Perspective

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Global Financial Governance
Improving Stability and Mitigating Future Threats

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EXECUTIVE SUMMARY

The financial crisis revealed the need for legislative and regulatory change in the oversight of financial institutions on both the international and national levels. Leaders in financial services, in government, and throughout the global business community have a vital interest in ensuring that regulatory reform promotes stability in the system and identifies emerging risks, while avoiding unintended consequences that could promote inefficiency and stifle innovation.

Policymakers will need to consider four aspects of the future governance framework, encompassing the measures needed to restore stability, the specific role of regulation, the changes that must take place in the industry itself, and the potential impact on the overall structure of the global financial services sector.

THE FUTURE OF GLOBAL FINANCIAL GOVERNANCE

The financial services (FS) industry is a global, dynamic, and fragile ecosystem where mistakes are prone to chain reactions and low system-wide transparency can lead to additional vulnerabilities as issues intensify while traveling through the system. Consequently, in the wake of the current economic crisis, old-fashioned virtues such as capital strength, high levels of liquidity, and a sustainable funding base are making a comeback.

Historically, no one had responsibility for identifying and assessing systemic risk at either the national or global level. However, today there seems to be agreement that a number of measures need to be taken (e.g., the macro prudential approach suggested by the U.K. Financial Services Authority and the G-20) to strengthen the global FS industry. Aside from the systemic risk issue, banks themselves mismanaged important risk categories: liquidity risk, portfolio risk, and underwriting risk, and also put too much trust in other market participants.

An effective governance framework should now address four key questions that will improve the stability of the global FS industry and proactively identify future risks and threats to the global financial system.

1. What measures need to be implemented to restore the financial services industry?
The global nature of financial markets requires oversight and regulation to take place in various local/national jurisdictions, complemented by international regulation, to ensure holistic and transparent oversight of a global industry and thus avoid the possibility of regulatory arbitrage and gaps in regulatory coverage between home and host jurisdictions.

There is a need for oversight/governance and regulation at local and international levels, as well as an all-encompassing, globally consistent regulatory framework that ensures clear accountabilities for regulators and covers all industry players.

One of the structural problems widely recognized as a reason for the system-wide problems revealed during the current crisis is that newer financial institutions (FIs) that had arisen over the past 20 years were either unregulated or subject to lower levels of supervision than traditional banking organizations. For example, the divorce of origination from distribution of assets and funds—as exemplified in the shift from an "origination to hold" model to an "origination to distribute" one—and the massive securitization of assets have significantly reduced the overall transparency in the FS industry. This "shadow banking system," as it has come to be known, included hedge funds, private equity firms, special-purpose vehicles, and other institutions that held trillions of dollars in asset-backed commercial paper conduits, structured investment vehicles, tender option bonds, variable-rate demand notes, tri-party repurchase agreements, and other assets.

Recent events have also shown that the roles and responsibilities of finance ministries, central banks, and regulators need to be reevaluated to ensure that accountabilities and areas of collaboration are clearly defined. Moreover, we know now that the industry relied too heavily on rating agencies, and that they too have been subject to too little oversight.

To be effective in assessing systemic risk, the governance framework will need to have visibility into the entire range of institutions that are taking positions in the financial markets, not just those that have traditionally been regulated and supervised by national governments.

Finally, the stability of the financial system would be increased in an environment where the various types of risks flow too those FIs that have the greatest ability to manage them. (In the case of credit risk, modern regulation fueled the opposite by requiring banks to set aside more capital for credit risk than non-FIs and thus encouraged banks to shift their credit risk to those that wanted a higher yield but had very limited ability to hedge this type of risk.)

2. What should be the specific role of regulations?

Given the range of legislative and regulatory proposals that are being made at the national and supranational level, there is little doubt that significant changes in FS regulations are in store. The final mix of national and international regulation should ideally provide a globally consistent and transparent governance framework that both is complementary in nature and ensures that regulatory arbitrage is minimized to the extent possible. However, the pursuit of a level playing field also needs to take into account the fact that countries have different regulatory philosophies, e.g., differing views on public sector participation in the private sector or on demand and supply side regulations.

