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"Overview of the international agenda of financial reform and implications for United Nations bodies", remarks for panel discussion, *Global Economic Governance and Development: Enhancing the coherence and consistency of the international monetary, financial and trading systems*, Economic and Social Council 2011 Substantive Session, Geneva, 11 July 2011

This afternoon I intend to survey major parts of the current agenda for international financial the reform and to look at its relation to and implications for work within the United Nations.

A cursory read of the April report of the Financial Stability Board (FSB) on progress in the implementation of G20's reform agenda indicates how vast the agenda has become. Agreement on the international agenda is being accompanied by measures implementing this agreement at national level and at the level of the EU. The focus of attention of policy makers and regulators concerns not merely the effectiveness of reform measures in reducing financial risks but the need perceived by national authorities for a reasonably high degree of convergence of reform to prevent frustration of the reform's objectives by regulatory arbitrage in the form of firms' search for locations in which activities will be most lightly regulated.

Major lessons of the crisis for financial regulation

1. The crisis illustrated the how far-reaching contagion can be in globally integrated financially markets. By and large the direct effects of the financial contagion in the form of threats to financial systems involved major financial markets in advanced economies. However, the effects of this contagion on interest rates and prices have been felt globally – by emerging-market and other developing countries - as have the challenges to policies in areas like the control of capital movements.

2.Regulation with a primarily microprudential focus does not adequately monitor and control systemic or macroprudential risks.

3. Regulation must keep up with transactional and institutional innovation and other changes. Failures to exercise control or even actually to prohibit outright certain activities and products can exacerbate microprudential and macroprudential risks.
4. Regulatory models relying heavily on market signals provide inadequate incentives for effective risk management.
5. More general questions need to be faced concerning both the reality and the desirability of the policy objective of increased global financial integration based on concepts like an international level playing field and progressive removal of obstacles to the expansion of international banking and to cross-border financial transactions. The crisis has highlighted the huge divergence between the capacity of advanced and developing countries to subsidise financial activities (which in some cases in advanced economies was required to ensure the survival of large financial institutions and thus their continuation as participants – and thus as also competitors of institutions from developing countries - in international financial markets). Many would also argue that the case for "speed bumps" in financial markets has been strengthened by the crisis.

The policy response to all these lessons needs to be monitored in the appropriate United Nations bodies. Perhaps special attention would be appropriate for the response to the first lesson, contagion from globally integrated financial markets, and the fifth lesson, pursuit of the objective of increased global financial integration.

Expanded range of the reform agenda in response to the crisis

After the Asian crisis of 1997-1998 the international reform agenda of financial reform was codified in international standards. Of the 12 key standards nine were directed specifically at subjects bearing directly on financial markets: banking supervision, securities regulation, insurance supervision, market integrity (a heading covering money laundering), payments and settlement, accounting, auditing, corporate governance, and insolvency. The United Nations was not accorded the lead role regarding either the issuing or the monitoring of these 12 standards.

The targets of the reform agenda now also include commodity markets, trade finance, remuneration within financial institutions, shadow banking; and credit rating agencies. Commodity markets and trade finance have long been subjects of special concern in various United Nations bodies.

Changes in the institutional framework for setting and implementing the reform agenda

The Financial Stability Board (FSB) has been assigned by the G20 the task of coordinating the design and implementation of the reform agenda. The FSB represents an extension of the Financial Stability Forum (FSF). As part of this extension the membership of the FSF was expanded so that it now includes several emerging-market and developing countries – Argentina, Brazil, China, India, Indonesia, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. Arguably, although countries responsible for the bulk of global financial and economic activity are now included in the FSB, its representativeness could still be improved, Africa, for example, still being ill served. The Basel Committee on Banking Supervision, a body which now occupies the role of a sort of Vatican of banking regulation and supervision, also now has a membership expanded to include new member countries of the FSB.

Basel capital standards

A central place in the reform agenda for banks continues to be occupied by capital standards and the integrally related subjects of the management of credit, market and operational risk. This central place reflects not only the obvious relation of capital standards to the existence and size of a buffer against banking insolvency but also the intrinsic limitations of the scope of international initiatives regarding bank regulation, structures, and management since prescription of international standards for many other important subjects related to policy towards banks would entail unacceptable infringements of national sovereignty. It is worth recalling that the Basel capital standards were originally designed for the major banks of the Basel Committee on Banking Supervision but subsequently during the 1990s became a global standard.

