CENTRE FOR EUROPEAN REFORM

HOW TO RESTORE FINANCIAL STABILITY

Philip Whyte

CENTRE FOR EUROPEAN REFORM

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How to restore financial stability

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Foreword

It is easy after the recent paroxysms faced by the world's economic and financial systems to believe that the solution is tighter control exerted through the various mechanisms that politicians and regulators control. There is an inevitable pendulum effect as previous regimes are identified as being too light on control and public calls are made for clamp downs to prevent something similar happening again.

Whilst many of the proposed solutions seem obvious and difficult to argue with, others seem to stem from previously held agendas which do not obviously solve any of the problems and could in fact make matters worse. The problem here is a lack of worthwhile analysis of what the causes are and then a failure to use this to assess the proposed actions designed to provide solutions.

An example is in the world of accounting where the attack on the use of fair value accounting by some in the EU appears more for the purpose of winning old battles than based on a careful analysis. The psychological effects of fair value accounting on the 'good time' feeling when markets were going up is something that might bear some careful study as might the effect of not recognising and dealing with impairments as quickly as possible. This kind of analysis however seems far from the minds of those advocating changes to restrict fair value.

It is in this context that we have agreed to sponsor this paper. We consider it an important contribution to understanding the various causes of the crises and the likely effects of the policies which have been proposed to solve them. As such it provides useful material to assist with the development of rationally based (rather than opportunistic) solutions which by addressing the real issues will give the best hope of success.

Peter Chidgey and Noel Clehane

BDO

1 Introduction

After coming close to collapse in October 2008, the global financial system appeared to stabilise during the course of 2009. But the world will be living with the economic and social scars of the financial crisis for a long time to come. For many countries, it will be years (rather than a few quarters) before economic activity, let alone unemployment, returns to pre-crisis levels. The public finances, for their part, will take a decade or more to repair.

It is no surprise, then, that avoiding a repeat of such a cataclysm has been a key focus of policy over the past year. Already, however, some observers are complaining that the crisis has been 'wasted'. Policy-makers, on this view, only had a narrow window of opportunity to crack down on the culture of excess in finance while the sector was on its knees in late 2008 and early 2009. That time has passed. Banks have returned to profit and are once again 'gaming the system' – as a cursory glance at recent bonus awards shows. With banks back on their feet, the critics add, a resurgent financial lobby can return to doing one of the things it does best: resisting attempts by public authorities to curb and regulate its activities. The chance to set the financial system on a more stable footing has been lost.

What to make of this critique? In some respects, it is unfair and inaccurate. A veritable avalanche of regulatory reforms has already materialised, in the EU and elsewhere. Over the past year, Europeans have brought forward proposals to regulate credit rating agencies and alternative investment vehicles (hedge funds, private equity firms, and so on); to overhaul the way cross-border institutions are supervised; to create a new EU body to monitor the financial system; to influence the way employees in banks are paid; and to channel the trading of derivatives through clearing houses. Further changes are in the pipeline, including tighter capital and liquidity requirements for banks. By any standards, this is an ambitious programme. The financial sector is not having much success in blocking it.

The real problem is not that policy-makers are doing nothing, or that the powerful financial sector is successfully resisting all their efforts. It is that crises are not always the parents of good policy. Although they expose flaws in established frameworks and present opportunities to correct them, crises can also have a number of unfortunate consequences. They can encourage populist responses. They can result in misdirected energy, with more attention being given to marginal (but totemic) issues than to more important ones that are harder for the public to understand. And policy can over-reach itself, imposing unnecessary costs. This report argues that all these traits, positive and negative, can be detected in the reform process to date.

Many of the changes afoot – such as those designed to ensure that prudential rules dampen rather than amplify the credit cycle – are sensible and hard to quarrel with. But the reform agenda as a whole suffers from three flaws. One is an over-emphasis on issues like bonuses and hedge funds that arguably owe more to politics than a desire to avert the next crisis. The second is an over-reliance on regulation to do all the heavy lifting. Financial stability will not be restored by regulation alone: more attention needs to be paid to the macroeconomic causes of the crisis. The third problem is the incrementalism of the process as a whole. Reforms are being pushed through in a piecemeal fashion to tackle particular problems, but insufficient attention is being paid to the combined impact of all the changes.

The report is structured as follows. It starts off with a thumbnail sketch of the financial crisis, drawing attention to its macro- and microeconomic causes. It moves on to examine how policy-makers in the EU (and the G20) have responded to date, arguing that the macroeconomic causes of the crisis have been largely side-lined; that the regulatory response has already been extensive; that the risk

of that response going too far is as great as it not going far enough; and that the financial system which emerges could be less 'globalised' than the one which preceded the crisis. The report concludes by calling for a clearer sense of priorities in the reform process. In particular, it suggests that less attention should be paid to populist issues, and more to tackling important ones which have been neglected.

2 The causes of the financial crisis: A brief overview

It has become commonplace to think of the global financial crisis of 2007-08 as an unprecedented event. In terms of its scale, it was unquestionably a once-in-a-century episode. But it cannot otherwise be described as unique. Since international capital movements were freed up in the 1970s and 1980s, banking and broader financial crises have occurred with depressing regularity across the globe. As far back as 2001, a study by the World Bank had already counted 112 systemic banking crises across 93 countries between the late 1970s and the end of the twentieth century – in countries with regulatory and economic systems as different as Argentina, Finland, Israel, Japan, Mexico, Russia, Sweden and Turkey.[1] The conflagration of 2007-08 was only the latest, if the largest, in a long line of crises.

[1] *Martin Wolf, 'Fixing global finance: How to curb financial crises in the twenty first century', Yale University Press, 2008.*

Nor was its genesis quite as unique as is often supposed. At root, it followed an utterly familiar pattern in which a period of robust economic growth, low interest rates and stable inflation bred growing complacency among lenders and borrowers. In time, stability bred instability. Lending standards weakened as people took on more debt to buy houses. Property price bubbles resulted – in the UK and the US, but also in Denmark, Ireland, the Netherlands, Spain and elsewhere. These were destined to burst when debt exceeded what borrowers could service with their incomes. The US was the first country whose bubble burst, but this was largely by chance. It could just as easily have happened in any number of countries with even more inflated property markets than the US, such as Ireland, Spain or the UK.

Macroeconomic causes

Since credit booms and property price bubbles emerged in countries with regulatory systems as different as Spain and the US, it is not unreasonable to conclude that the crisis must have been partly rooted in macroeconomic factors which they shared. One such factor was the cost of borrowing. For much of the period between 2001 and 2007, interest rates were exceptionally low – in nominal terms and, at times, in real terms too. Central banks across much of the developed world kept short-term interest rates low for so long because they feared a Japanese-style depression following the bursting of the dotcom bubble in 2000. They were subsequently slow to raise interest rates in response to the resulting credit booms, largely because rises in output and inflation remained well within bounds.