Another danger is that local governments could become even more parochial; some have already pushed to protect their sovereignty by revising foreign investment rules, encouraging banks to make in-country loans if they are taking deposits, and more. This requires counterbalance at the international level to ensure consistency and holistic coverage of regulatory frameworks on a global basis. These frameworks will have major consequences for the FS industry itself, and for the business community and global economy at large. A clear understanding of the desired philosophy, hence the role, of regulation on a national and global basis is thus essential.

Effective regulation and governance rests on the ability to monitor the stability of the global FS system in "real time" to determine the overall health of the system and assess responses that reduce the risk of chain reactions and system-wide failures. Identified risks need to be mitigated in an efficient and effective manner across all affected players and jurisdictions.

At the same time, the FS industry is already one of the most regulated, with more regulation on the horizon, which may have a detrimental impact on innovation and on other FS-dependent industries. To build stability and create the required transparency in the global FS industry, lessons learned from other industries should be taken into account.

An "optimal" level of regulation and risk oversight should ensure the overall macroeconomic stability of global financial markets while avoiding an overly restrictive system that curtails economically purposeful innovation. A clear message from financial and economic history is that "incentives" that trigger the right behaviors are generally more effective and thus often better suited to managing risk than pure regulation, or should at least complement regulation where possible.

A complementary measure to regulation of FIs is to regulate complex products more systematically. For example, product regulation could

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be mandatory for all products exceeding certain thresholds. In addition, high-risk products could be routed through global clearing facilities, which would further reduce systemic risks. This in turn would promote the creation of standardized products and increase transparency, further reducing liquidity and counterparty risks.

3. What needs to change within the industry itself?
Any regulatory framework is unlikely to achieve the desired FS stability effect in the absence of a strong risk culture or the lack of organizational risk DNA that guides and informs the "right" behaviors. Preferably, FI management should be incentivized to set the right vision from the top, thereby aligning performance targets and incentive metrics to drive the organization as a whole toward an optimal and sustainable risk–reward balance.

However, the changes in the industry are likely to make it harder to find the skills and capabilities that are required to lead change across the global FS industry. Talent is moving elsewhere or has been taken out of the industry as a consequence of significant capacity reduction. In addition, given the caps on compensation and other measures currently being discussed—such as clawback—there is a real danger that these jobs are not worth the trouble, especially when the level of public scrutiny, hostility, and reputational risk is considered. Also, some of the FIs may just be too big and complex. The solutions are not yet obvious; smaller FIs with smarter people, better management information, and better risk management could all be part of the solution.

The point is that these are high-risk jobs. Fundamentally, do we care about talent in FS? Yet securing top-grade talent is critical to guarantee the success of current industry restructuring initiatives and to ensure long term that the right capabilities are available in a complex environment. Therefore, future compensation schemes need to be based on actual profits at the bank rather than accounting profits, and on an adequate profit distribution between the individual and the bank as opposed to the current revenue share agreement for the individual.

According to common belief, banks should be required to hold more capital: more capital for credit, market, liquidity, investment, and operational risk—in short, for any kind of risk that exists. However, just increasing overall capital requirements is not a panacea for the problems that caused the current credit crisis because it fails to take into account the different types of risk and the differences among FIs.

Capital requirements need to be in line with the business model and the risks inherent in the business, taking into account local as well as global requirements. Furthermore, capital requirements also need to be assessed in the context of who would ultimately bail out an FI if that should become necessary (recent history seems to indicate that this is done by national governments and ultimately the tax-payer—the underwriter of last resort). For the majority of countries, the risks of supporting global institutions are high and even threaten sovereign default. Consequently, the ability of a sovereign to bail out an FI will influence the optimal/maximum size of an FI: If the size of a potential bailout is too large, then the FI is too big and needs to be downsized to make a bailout "palatable" for the national taxpayer.

