The urgency of reforming financial regulation now
Stephany Griffith-Jones

The financial crisis seems increasingly serious, as it threatens to become a financial meltdown. Governments and Central Banks – though taking many and costly measures – seem, until now, powerless to stop the crisis. The fear of a recession grows in several major countries and also globally.

Managing the financial crisis and limiting the impact on the real economy must be a priority. However, the issue of future crisis avoidance becomes also very urgent. Ironically, the only silver lining today seems to be that regulatory measures to prevent future crises have become politically far easier to accept. This window of political opportunity for introducing such regulatory changes may be relatively narrow, so the task is urgent.

Martin Wolf rightly argued in the *Financial Times* that crises are inevitable in deregulated financial systems. There is, therefore, ever-growing consensus that more complete and more effective financial regulation is required. The key question is how best to do it. The main aims must be to help avoid future building-up of systemic risk, whilst allowing desirable financial innovation that supports the real economy.

There are two broad principles on which future financial regulation needs to be built. The first is counter-cyclicality, in order to correct the main market failure of banking and financial markets, their boom-bust nature. It should be fairly easy to implement; in fact, the Spanish and Portuguese regulators already required banks to have dynamic provisions, which are, de facto countercyclical regulations. This has resulted in Spanish banks apparently being stronger than in other countries. This positive experience needs to be built on by other countries, either through forward-looking provisions and/or counter-cyclical capital. An excellent proposal for the latter was made by Goodhart and Persaud (*Financial Times*, June 4)

The second key principle for modern, effective regulation should be comprehensiveness. There are several reasons. A particularly obvious one today is to avoid moral hazard, as an ever-increasing range of financial institutions (many of them not – or lightly – regulated) have had to be bailed out with likely massive costs to taxpayers. The only way that we can avoid this happening again is by ensuring far more complete and countercyclical regulation to avoid excessive risk taking in the boom across the financial sector. A second reason is that economic theory tells us that for regulation to be effective, the domain of the regulator has to be the same as the market to be regulated. In the United States, banks represent less than 25 percent of total financial assets; furthermore, only a part of commercial banking activity has been properly regulated, with off-balance-sheet activities largely excluded. A system of regulation that focused only on parts of the banking industry and regulated neither the rest of the banking system, nor much of the rest of the financial system, clearly did not work. It was the parts that were not regulated (having very little or no capital requirements in the U.S.), such as Structured Investment Vehicles, that tended to be the cause of the largest problems. Inevitably, there was regulatory arbitrage. Another area for potential regulation surely must be the ever-growing OTC derivatives markets. Should, at a minimum, derivatives contracts be made simpler, more standardized, and go through the exchanges?

The need, therefore, seems to be for comprehensive and equivalent transparency, as well as regulation of all financial activities, instruments, and actors. Both minimum liquidity and solvency requirements need to be regulated. Indeed, if banks had stronger liquidity, as in the past, their solvency problems may have been smaller in the current crisis.

There will be technical obstacles to define equivalent regulations for different activities or actors, but these can be overcome. A key element to define solvency requirements could be the capacity to bear risk, linked to the maturity structure of assets and liabilities. This could help encourage diversity of behavior by heterogeneous institutions, whilst trying to avoid regulatory arbitrage.

The magnitude of the crisis, and the damage that it is causing, should make it far easier and more urgent to design desirable changes in financial regulation. Weaker financial institutions may be less able today to oppose such regulation. They may also realize that good regulation is actually in their own long-term interest.

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