Another macroeconomic factor which contributed to the global crisis was the massive scale and peculiar direction of international capital flows from the late 1990s onwards. Not only did global macroeconomic imbalances explode during the first half of the 2000s; but capital increasingly flowed 'uphill' from poorer countries to wealthier ones, rather than the other way round. Almost all the developed countries which experienced house price bubbles in the run-up to the global crisis attracted large capital inflows: just before the crisis, some 70 per cent of global capital flows were going to one of the world's wealthiest economies, the US. One consequence of these inflows was to depress US long-term interest rates and make monetary conditions more expansionary than would otherwise have been the case.

The final macroeconomic factor which contributed to the global crisis was, perhaps paradoxically, the prolonged period of stability which led up to it. For much of the world, the period which began in the 1990s was exceptionally benign, with many countries enjoying steady economic growth and low and stable inflation. The 'Great Moderation', as the period is now known, produced effects which became more pernicious the longer the good times rolled. The central problem was that borrowers and investors extrapolated the recent past into the future: they assumed that stability had become permanent. As a result, they under-estimated future risks, leaving themselves dangerously exposed to 'tail risk' – that is, to the low frequency but high impact event which their very behaviour was promoting.[2]

[2] *Andrew Haldane, 'Why banks failed the stress test', Bank of England, February 2009.*

Microeconomic causes

Some observers believe that the explanation of the crisis largely ends there – and conclude that the lessons are all for macroeconomic policy. This is a mistake. The macroeconomic backdrop unquestionably provided fuel for the unsustainable property booms which developed in a number of countries. But it does not fully explain the expansion of leverage across the financial system, or the catastrophic loss of confidence which ensued when the under-capitalisation of the system became apparent. This can only be explained by financial innovation, and by the opaque 'shadow banking system' which it produced. In the run-up to the crisis, it was this shadow banking system which was primarily responsible for the increase in lending to sub-prime mortgage borrowers in the US.

Before the crisis, it was widely assumed that innovation was a stabilising force which would increase the system's resilience to shocks. The IMF, for example, argued that the removal of credit risk from banks' balance sheets, and its dispersal to a broader range of investors, would help to make the financial system more robust.[3] So what went wrong? In a nutshell, financial innovation worked differently in practice than it had promised in theory. Financial innovation was driven as much by banks' attempts to evade regulatory rules on capital adequacy as by their desire to shed risk from their balance sheets. And banks did not unload nearly as much risk as had widely been assumed. The upshot was that banks were left with too little capital to cover the risks to which they were effectively exposed.

[3] *International Monetary Fund, 'Global financial stability report', 2006.*

An exhaustive account of the way financial engineering contributed to the crisis is beyond the scope of this report. But three features are worth highlighting. The first is that financial innovation helped to ramp up the overall level of risk across the system as a whole. One reason is that it increased the system's leverage by allowing banks to arrange more loans than their capital buffers would normally have allowed. Another is that it was associated with a steady decline in lending standards.[4] Securitisation – the practice of arranging loans, bundling them into securities and selling them on to investors – suffered from a classic agency problem: as institutions that arranged loans earned fees for doing so but sold the risk on, they cared little whether borrowers would ever be able to repay their debts.

[4] *Luci Ellis, 'The housing meltdown: Why did it happen in the United States?', BIS working paper 259, September 2008.*

Second, securitisation did not spread risk as widely as had been supposed. When the financial crisis broke, it transpired that a lot of risk had not been removed from banks' balance sheets after all. One reason was that banks were 'warehousing' assets they had yet to repackage and sell. Another was that some of the largest investors in asset-backed securities (ABSs) were actually banks, so the sorts of assets which were being shed from their banking books simply reappeared on their proprietary trading books. A third reason was that the fate of regulated banks turned out to be far more closely bound up with that of 'shadow banking' entities than had been imagined. Special investment vehicles (SIVs), for example, turned out to be as intimately connected to formal banks as a garage is to a house.

The third and final feature worth highlighting is the growing complexity of financial instruments, and the bewildering intricacy of relationships which these created between banks and other financial institutions. The opacity which resulted from this cat's cradle of relationships did more to spread uncertainty than risk – and in the end created a massive information failure.[5] The gradual freezing of the financial system, and its virtual seizure

[5] *Andrew Haldane, 'Rethinking the financial network', Bank of England, April 2009.*

following the collapse of Lehman Brothers in September 2008, resulted from the inability of firms to locate or determine the precise scale of their exposures to asset-backed securities, let alone that of their counterparties. This uncertainty so eroded confidence and trust that the system as a whole ceased functioning: firms hoarded cash, while those reliant on short-term funding faced liquidity crises.

Agatha Christie and the financial crisis

Since the global financial crisis erupted, there has been no shortage of attempts to single out the ultimate culprit (or scapegoat). Invariably, these fall short. Greedy bankers driven by short-term bonuses? Greed was a factor. But poor lending decisions were not confined to institutions with munificent bonus cultures. A lack of regulation? The crisis certainly exposed flaws in regulatory rules. But highly regulated banks like Citigroup were more deeply implicated in the crisis than more lightly regulated hedge funds. The recklessness of Anglo-Saxon countries? The US and the UK allowed debt-fuelled excesses to develop, but so did a number of other countries. Excessive off balance sheet activity? It played a role, but property bubbles also developed in several countries with traditional models of credit intermediation.

Tempting though it might be, it is wrong to try and pin the financial crisis on a single culprit: as in 'Murder on the Orient Express', there were many.[6] In many respects, the financial crisis followed a classic script in which a prolonged period of cheap money and prosperity progressively dulled the judgement of lenders, borrowers and investors. But there were novel aspects too. Macroeconomic imbalances exploded, resulting in huge (and unusual) capital flows to some of the wealthiest countries in the world. The UK and the US, the countries with the world's most sophisticated financial systems, recycled these flows with ever more complex instruments.[7] In the end, however,

[6] *Charles Bean, 'The great moderation, the great panic, and the great contraction', Bank of England, August 25th 2009.*

[7] *Anton Brender and Florence Pisani, 'La crise de la finance globalisée', La Découverte, Paris 2009.*

neither firms nor their regulators fully understood the system-wide consequences of this relentless increase in complexity.

3 Macroeconomic policy and financial stability

The financial crisis, then, resulted from the complex interaction of macroeconomic factors (particularly cheap money and the unsustainable scale and pattern of international capital flows) with microeconomic ones (financial innovation, poor risk management, excessive leverage, under-capitalisation, growing complexity and opacity, and so on). Yet, as this report will show in later chapters, the policy response to date, nationally and internationally, has focused disproportionately on the lessons for microeconomic policy (or regulation). The result is that the regulatory framework is being overhauled. But the macroeconomic factors which contributed to the crisis – asymmetric monetary policy regimes, and massive global imbalances – could yet be left in place.