The revisions of the Basel capital standards reflect weaknesses in the rules and other lessons highlighted by the crisis. The crisis mercilessly exposed actual and potential weakness in the regulation, supervision and risk management of banks in major advanced countries, some of which were supposed eventually to be controlled by Basel 2.

Of these weaknesses perhaps the most important was the basic one of inadequate levels of capital in relation to poorly assessed risks. Ratios of capital to risk-weighted assets proved highly misleading indicators of the strength of major banks, as should have been evident earlier from comparison of these ratios with ratios of the capital to assets *not* weighted for risks, which were

often three to five times lower. Moreover the ratios of capital to market risk exposures were often egregiously low. Other weaknesses of the Basel capital standards which have been the subject of increased attention by regulators owing to experience of the crisis were the following: procyclicality and the closely associated subject of inadequate attention to systemic risk; conditions for the removal of securitised assets from banks' balance sheets and the risk weights for the assets remaining; and excessive regulatory discretion and in some cases regulatory capture.

The capital standards of Basel 3 include increased levels of capital in relation to risk weighted exposures (though levels considered by many in the regulatory community and academia as still too low), a more rigorous definition of the items which can be included in capital based on their capacity to absorb losses, requirements for market risk which take account of many more dimensions of such risk (including that of securitisation exposures) than the rules of Basel 1 (which in early drafts of the revised capital standards were largely carried over into Basel 2), an explicit countercyclical buffer, and capital surcharges for Global Systemically Important Financial Institutions.

Basel liquidity standards and macroprudential risks

It is often remarked that financial crises usually start as crises of liquidity among institutions whose solvency as measured by their capital positions does not initially seem threatened. However, the effects of the liquidity crises on banks' access to financing and on the value of their saleable assets can soon transform liquidity crises into solvency crises. By highlighting the intimate relations between liquidity and solvency the crisis served as a tocsin for regulators. Standards for liquidity management -. in the form of two supervisory indicators, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), are now an integral part of Basel 3, and the assessments by the Basel bodies of the likely macroeconomic impact of Basel 3 – and the protests directed at Basel 3 from parts of the banking lobby - have included the liquidity as well as the capital standards.

The Basel capital standards never completely ignored liquidity risks. The rules and risk weighting for different exposures and for collateral made some allowance for such risks. But this allowance was always in a conceptual framework which was microprudential. The new rules for the

management of liquidity risk represent a considerable step in the direction of addressing systemic risks. However, it is generally accepted that they should be a complement of - and not a substitute for - other measures which have been proposed for the mitigation of systemic risk – and which have already been part of the regulatory tool kit in many countries since well before the current crisis.

Available data suggest that at the aggregate level the banks of developing countries should be able to introduce the capital standards of Basel 3 without major problems, though some of its rules for capital requirements for particular sectors or activities may require modification in the light of local circumstances and the requirements of development policy. A source of greater difficulties may prove to be the rules on liquidity management whose designers appear to have had fairly highly developed financial markets in mind.

Commodities and securities markets

Proposed reforms of the commodities and securities markets are now part of an agenda which is response not only to the current financial crisis but also to longer-standing concerns as to market integrity and price volatility.

In the case of the commodities markets the pressures for regulatory changes have been triggered partly by recent cases of extreme volatility in grain and oil prices. Volatile grain prices have historically been associated with political instability – on occasion of an extreme or revolutionary character and thus a prospect likely to be not far from politicians' minds as they confront the manifestations of such volatility. The proper functioning of securities markets is not only a matter for investors in them but also for financial institutions since large fluctuations in securities prices contribute to determining the risk exposures of financial institutions.

The principal policy initiatives on the front of securities and commodities markets are taking the form of standards being developed by the International Organisation of Securities Commissions (IOSCO) and of measures currently under discussion or being implemented in the United States and the EU. I shall not attempt even a summary treatment of these measures and initiatives but shall make a few points which may help to orient questions and discussion here.

