# Where are we in terms of heightened regulation and why are we here?

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The following is a presentation by Michael Callaghan to the Regional Symposium: Enhancing International and Regulatory Cooperation — Post Global Financial Crisis, delivered in Melbourne on 8 March 2011.

1 The views in this article are those of the author and not necessarily those of the Australian Treasury.

I will provide some 'big picture' comments on where we are in terms of heightened financial regulation and why we are here.

It is a personal view from an official who has been associated with this process since the crisis.

I interpret 'big picture' as an invitation to make some sweeping generalisations.

First, some history.

The global financial crisis first made its presence felt in mid-2007, with the emergence of problems in the US market for sub-prime housing loans.

The turmoil that first broke out in financial markets in mid-2007 followed an exceptional boom in credit growth and leverage in global financial systems. A long period of benign economic and financial conditions and low interest rates resulted in a situation where borrowers and investors were taking on more and more risk.

Institutions, particularly in the US, expanded the market for securitisation of credit risk and aggressively developed the originate-to-distribute model of financial intermediation.

Loans were increasingly being securitised by the original lenders to be sold off to other investors. This occurred through conventional mortgage — backed securities but also through complex products called Collateralised Debt Obligations (CDOs).

These complex arrangements enabled securities to gain high credit ratings even when the average quality of the underlying loans was poor. Their relatively high yield made them attractive, but they were not well understood, particularly in terms of the holders exposure to substantial losses in a general downturn in the market — something which did occur.

The crisis entered a new phase in 2008 as doubts emerged about the solvency of key global financial institutions in Europe and the US.

It became increasingly apparent that a number of major banks had invested heavily in these securities and could be exposed to significant losses. But there was uncertainty about the size and location of these exposures. This lack of transparency resulted in a serious loss in investor confidence.

The crisis intensified sharply with the failure of Lehman Brothers in September 2008.

This spiked a severe lack of confidence, not just in the financial sector, but across households and businesses. The Global Financial Crisis was unleashed.

From a global perspective — what were some of the regulatory lessons from the crisis?

- Banks did not have enough capital, both in terms of quantity and quality. A lot of risk had been accumulated but not well measured. Capital held against complex structured products was insufficient. Risk which had been held 'off balance sheet' in an effort to conserve capital soon came back on to the balance sheet. And this represented a regulatory failure.

- Banks had not paid enough attention to the consequence of a market shock where liquidity would be constrained.

- The regulatory perimeter was too narrow. Systemic activity was taking place in un-regulated or less-regulated sectors — investment banks, hedge funds and money market mutuals.

- Banks were globally active, establishing complex operations across national borders, but their supervisory structures and resolution arrangements were nationally based.

But these 'lessons', or deficiencies, were not evident from the experience of banks in all countries — they were not evident in Australia or in many emerging market economies. Banks in these countries were not under-capitalised, did not have a high exposure to sub-prime loans, and had limited investments in complex structured products. But the financial crisis which originated in the US and the euro area spread and had an impact on all countries — highlighting that we live in a highly integrated global economy.

In November 2008, G20 Leaders met for the first time in Washington. The G20 became the forum to galvanise the international response to the crisis. As the saying went, it was a global crisis, it needed a global solution.

The elevation of the G20 as the premier forum for international cooperation was one of the most important developments in global economic leadership in the wake of the financial crisis. It reflected the increasing weight and importance of emerging markets and the need for a more representative global forum, certainly more representative than the G7.

The initial G20 Leaders meeting in Washington in November 2008 focussed on actions to stabilise markets and restore global growth, but it also looked to the future in terms of the financial reforms necessary to minimise future financial crises.

In fact, the G20 Washington Declaration dealt in some detail with measures to strengthen the international regulatory framework for the financial system. It essentially picked up the recommendations from a report prepared by the Financial Stability Forum (FSF) in April 2008, at the request of the G7. This was before the Lehman collapse.

Was it appropriate to focus so much attention in the G20's response to the crisis on strengthening the financial sector regulatory framework?

It is natural that when some blatant regulatory shortcomings are exposed, and are seen as significantly contributing to a crisis, part of rebuilding confidence is to address those shortcomings.

In addition, the fact that G20 Leaders were able to outline at their meeting in November 2008 a concrete action plan to strengthen financial regulation, ensured that the meeting produced something more tangible than a declaration consisting mainly of rhetoric. This helped build confidence. Moreover the 'sense of purpose' from the Washington meeting was enhanced by the Leaders setting timelines for the 47 action items attached to the Washington Declaration. This demonstrated that the meeting was more than a talk fest.

However, when negotiating the Leaders' Declaration and embracing the FSF's recommendations, a stumbling block was that a number of emerging market members of the G20 were not members of the FSF and would not endorse recommendations coming from the FSF unless its 'representativeness' was improved.

- The FSF was essentially a creation of the G7 following the Asian Financial Crisis, although its membership had been extended to cover a representative from Australia, the Netherlands, Hong Kong and Singapore — but it did not include countries like China, Brazil, Russia, Indonesia, Turkey, Saudi Arabia and South Africa.