Monetary policy: Leaning is preferable to cleaning

For much of the period leading up to the global financial crisis, interest rates across the globe were exceptionally low. Cheap borrowing costs encouraged speculative behaviour on the part of borrowers, lenders and investors. Signs of excess were everywhere to be seen. Credit and the money supply were growing exceptionally strongly. Property prices in a number of countries were soaring to unprecedented levels relative to incomes. And the household savings rate in the UK and the US fell relentlessly towards zero. None of these signs escaped the attention of central banks – and all of them ought to have set alarm bells ringing. Yet many central banks chose not to raise interest rates in an effort to counteract them. The question is: why, and how does that judgment look with the benefit of hindsight?

Central banks, particularly in the US and the UK, advanced several reasons why they should not try to calm such excesses. One was that headline inflation was subdued, so raising interest rates to cool property prices would have pushed inflation below target and risked causing Japanese-style deflation. Another was scepticism about targeting asset prices: even if central banks could identify which assets to target, they had no fool-proof criteria for determining whether they were over-valued. The interest rate increases needed to prick an asset price bubble might in any case be so large that the costs to the rest of the economy would be intolerable. Better, the reasoning went, to use interest rates to limit the fall-out after an asset price bubble had burst than to prevent bubbles from occurring in the first place.

This preference for 'cleaning up' rather than 'leaning against the wind' imparted an asymmetric bias to monetary policy: central banks repeatedly slashed interest rates in response to falling asset prices, but never raised them in response to rising ones. This had two unfortunate consequences. First, it promoted risky behaviour by encouraging investors to believe they would always be bailed out by central banks. Second, it postponed the inevitable day of reckoning by encouraging already indebted households to sink ever deeper into the red. The task of central banks has famously been described as 'removing the punch bowl before the party gets going'. Many, however, were doing just the reverse. They indulged one party after another, then repeatedly administered the 'hair of the dog' to cure the resulting hangovers.

In retrospect, this preference for 'cleaning' over 'leaning' alleviated pain in the short term, but at the price of storing up even more of it in the future. And the long run costs turned out to be far larger than anyone could imagine. So it seems clear in future that central banks should do more to prevent excesses from building up, even if this comes at the price of a shallow downturn in the short run. Doing so would not, as some suggest, mean targeting particular asset prices. It would, however, incline central banks to raise

interest rates if faced with a combination of rapid growth in the supply of money and credit, or sharp rises in asset prices and household debt. The aim would be to reduce excesses in the short term in order to moderate the severity of any downturn in the longer run.[8]

[8] *William White, 'Should monetary policy lean or clean?', Federal Reserve Bank of Dallas, working paper 34, August 2009.*

Pure inflation targets have surely been discredited by the crisis. Central banks can no longer assume, as some have done over the past decade, that they can simply target some headline measure of inflation and largely ignore what is going on in asset markets (at least until asset price bubbles burst). In Europe, this lesson perhaps applies more to the UK's previously much-vaunted inflation targeting regime than it does to the euro area's more complex 'twin pillar' framework, which takes account of a broader range of factors than the outlook for inflation. There has been a certain reluctance to recognise this in British policy-making circles, but the UK's monetary policy framework is going to have to be rethought – and it may end up looking a little more like the European Central Bank's.

Global imbalances: The need to share responsibilities

Almost every report into the origins of the crisis agrees that global macroeconomic imbalances played a role. In the run-up to the financial crisis, a number of countries with low and declining savings rates (most notably Ireland, Spain, the UK and the US) were running huge and widening current-account deficits, which were funded by capital inflows originating from countries (like China and Germany) that were running equally large current-account surpluses. Each inevitably depended on the other: it was the excess of savings over investment in the surplus countries that funded the relentless increases in household debt in the deficit countries. It is no coincidence that property price bubbles were overwhelmingly concentrated in countries that were running large current-account deficits.

Despite this, some countries have been reluctant to acknowledge that the massive external imbalances that built up between the late 1990s and 2007 may have contributed to the crisis. The communiqué of the G20 summit in London in April 2009 made copious references to hedge funds (which played almost no role in the crisis), but none to global imbalances. The US did manage to insert a reference to imbalances in the communiqué of the G20 summit in Pittsburgh in September 2009, but only after overcoming strong resistance from surplus countries such as China and Germany. So it is not clear that some of the countries running the largest current-account surpluses are really committed to the G20 call at Pittsburgh for "sustained and balanced growth" in the world economy.

True, China and Germany have both pushed through large fiscal stimulus programmes. Global imbalances, moreover, have narrowed since the crisis broke. Nevertheless, there are few signs that underlying policy thinking has shifted in either of these countries. The Chinese government has continued to intervene heavily to prevent its currency, the renminbi, from appreciating against the US dollar. And while Germany cannot be accused of currency manipulation, its hostility to discussing global imbalances in the G20 suggests that it is as wedded to export-led growth as ever. If anything, the crisis has strengthened mercantilist mind-sets in both countries. Since the crisis erupted in deficit countries, political leaders in China and Germany seem to have concluded that their countries were right to run external surpluses – and should continue doing so.

Global imbalances reflect the difference between national savings and investment in different countries. If the world is to rebalance, the deficit countries must save more and spend less, while the surplus countries must do the reverse. If the surplus countries impede the rebalancing of the world economy, they will effectively be forcing the deficit countries to spend their way to insolvency. Sadly, the fallacious belief that trade surpluses are a measure of a

country's 'competitiveness' remains depressingly widespread in China and Germany.[9] Leaders in these two countries must dispense with such beliefs. They should embrace the need for the world economy to rebalance; and push through the kinds of reforms that will make their economies less reliant on foreign demand.

[9] *Paul Krugman, 'Pop internationalism', MIT Press, 1996.*

Political leaders in China and Germany have rightly castigated the Americans and the British for their profligacy. But they cannot have it both ways. Since one country's surplus is another's deficit, it makes no sense to extol one while deploring the other: doing so is akin to a drug pusher lecturing a junkie for his habit. If the deficit countries behave more responsibly by saving more relative to investment, then China and Germany have to accept that their external surpluses will narrow or disappear. If, however, China and Germany actively seek to run massive trade surpluses, they must then abandon any pretence that foreign irresponsibility has nothing to do with their own growth models.

Why macroeconomic issues should not be sidelined

The financial crisis had clear macroeconomic causes. Yet to date these have attracted much less attention than regulatory failures: there has been very little discussion of the lessons of the crisis for central banks, and there has been strong opposition from some countries to discussing global imbalances in the G20. Indeed, certain leaders appear to take the view that the crisis had everything to do with regulatory failures and nothing to do with macroeconomics. One proponent of this view is the German chancellor, Angela Merkel. In the run-up to the G20's summit in Pittsburgh, she dismissed global imbalances as an *ersatz* issue but pressed hard for action to be taken to curb bankers' bonuses. The implication was clear: bonuses are more important to financial stability than international capital flows.