- We are experiencing a profound transformation in the markets for commodities and securities at an institutional level driven both by technology and by pressures for cross-border consolidation of exchanges. Introduction of the technology – large-scale computer technology – is hugely costly. In the case of high-frequency trading the technology has proved capable of contributing to incidents of extreme volatility. Both the new technology and the consolidation of exchanges would appear to need to be assessed against the benchmark of the social and economic function supposed to be performed by capital markets, namely the costing and allocation of capital. Increased fees generated by increased turnover on exchanges and profits generated for institutions by being nanoseconds ahead of one's competitors do not appear to add social value.
- When considering such developments, it should not be forgotten that the globalisation of securities markets, including those of emerging-market countries, which is still sought by major financial institutions and lobbies, is likely eventually to be accompanied by pressures also to allow the introduction of the new trading technologies.
- In discussion of recent fluctuations on commodity markets there has been controversy between those claiming that the prices are driven by speculation and those claiming that the prices reflect fundamentals. In many cases this argument seems to me to be related to a false dichotomy. In the case of commodities for which organised exchanges exist, prices - including those negotiated between parties who do not necessarily have corresponding positions on exchanges - are typically connected to prices on the exchanges. To the extent that benchmarks based on futures prices are applicable, then it is the expectations and trading strategies of participants in these markets which determine prices. At times the main influence on these expectations may be of a speculative nature, and at other times the main influence may be information – almost always partial – concerning the balance between demand, production and inventories, in other words fundamentals.

Both the effects on financial markets of new trading technologies and the volatility of prices in commodity markets are subjects which are appropriate for close monitoring by the appropriate United Nations bodies.

Systemically important financial institutions

Policy towards this category of institution - perhaps better characterised by the term, Too Big To Fail, or the acronym, TBTF, - is proving the source of much controversy as well as of problems formidably difficult to solve. It has long been acknowledged that the lack of generally accepted arrangements for dealing with large cross-border insolvencies of financial firms was an important Achilles heel of the global financial system. Nevertheless policy makers had not anticipated how immediate difficulties associated with such insolvencies could become until 2008-2009. As I mentioned earlier, agreement on capital surcharges for TBTF institutions has recently been reached. But a long-term, comprehensive framework for procedures to be followed in the cross-border insolvencies of TBTF institutions and the ways in which the costs should be distributed among the countries in which these institutions have a commercial presence still seem some way off.

WTO negotiations, FTAs and BITs

I have already mentioned the way in which the current financial crisis has rendered both the reality and the policy objective of a level international playing field for suppliers of financial services still more unreal than previously. In the light of this, the rules of the WTO General Agreement on Trade in Services (GATS) as they apply to banking need revisiting and possibly extensive revision. Moreover provisions of Free Trade Agreements (FTAs) and Bilateral Investment Treaties (BITs) on the cross-border opening of financial markets – provisions which are often more constraining on the policy autonomy of countries affected than the WTO GATS - should also be opened for revision which takes account of lessons from the current crisis and the generally more restrictive regulatory framework that is likely to emerge from current international and national initiatives.

A revisiting of these rules and agreements can have important implications for the restoration and preservation of policy space or policy autonomy for developing countries, and should therefore be closely monitored by the United Nations.

Concluding remarks

1. Work on the agenda of financial reform is still in flux and the final outcomes continue to be the subject of formidable pressures from bank lobbies.

2. The reforms enunciated under the international agenda have been very much a response to problems revealed by the crisis in the regulatory regimes of advanced countries rather than emerging-market and other developing ones.

3. Nevertheless the new emphasis on the need for macroprudential regulation potentially opens the way for acknowledging links hitherto largely ignored between effective financial regulation and development policy.

4. The April progress report of the FSB covers several other important matters which I shall not attempt to elaborate this afternoon. These include country peer reviews including those of rules for financial institutions' remuneration policies, filling gaps in data essential to the monitoring of crises, the avoidance of conflicts of interest at credit rating agencies and the role of their ratings in financial regulation, and agreement on the convergence of accounting standards enunciated by the International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB). Of these subjects gaps in the data essential to monitoring financial crises and the international convergence of accounting standards are natural subjects for the agenda of United Nations bodies with mandates in the areas of statistical data and accounting.

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