The solution was a commitment by Leaders' in Washington for the FSF to 'expand urgently' to a broader membership of emerging economies', and all references to the FSF in the Washington Declaration were to an 'expanded FSF'.

The FSF was subsequently expanded to include all G20 members and at the London Summit in April 2009, it was re-launched as the Financial Stability Board (FSB).

The work of the FSB now receives the full weight of G20 Leaders and the FSB is effectively 'oversighted' by G20 Finance Ministers and Leaders. The FSB reports to each meeting of G20 Finance Ministers and Leaders on progress in progressing the commitments made by Leaders' to strengthen the regulatory framework.

By the time of the G20 Seoul Summit in November 2010, Leaders could say:

> Today, we have detailed core elements of the new financial regulatory framework to transform the global financial system.

I will not go into the details of these core elements involving strengthening bank capital requirements, liquidity requirements, limiting leverage, improving market infrastructure, resolution regimes and so on. This will be covered in detail over the course of the seminar.

One aspect I would emphasise is that throughout the negotiations to strengthen the international regulatory framework, the tension was always recognised between measures which would ultimately be an impost on banks and may restrict their lending capacity, at a time when many jurisdictions were seeking to salvage their financial systems and encourage bank lending to restore growth. Part of the answer in dealing with this tension was to introduce significant transition periods for the implementation of the new standards.

Another aspect to highlight is that the FSB is focussing on promoting global adherence to the standards. FSB members have stated that they will lead by example in implementing the strengthened regulatory standards.

The FSB is also seeking to promote adherence to the standards by all jurisdictions — in particular all jurisdictions ranked highly in terms of financial importance. Such a group of jurisdictions, in addition to FSB members, has been identified, and a process has been launched to encourage adherence to the international standards on cooperation and information exchange. This involves positive measures — such as offering technical assistance — as well as the option of publishing the names of jurisdictions defined as 'non-cooperating', as well as moving to more negative measures.

An issue that Australia has stressed in the G20 and FSB was that while the development of the new international standards is one thing, when it comes to ensuring financial stability, the quality of supervision is important, if not more important.

In addition, Australia has emphasised the need to take into account country specific circumstances. This was not motivated by seeking to undermine the objectives of enhanced international standards, but the need to recognise that there are differences in country circumstances which will have an impact in terms of how the objectives can be achieved.

- An example was the strengthening in liquidity standards for banks. With banks being required to hold significantly higher levels of domestic sovereign debt, allowance had to be made for the fact that given Australia's sound fiscal position there was simply not enough Australian government debt on issue for Australian banks to meet the new standards. An alternative approach was required.

In arguing the need for recognition of country circumstances, we are not seeking a competitive edge for our institutions through competitive arbitrage. We will open ourselves to international and peer review to judge whether we are meeting the objectives of the international standards while taking into account relevant domestic circumstances.

This issue may be very relevant to emerging markets as they apply the new standards. Regard will have to be given to their domestic circumstances, which will differ from those in many developed countries.

What are some of the implications of all the changes that have taken place in the financial system since the crisis?

When the new regulatory standards are fully implemented, we should have a safer financial system, less prone to excessive risk taking. But in some jurisdictions, the cost of intermediation may be somewhat higher depending on the extent of the changes required to meet the new standards. Lenders are meant to operate with more capital against the risks they are taking. But capital is not free. Banks in some jurisdictions will have to significantly increase their capital. In addition, high quality risk assets typically have lower yields. But shareholders in financial institutions should have a less risky investment and should be prepared to accept lower returns.

Some other possible changes and challenges:

- Banks may return to more traditional functions — many jurisdictions whose banking systems were largely unaffected by the crisis had more traditional banking systems.

- More activity may flow to the non-banking sector — in fact, the G20 agreed in Seoul to examine ways to strength the regulation and supervision of shadow banking.

- The financial sector will continue to evolve and authorities will need to continue to monitor developments and identify systemically important institutions, markets and infrastructures on an ongoing basis.

- Previous business models may not be viable in the post-crisis environment.

- The impacts of recent developments on competition and on efficiency and innovation must be balanced to ensure that the financial system continues to perform its fundamental role in supporting economic activity and growth.

- And there is the important question of the application of the regulatory reforms to emerging markets. As already noted, allowance has to be made for the fact that the nature of financial systems in emerging markets and developed economies differ, emerging markets have different starting points and may face different challenges. But all countries should support the objective of a stable and efficient financial system.

Importantly, emerging markets have to be brought into the process. At the G20 Seoul Summit, Leaders agreed to work on 'financial stability issues that are of particular interest to emerging markets and developing economies'. To take this forward, the FSB has enhanced its regional outreach arrangements and in conjunction with the IMF, have a work program under way to provide a detailed report to the next Leaders' meeting on the specific financial stability issues facing emerging markets.

I am sure that an important aspect of that report will be the need to enhance the capacity of emerging markets, and in particular developing countries, to be able to ensure the stability of their financial systems.

So that is a very broad overview of where we are and why we got there in terms of international efforts to strengthen the regulatory framework for the financial system.