The belief that financial stability has everything to do with regulation is tendentious because it assumes that more regulated financial systems will inevitably cope better with the same set of macroeconomic factors. Would the UK and the US have managed capital inflows differently if employees in their free-wheeling financial sectors had not enjoyed large bonuses? Perhaps – although bubbles also developed in countries with different pay practices. Would a more tightly regulated financial sector have prevented property price bubbles in the UK and the US? Again, it is not clear. Indeed, given the policies they were pursuing, Anglo-Saxon central banks might have responded to a more regulated financial sector by holding interest rates even lower to deliver their preferred rate of growth and inflation.

The point is not that regulation is useless, or that reforms are not needed. It is that macroeconomic policy matters too, and that it is unrealistic to expect regulation to do all the heavy lifting. Spain's regulatory regime, for example, has good design features that other EU countries rightly want to copy. But it was still overwhelmed by a combination of cheap money and huge capital inflows. Focusing on regulatory side-issues while side-lining pressing macroeconomic ones, as the G20 did for most of 2009, is also dangerous. In late 2009, financial markets witnessed sharp rises in a whole range of asset prices that would normally be expected to move in opposite directions from each other. History may show that the G20 would have been better advised discussing these liquidity-driven rises, rather than bank bonuses.

4 Recasting prudential rules

The financial crisis unquestionably exposed major flaws in the regulatory rules to which the financial sector was subject. Financial engineering left regulated banks holding too little capital. Capital adequacy rules did nothing to restrain banks at the top of the lending cycle. And supervisory authorities did not pay enough attention to the way banks funded themselves. The direction of reform is therefore clear. Banks will need to hold more capital than they have done in the past. Regulatory rules will need to do more to dampen the credit cycle. And liquidity requirements will need to be tightened. However, if the direction of reform is clear, the end destination is less so. It is possible, therefore, that some of these changes could go too far.

Raising capital requirements

Every single official report into the financial crisis – in Britain, the US, at EU level and elsewhere – has concluded that banks were under-capitalised when the crisis hit. Given the amount of public money that has been poured into recapitalising insolvent banks, this conclusion is unsurprising and hard to contest. More difficult, however, is determining just how much higher capital requirements should be. Until the financial crisis broke out, this was a question that international forums of regulators never really tackled. The focus of the Basel I and Basel II accords was on ensuring that banks' capital did not fall below a minimum threshold. But the setting of that threshold was fairly arbitrary. Basel II never revisited the Basel I ratio. It took it as given, and simply tried to make it more sensitive to risk.

In hindsight, it is now clear that the minimum capital ratios were set too low. There is widespread agreement across the G20 and the EU that banks will need more capital as a buffer against future losses. The quality of capital will also need to be higher, with more held as common equity. But there is much less certainty about just how much more capital banks should hold. The answer is crucial, because one result of higher capital requirements will be an increase in the cost of borrowing. According to one estimate, raising capital ratios by 2 percentage points above their historical average would dampen investment spending by between 0.2 per cent and 0.8 per cent in the long run.[10] Just as an under-capitalised banking sector undermined financial stability, an over-capitalised one could hit long-term economic growth.

[10] *Dirk Schumacher, 'Bank capital, lending rates and investment', European Weekly Analyst, Goldman Sachs, September 24th 2009.*

It is critical, therefore, that regulators achieve the right balance. Could they go too far and stifle growth in their attempts to underwrite financial stability? There is certainly a risk if regulators succumb to excessive incrementalism. Higher capital requirements, for example, have already been proposed for the banking sector generally; to cover exposures on trading books; to penalise banks whose risk management systems are not up to scratch or whose pay policies encourage excessive risk-taking; as a form of 'pollution tax' on financial institutions that are considered too big to fail; and so on. The point is not that these measures have no merit individually. It is that regulators could end up piling ever more requirements on to existing ones, without paying enough attention to their overall impact.[11]

[11] *Jacques de Larosière, 'Financial regulators must take care over capital', Financial Times, October 15th 2009.*

There are two further risks which regulators must ward against. The first would be for very different capital adequacy regimes to emerge in different countries, which would be an invitation to regulatory arbitrage. The Financial Stability Board, the Basel Committee on Banking Supervision and the EU must make sure they thrash out common approaches before national differences develop and become embedded.[12] The second danger is

[12] *Howard Davies, 'We need to rationalise the rules on capital', Financial Times, September 24th 2009.*

one of timing. Banks – notably in Europe – remain under-capitalised and will need significantly to raise their capital ratios over the years ahead. But if they are required to do so too fast and too early, their ability to lend to the wider economy will be crimped. This could pose a threat to the economic recovery, which is already at risk from banks hoarding earnings and shrinking assets.

Counteracting the credit cycle

Market-based financial systems are demonstrably better at allocating capital than state-dominated ones. They are notoriously susceptible, however, to periodic cycles of greed ('irrational exuberance') and fear.[13] The challenge for policy-makers, therefore, is how to harness the allocative efficiency of private markets while restraining their propensity for collective bouts of euphoria and depression. Managing this balancing act is difficult. But there is growing agreement that most countries' regulatory frameworks in the run-up to the crisis not only failed to dampen the credit cycle, but also exacerbated it. To use the jargon, regulatory rules acted 'pro-cyclically', rather than 'counter-cyclically': they promoted an unsustainable credit boom on the way up, and a deeper recession on the way down.

[13] *Robert Shiller, 'Irrational exuberance', Princeton University Press, 2005.*

Consider the way capital requirements worked. When lending was buoyant and credit losses were low, capital requirements tended to fall, fuelling further growth in lending. When the credit cycle turned, however, the process went into reverse, and banks were forced to increase the size of their capital cushions. In effect, capital adequacy rules encouraged banks to open the taps when lending was already growing strongly, and to close them faster when it was slowing. One of the few countries whose regime actively tried to counter-act the credit cycle was Spain. The Spanish system of 'dynamic provisioning' worked by forcing banks to make provisions against loan losses when the times were good, so that these could be used when the economy turned down and losses materialised.

Spain's counter-cyclical regime has attracted considerable international attention since the crisis broke out . In July 2009, EU finance ministers rightly agreed that some variant of it should be adopted at European level. Precisely what form this will take has yet to be decided. Pro-cyclicality could be reduced by copying the Spanish system (and making banks build up provisions in good times); or it could be achieved some other way (for example, by defining a minimum capital ratio, but forcing banks to exceed it in periods of strong growth). The other choice is whether the new regime should be driven by a pre-agreed formula, or whether it should be left to the discretion of regulators. A formula would have the advantage of imposing a common discipline and reduce the influence of lobbying.