In addition, increased capital requirements need to be aligned with an organization's risk taking and risk capacity. Modern regulation (often erroneously) assumes that risks are a precisely quantifiable property of an asset. Apart from the fact that risks come in many forms (credit, market, liquidity), different parts of the financial system have different capacities to hedge risk. Accordingly, risk has as much to do with what the asset is as with who is holding the asset; the popular notion of "safe" instruments that should be promoted at the expense of "risky" ones that should be banned needs to be reevaluated in that context. Consequently, capital requirements should be considered in the context of an organization's ability to hedge the types of risks it takes (e.g., bank deposits and liquidity risk). Banks, for example, should be able to hedge effectively against credit risk by diversifying their lending and proactively using the information they have about potential borrowers. This gets back to one essential rule: Know very well the individuals you are interacting with and strive to answer the key question, "Can I trust them?"

Besides banks, rating agencies also played a central role in creating financial instability. In the past the industry relied too heavily on the ability of rating agencies to "get it right," which deflected the serious and inherent risks in global financial systems. The rating agencies' role was based on a business model in which the agencies had incentives to ensure that their assessments and ratings matched the commercial interests of FIs, which, in turn, paid them most of the time.

Furthermore, despite their role in the crisis the rating agencies remain subject to little oversight, and thus far have evaded the scrutiny of their practices that the rest of the FS industry has received. Given their importance to the overall stability of the system, it is some key questions come to mind. Do ratings agencies have the right capabilities in place? Are they close enough to the information flow to be able to assess risk? Do they have the risk management talent they need? Some evidence suggests that ratings agencies have relatively immature capabilities and do little more than ask basic questions working from a formulaic template. If that is the case, then their ability to assess any level of risk or offer any insight would be extremely limited.

4. What is the potential impact on the structure of financial services?
Jurisdictions around the world are increasingly demanding that global banks hold capital locally to underwrite local operations, which makes it likely that operations will need to shrink to match local capital. In addition, there is an ongoing discussion about whether retail and/or deposit-taking activities that typically exemplify low risk should be organizationally and legally separated from higher-risk activities such as trading and investment banking. If the U.S. is one of only a few economies with the scale to support global institutions, will other nations feel the need to pick national champions—and, more fundamentally, do we want global banks?

Higher capital requirements in their own right may even exacerbate the problem in that they raise the barrier to entry for smaller banks, leaving the playing field largely to FIs that are deemed "too big to fail" (TBTF) and may thus require a significant capital injection.

Most proposals that address the TBTF problem rest on regulating complex FIs more tightly. An alternative is to address the root cause—namely, to prevent FIs from becoming TBTF. Options include antitrust/anticompetitive measures and levying capital charges on institutions in proportion to the level of systemic risk they pose, in effect charging these institutions a market price for the TBTF guarantee.

However, if an FI ultimately is nationalized, the role of the state as a significant shareholder needs to be understood to avoid potential conflicts of interest (e.g., the use of FIs to drive policy). Likewise, the state needs to determine how it wants to manage the potentially conflicting objectives of its portfolio of companies—i.e., support the economy, promote lending, and/or make a modest return on its investments on behalf of its shareholders (the taxpayers).

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CONCLUSION

It is debatable whether "significant" regulation actually makes FIs safer. During the present crisis, markets, not regulators, first identified and acted on the problems. The "true" riskiness of FIs and financial activities/transactions can best be determined closest to the source of risk buildup; proposals for different types of FIs need to take into account their different risk profiles. This asymmetry of information and the lack of transparency are likely to lead to a level of regulation above the optimal.

Therefore, the objective of financial regulation should be not to identify and reduce risk, per se, but rather to ensure that the risks are dealt with appropriately by those FIs that are best equipped to handle them.

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