehensively.

In particular, the impact of the ongoing movement towards reregulation on global financial integration could materially impact economic trends, to the extent that financial openness is associated with higher levels of economic growth (Cline, 2010). Also, how regulation might encourage or limit competition among financial intermediaries, innovation in financial services, and the allocation of capital to risky new ventures, remains poorly understood, especially given the large number of interrelated recent or ongoing financial reform initiatives.

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