Tightening liquidity rules

In the two decades leading up to the financial crisis, the Basel Committee on Banking Supervision focused overwhelmingly on the issue of capital adequacy. This reflected an implicit assumption that the main threat to systemic stability came from the risk of contagion following the failure of an insolvent institution. Yet when the crisis struck, it first manifested itself on the liabilities side of financial institutions' balance sheets: the entities which came under most pressure were not those with deteriorating loan books, but institutions like the British bank, Northern Rock, which were heavily reliant for their funding on the short-term inter-bank market. When the inter-bank market seized up, it was the institutions that were most reliant on such short-term funding that were exposed to bank runs.

In the run-up to the crisis, supervisory authorities did not make enough of a distinction between banks with similar assets but different funding profiles. Nor, for that matter, did the financial markets. Indeed, Northern Rock, which relied so heavily on short-term borrowing in the capital markets, had a higher stock market rating than HSBC, which was more reliant on less volatile but

more expensive retail deposits. The markets, in other words, appeared to be rewarding the least stable institutions on the grounds that they were more 'efficient'. In retrospect, it is clear that both regulators and markets severely under-estimated banks' vulnerability to funding crises. In future, banks with long-term assets that are not easily sold in the market will need to become less reliant on short-term funding.

The G20 has rightly called for prudential supervisory rules on liquidity to be tightened. What exactly will this entail? Internationally, the answer is still being worked on. How banks manage the 'maturity mismatch' between their short-term liabilities and their longer-term assets has long been one of the least developed areas of international regulation. Broad international principles on liquidity risk management were drawn up in 2008.[14] And working groups have been established in the Basel Committee on Banking Supervision and in the EU's Committee of European Banking Supervisors (CEBS) to agree on common definitions and approaches. In the meantime, much of the impetus for tightening liquidity regimes will come from national initiatives, rather than international agreements.

[14] Basel Committee on Banking Supervision, 'Principles for sound liquidity risk management and supervision', BIS, September 2008.

A handful of developed countries have already outlined how they intend to tighten their liquidity regimes. The first country to do so in the EU is the UK. The UK's new regime, which was announced by the Financial Services Authority (FSA) in October 2009, will involve several measures. Banks will have to hold larger 'liquidity buffers' than in the past – that is, a greater proportion of liquid assets that they can dispose of easily in a crisis. Only holdings of investment grade government bonds will count towards banks' liquidity buffers. Regular stress tests will be held to ensure that a bank can survive a liquidity shock without having to rely on funding support from the central bank. And banks with weak governance or internal controls will be forced to hold larger liquidity buffers.

The FSA's new policy raises important questions about the future of national liquidity regimes, and about their impact on globalisation and financial stability. The FSA has said that its 'default policy' will be to require all banks operating in the UK to manage their liquidity on a self-sufficient basis, without relying on funding from other bits of the group located in another country. This particular aspect of its regime has proved contentious with many banks and foreign supervisory authorities. They complain that it could create 'trapped pools' of liquidity which lead to a fragmentation of the global financial system; and that by making it harder for banks to manage their liquidity needs on a group-wide basis, firms could become more vulnerable and reliant on volatile wholesale funding in local markets.

The issue, then, is whether individual countries will adopt new rules that make sense nationally but which might be damaging if adopted by all. The Basel Committee and the EU should therefore make sure that if host country liquidity regimes are tightened, they are done so in a non-discriminatory manner: foreign banks should be subject to the same rules as domestic ones. In addition, home and host countries must explore ways in which banks might secure a waiver from host country regimes. This will require greater levels of co-operation and trust between home and host country authorities. The trouble is that trust may be in short supply: the crisis has given supervisory authorities every reason to fear that home countries will, in difficult times, impede the flow of liquidity to a bank's branches in other countries.

Accounting standards and transparency

Since the market turmoil that followed the collapse of Lehman Brothers in 2008, one of the most divisive issues has been that of fair value (or 'mark-to-market') accounting – that is, the practice of valuing financial assets at current market prices, rather than the price at which they are bought. Prominent banks, backed by some politicians, have blamed mark-to-market accounting for

aggravating the crisis. Fair value accounting, critics claim, led to profits being over-stated before the crisis, and to losses being over-stated during it. When the crisis hit, a vicious cycle developed in which falling asset prices led to accounting write-downs; write-downs forced financial institutions to sell assets to meet their capital adequacy requirements; and forced sales provoked further falls in asset prices.

Standard-setters retort that banks and politicians are shooting the messenger. Fair value accounting standards did not cause the crisis. They did not force banks to make loans that would never be repaid, or design and hold complex financial instruments that blew up in their faces. All fair value accounting did was make banks come clean about their exposures. Accounting standard-setters also point out that it is spurious to argue that the financial system can be made safer by allowing banks to pretend that their assets are worth more than their market price. If they are allowed to mark assets to market when it suits them but disregard fair value when it does not, banks will effectively have *carte blanche* to overstate profits when prices are booming and understate losses when prices are falling.

Despite these objections, standard-setters have come under huge pressure from certain banks and governments over the past year to relax fair value accounting. In October 2008, the International Accounting Standards Board (IASB), under political duress from the EU, excluded certain financial instruments from fair value accounting. Similarly, in April 2009, the US Financial Accounting Standards Board (FASB) issued guidance in a number of fair value areas following threats by the US Congress to overhaul accounting standards by legislation. The EU, in turn, responded by putting renewed pressure on the IASB to make more changes, purportedly to ensure that International Financial Reporting Standards (IFRS) did not diverge from the US's General Accepted Accounting Principles (GAAP).[15]

[15] *Financial Crisis Advisory Group, 'Report of the Financial Crisis Advisory Group', July 28th 2009.*

In April 2009, the G20 asked the IASB to draw up new rules. The IASB obliged by issuing new guidelines that attempt to steer a middle course between carrying assets at cost (which would allow banks to write them down only when losses are thought to be likely), and marking them to market. The new standards would recognise just two types of asset. The first would be loans and certain debt securities, which banks would be able to value at their original cost (if they can prove these are being held for the long term). The second would be shares, derivatives and other risky instruments, which banks would have to mark to market. Despite the IASB's concessions to politicians and banks in a number of EU countries, the EU opted in November to delay the introduction of the new standards.

There are legitimate concerns about the pro-cyclicality of mark-to-market accounting, and about the responsiveness of standard setters in times of crisis. But the political pressure which has been heaped on the IASB since late 2008 has been unfortunate. The catastrophic loss of confidence which followed the collapse of Lehman Brothers was partly linked to the opacity of counterparty exposures. It is therefore odd that so much pressure should have been exerted on standard-setters to make financial reporting less transparent. Several EU countries (particularly France, Germany and Italy) believe that accounting is too important to be left to independent standard-setters. But it is hard to see how a more politicised standard-setting process can possibly maintain investors' faith in financial reporting.

Attempts to politicise the standard-setting process and reduce the transparency of financial reporting have been two undesirable features of the response to the crisis over the past year. If the concern is to make sure that fair value accounting does not have pro-cyclical effects, there is no reason why this should not be possible. If regulators want banks to make provisions beyond those required by accounting standards, all that is required is that this be done in a way that does not compromise the integrity of the financial

accounts. But moves to tackle the pro-cyclicality of fair value accounting must not become an excuse for concealing losses. The example of Japanese banks in the 1990s suggests that not recognising losses does not solve the problem, but allows it to fester.

The risk of doing too much

There is a widespread perception, among commentators and public alike, that the financial sector is successfully resisting a much-needed regulatory crackdown. So far as prudential rules are concerned, there is little evidence to support this perception. True, some banks have lobbied hard for mark-to-market accounting standards to be revised, and they have found a ready ear among certain politicians (particularly in France, Germany and Italy). Accounting standard-setters have had to bow, at least partly, to the huge political pressure which has been piled on them. Mostly, however, the view that politicians and regulators are being cowed by the financial sector to water down reforms to prudential rules is wrong. There is every sign that capital and liquidity requirements will be tightened.

Indeed, if there is danger to the way prudential rules are being rewritten, it is not that politicians and regulators are doing too little. It is that they could end up doing too much. It is hard to question the broad direction in which reforms are currently heading: banks must certainly hold more capital than they have done in the past; the 'pro-cyclicality' of rules should be reduced; and banks must become less reliant on short-term funding. What is less clear is precisely how far these changes ought to go. But it is important that policy-makers do not subordinate all other considerations to that of financial stability. An over-capitalised financial system that does not produce much maturity transformation would be close to fail-safe. But it would equally be quite unable to meet the demands of a modern economy.

5 Widening the supervisory net

Until the crisis blew up, it was widely assumed that financial stability would follow naturally if central banks delivered stable growth and inflation, and if individual financial institutions complied with prudential rules. This approach, however, turned out to be flawed. The focus on supervising individual institutions ('micro-prudential supervision') turned out to be insufficient. It wrongly assumed that the stability of the financial system would flow naturally from that of its components. And it failed to identify – or fully understand – how financial engineering was transforming the nature of the system itself. Not only was innovation spawning new entities outside the traditional supervisory net, but it was also creating new, complex relationships between the proliferating entities within the system.

In short, prudential supervisory regimes across the developed world suffered from an 'underlap'. It was as if they were supervising an electricity grid by checking the safety of individual power stations, but ignoring the power lines connecting them. Unsurprisingly, there is broad agreement across the EU that the scope of supervisory oversight will have to be broader than it has been in the past. Widening the perimeter of supervision will essentially entail three things: monitoring developments at the level of the system ('macro-prudential' surveillance), as well as the firm; bringing 'shadow banking' entities (hedge funds, private equity firms, special investment vehicles and so on) under some kind of oversight; and paying closer attention to financial instruments and to the exposures which they create between counterparties.

Macro-prudential surveillance

One of the greatest flaws of supervisory regimes before the financial crisis was their tendency to conflate individual with collective rationality: they implicitly believed that actions aimed at bolstering the stability of an individual institution would strengthen that of the system. They never really considered that it might undermine it. For example, from a micro-prudential perspective, it seemed sensible that banks should shed credit risk by buying insurance against the risk of default. By doing so, they freed up capital to make more loans. But since many banks were playing the same game, the collective result was a huge increase in leverage and a financial system heavily reliant on the entities providing the insurance. When these entities ran into trouble, it emerged that the system as a whole was under-capitalised.

Micro-prudential oversight was inadequate because it failed to spot how the sum of individual institutions' decisions was changing the nature of the system as a whole. It is no surprise, therefore, that a key lesson which policy-makers are drawing from the crisis is that more attention needs to be paid to developments at the level of the system (hence the term 'macro-prudential' surveillance). The UK is moving in this direction, following the Turner review.[16] The European Commission has agreed to establish a macro-prudential body at EU level, the European Systemic Risk Board (ESRB), in line with the recommendations of the de Larosière report.[17] And the International Monetary Fund (IMF) and the Financial Stability Board (FSB) have been asked by the G20 to perform the same task at global level.

[16] *Financial Services Authority, 'The Turner review: A regulatory response to the financial crisis', March 2009.*

[17] *Jacques de Larosière, 'Report of the high-level group on financial supervision in the EU', February 25th 2009, Brussels.*

Macro-prudential surveillance is a good idea. But it is easier to see how it might work in theory than in practice. In theory, it seems clear that key tasks would include tracking the build-up of common exposures to the same asset classes across the financial system as a

whole (this will highlight the risk of firms failing together); monitoring feedback effects between the real economy and the financial system (for example, between asset prices and investor confidence); and tracking how these feedback effects contribute to the build-up of risk over time.[18] However, if it is to be more than just an academic exercise, macro-prudential surveillance must also shape regulatory and monetary policy. It would have to influence, for example, how capital adequacy requirements for individual institutions are set.

[18] *Claudio Borio, 'The macro-prudential approach to regulation and supervision', Voxeu, April 14th 2009.*

Macro-prudential surveillance also raises awkward questions of representation and co-ordination at international level. Few of these are insuperable. In the EU, for example, a potential difficulty arose because the region's largest financial centre, the City of London, is based in a country which does not belong to the euro area. The EU has got round this problem by giving the chairmanship of the ESRB to the governor of the European Central Bank, and the deputy chairmanship to the governor of the Bank of England. The issue of co-ordination arises because numerous bodies, from the FSB to the IMF, will have some responsibility for macro-prudential surveillance. These bodies need to work well together if wasteful duplication and the risk of a cacophony of potentially discordant messages are to be avoided.

Sceptics question what difference the new focus on system-wide surveillance will make. They point out that the Bank for International Settlements (BIS) issued warnings before the global financial crisis – and these were repeatedly ignored. There is a danger that international bodies could become talking shops that issue sermons which national authorities ignore. Integrating macro-prudential surveillance with micro-prudential supervision will also be hard. But there are also reasons for optimism: the crisis has nailed home the importance of system-wide surveillance; international discussions should force countries to justify themselves before their peers, particularly if they disagree with the majority view; and foreign bodies may give national authorities cover for something they want to do anyway.

Bringing more entities within the supervisory net

A key feature of the credit boom and subsequent crunch was the explosive growth of a 'shadow banking system' of which regulators were only dimly aware. Policy-makers on both sides of the Channel (and the Atlantic) agree that supervisory authorities will need to pay more attention than they have done in the past to entities outside the formal banking sector. However, there are profound disagreements across the Channel about precisely how shadow banking entities should be supervised. These disagreements have come to a head over the EU's draft directive on alternative investment managers. The UK believes that the original draft was draconian and poorly drafted (notably because of its 'one size fits all' approach to different investment vehicles). France and Germany argue that it does not go far enough.

It has been clear since the rescue of a US hedge fund, Long Term Capital Management, in 1998, that large, highly geared institutions outside the formal banking sector can pose a risk to systemic stability. Given this threat, supervisory authorities have a legitimate interest in subjecting them to some kind of oversight. However, hedge funds had little or nothing to do with the global financial crisis. They did not drive the growth of sub-prime mortgage lending in the US (or Europe). Nor did they force regulated banks (such as IKB and Hypo Real Estate in Germany) to hold collateralised debt obligations on their balance sheets. In short, the financial crisis would have happened whether hedge funds were more regulated or not.

Nonetheless, France and Germany have seized on the opportunity thrown up by the crisis to press for a clamp down on entities like hedge funds and private equity firms which they have never liked. They have turned the regulation of these entities into a litmus test.

And they have interpreted British reservations about the detail of regulation as hostility to the very principle of regulating hedge funds and other 'alternative investment managers'. The determination of France and Germany – as well as influential figures in the European Parliament – to crack down on alternative investment managers has had unfortunate consequences. It has stoked a largely unnecessary conflict across the Channel; resulted in poorly drafted EU legislative proposals; and distracted attention from far more important issues.

The cross-Channel conflict could have been avoided because the UK is not opposed to the principle of regulating and supervising shadow banking entities – as the review by the Financial Services Authority (FSA) into the crisis makes clear. The FSA believes that regulation should focus on 'economic substance not legal form'; that this principle needs to be agreed and implemented internationally; that off balance sheet entities like special investment vehicles (SIVs) which create a 'substantive economic risk' to a bank or to systemic stability should be treated as if they are on a bank's balance sheet; and that public authorities need to keep track of shadow banking entities and supervise them if they become large enough or acquire bank-like characteristics (like dealing directly with retail investors).

The political pressure exerted on the European Commission has also had a damaging effect on the quality of draft legislation. The British government and the FSA agree that to help the supervisory authorities track and measure the build-up of risk across the system, all managers of hedge funds above a certain threshold should provide information on their funding and leverage. The FSA has also indicated that it is prepared, where necessary, to subject certain hedge funds to prudential rules on capital and liquidity. However, the UK has legitimate reservations about the way the Commission's legislative proposal was originally drafted. It rightly points out that the draft directive takes a 'one size fits all approach' that makes little distinction between entities as different as hedge funds and investment trusts.

Although it is desirable that supervisory authorities subject shadow banking entities to closer oversight than they have done in the past, the attention that some EU countries are devoting to hedge funds is excessive. An important (but rarely mentioned) lesson of the crisis is that obsessing with hedge funds can divert governments' attention away from the main story. When Germany chaired the G7 in 2007, it tried hard to steer the agenda towards hedge funds. In hindsight, however, the key issue at the time was not 'unregulated' hedge funds. It was the way financial innovation was contributing to the excessive leverage and under-capitalisation of regulated banks. Germany ought to have devoted less attention to hedge funds, and more to other entities in the shadow banking system – like SIVs and monoline insurers.[19]

[19] *Gillian Tett, 'Some effects of an unhealthy fixation on hedge funds', Financial Times, May 8th 2009.*

Monitoring complex financial instruments

The Turner review in the UK has argued that the financial crisis raises awkward questions about financial innovation – about its social utility, and about the attitude that regulators should take towards it. Before the crisis, it was widely assumed that financial innovation was a good thing, for the same reason that it was in other sectors: it would help to boost productivity growth. Regulators did not interfere with such innovation, because they feared that doing so would reduce the dynamism of capital markets. In retrospect, that fear looks misplaced. Much of the engineering that took place was designed to get round regulatory rules, rather than to allocate credit more efficiently. And it produced a system with a higher overall level of risk – and less transparency about who was exposed to it.

Supervisory authorities' understanding of collateralised debt obligations has increased since the crisis. But it would obviously have been better if it had done so before it. It is now clear that supervisory authorities need to pay closer attention to financial innovation, because new products can transform the very nature of the system and cause damaging externalities. Some observers argue that financial

products should be regulated and certified, just as new drugs are in the pharmaceutical industry.[20] The trouble, however, is that this judgment will rarely be as clear-cut in the financial sector: the systemic impact of a financial instrument is harder to predict, not least because good instruments may turn bad through misuse. An excessive bias towards safety could also result in perfectly good instruments being prohibited.

[20] *George Soros, 'The game changer', Financial Times, January 28th 2009.*

Policy-makers in the EU and the US have rightly concluded that instead of deciding which instruments are 'good' and 'bad', it is better to monitor financial instruments more closely by exposing the way they are traded to more daylight. Before the crisis, trade in derivatives did not occur on exchanges, but mainly in bilateral 'over-the-counter' (OTC) transactions. When Lehman collapsed, however, this spider's web of bilateral transactions meant that neither regulators nor counterparties had the slightest notion about the size or concentration of individual firms' exposures to credit derivatives. The lesson that policy-makers have drawn is that the information failure (and catastrophic loss of confidence) which resulted might have been averted if these bilateral OTC transactions had been less opaque.

To become more transparent, trading in credit derivatives will need to become more centralised. And the way to achieve that is to push as many transactions as possible through central counterparties. The latter essentially work by breaking all deals into separate contracts with a clearing house in the middle. The clearing house acts as a buyer to every seller, and as a seller to every buyer. This promotes systemic stability in two ways. First, as all deals are registered, central counterparties increase transparency (notably for the supervisory authorities). Second, by inserting themselves between deals, central counterparties can contain the systemic repercussions of an individual firms' failure. In other words, central counterparties reduce the opacity of the system and act as vital firebreaks.

Policy-makers on both sides of the Atlantic rightly want more OTC derivative contracts to be cleared by central counterparties. The US

Treasury has made specific proposals to this effect and the European Commission is due to do so soon. In theory at least, the introduction of central counterparties should make life easier for supervisory authorities, because it will provide them with a clear point of entry next time a crisis hits. It should also make the financial system more resilient by giving firms greater confidence that their trades will be settled, even if the ultimate investor on the other side of the trade defaults. However, one result of routing more trading in derivatives through central counterparties will be to make the resilience of the financial system more dependent on that of clearing houses themselves.

It is odd, therefore, that so little attention has focused on how clearing houses should be regulated, or by whom they should be supervised – not least as the entry of new players is being actively encouraged in the name of competition. This raises two risks. The first is that policy-makers may be encouraging the emergence of numerous clearing houses that do not have the financial strength to withstand the failure of a single large member. The second is that they may be creating a new type of systemically important institution that could be too important to fail (and which consequently carries the implicit backing of the taxpayer). It is therefore essential that policy-makers pay more attention than they have done to date to making sure that clearing houses are financially strong and properly supervised.

The perimeter of supervision: The importance of calibration

The perimeter of supervision is set to become wider than it has been in the past – internationally, at a European level and nationally. Many of the changes needed to broaden supervisory oversight are already underway. The EU is setting up an ESRB to carry out macro-prudential oversight; it is discussing how supervisory oversight should be widened to 'shadow banking' entities; and it intends to reduce counterparty risk by coaxing as much trading in OTC derivatives as possible out of the shadows and into the daylight. The

EU is still some way off adopting its directive on alternative investment funds. But other changes are close to hand. The ESRB should be up and running in 2010. And the migration of trading in OTC derivatives has started before legislation has even been adopted.

As the scope of supervison is broadened, the EU must make sure that it strikes the right balance. New rules need to be properly targeted, and carefully calibrated to the nature, leverage and size of the institutions concerned. Just as health programmes target people with high infection rates or in high risk brackets, so supervisory oversight needs to focus on the entities that are most likely to contaminate the rest of the financial system. It is not clear, however, that the EU's programme of reforms is striking this sort of balance. Vehicles like investment trusts, which pose no systemic risk and have been established for over 150 years, risk being caught up by inappropriate new rules. And while too much attention is focusing on hedge funds, too little is being devoted to ensuring that clearing houses are financially sound.

Discussions within the EU are also throwing up a number of unexpected difficulties that need to be managed sensibly. One of these is how the move towards centralised clearing should accommodate non-financial firms like Rolls Royce and EON. The latter have complained that their hedging activities – which insure them against fluctuations in currencies or commodity prices – could become prohibitively expensive if these are effectively forced through a central counterparty. Policy-makers therefore face an awkward problem. If they design a system that pays no regard to non-financial companies, they will provoke a sharp increase in the cost of hedging. And if they exempt non-financial firms from the requirement, they could potentially open the new regime to abuse by financial institutions.

6 Fixing incentives

The issue of incentives has attracted more public attention than any other. Some observers believe that these were at the heart of the financial crisis; and that reforming capital adequacy and liquidity rules without tackling the reasons which encouraged banks and their employees to take excessive risks will never produce a more stable financial system.[21] Those who take this view usually worry about two things. The first is the implicit government guarantee enjoyed by systemically important institutions which are considered 'too big to fail'. The second is the way employees in the financial sector are remunerated. More often than not, the observers who worry most that the crisis is being 'wasted' are those who think that policy-makers are not doing enough to fix the problem of incentives.

[21] *Martin Wolf, 'Reform of regulation has to start by altering incentives', Financial Times, June 23rd 2009.*

Moral hazard: Tackling the 'too big too fail' problem

Regulators and central banks have long worried about 'moral hazard' – that is, the motivation of banks to take excessive gambles if they believe they will be bailed out by the state. The focus of concern has usually fallen on banks which are 'too big to fail' because their collapse would bring about that of the financial system itself. Moral hazard has been a background factor in many decisions taken during the crisis. Faced with demands for state support, governments and central banks have had to wrestle with an awkward dilemma: either make an example of irresponsible institutions and allow them to fail, but risk the kind of systemic crisis which followed the collapse of Lehman; or rescue them, but end up sowing the seeds of a potentially bigger crisis at some point in the future.

Some observers believe that moral hazard can only be fixed by radical measures. One such measure would be to break up large banks into units that are small enough to fail. Another would be to reintroduce the kind of separation previously practised by the US under the Glass-Steagall Act. Narrow (or 'utility') banks would perform classic retail and commercial banking functions and would have access to the central bank's lender of last resort facilities. The price of that access would be strict restrictions on riskier trading activities. Investment (or 'casino') banks would face no such restrictions, but nor would they have access to the central bank's lender of last resort facilities. They would therefore be subject to the full discipline of the market-place and be allowed to go under if they ran into difficulties.

These solutions – which have been advocated by the governor of the Bank of England, Mervyn King – can be likened to town planning. They rest on the belief that the financial system's susceptibility to fires can be reduced if its structure is reorganised. In theory, it is a beguiling idea. But it is not certain that the crisis would have unfolded differently under another industry structure. For one thing, the quality of risk management seems to have been a more important factor than size in explaining the behaviour of banks: JP Morgan may have been 'too big to fail', but it did not have the same level of exposures to collateralised debt obligations as Citigroup. Besides, it was not risky proprietary trading that got HBOS into difficulties, but classic 'utility' functions like lending to residential and commercial property.

Nor would the scale of state support necessarily have been smaller under a different industry structure. One lesson of the crisis is that systemic risk can arise not just from the failure of a single large firm, but also from the common exposures of many firms of different size to the same asset (entities can be 'too similar to fail'). Another lesson is that in a crisis, institutions may be considered 'too interconnected to fail'. As an insurance firm, AIG did not in theory have access to the US Federal Reserve's lender of last resort facility. Yet when confidence in AIG ebbed away after the collapse of Lehman, a central bank credit line was still extended to the densely interconnected insurer in order to avert the collapse of the banking system. In other words, the problem of systemic risk depends very much on context.

These caveats notwithstanding, one thing seems hard to dispute: the problem of moral hazard has worsened since the crisis broke out. Not only has state support been extended to a wide range of institutions – large and small, 'utilities' and 'casinos'. But the financial sector is more concentrated than it was before. So there are more banks that know with greater certainty that, in a crisis, governments can be relied on to act weaker than they talk. This state of affairs cannot be conducive to financial stability. It means that banks have less of an incentive to take risk management seriously – and more of an incentive to take risky bets in the expectation that the state will bail them out. This is all the more alarming because some firms have grown so large that their rescue would threaten the solvency of the state concerned.

A major headache for policy-makers, therefore, is how to bolster financial stability at a time when the expansion of the state safety net could encourage firms to take on more risks. The answer must be to reduce the scale of risks that are insured by the state, and to make the state's safety net less vulnerable to gaming.[22] One idea, which the Basel Committee on Banking Supervision is discussing, would be to introduce a leverage ratio to reduce banks' use of debt to finance investment. This would have a major impact on EU banks, some of which have 30 times more debt than capital. Another option would be to apply the 'polluter pays' principle: firms posing the greatest threat to systemic stability (because of their size or risk profile) would be subject to more stringent requirements on capital and liquidity.

[22] *Andrew Haldane, 'Banking on the state', Bank for International Settlements, November 11th 2009.*

However, it is also crucial that all financial institutions, and large ones in particular, be subject to market discipline – notably by being better prepared for failure. This is a principle that already commands widespread political support. In April 2009, leaders of the G20 endorsed a list of principles drawn up by the Financial Stability Board. One of these was that financial institutions should maintain recovery and resolution plans (or 'living wills') for use if they hit trouble. EU countries must now develop resolution frameworks to give this commitment effect. Resolution authorities (or 'undertakers') should have similar powers to a bankruptcy court. One of their main aims should be to make sure that management, employees and investors all suffer losses commensurate with the risks they allowed the firm to run up.[23]

[23] *Arthur Levitt, 'We need an orderly way to let institutions fail', Financial Times, October 8th 2009.*

Meanwhile, banking supervisory authorities across the EU must make sure that banks have recovery and resolution plans (RRPs) in place. RRPs must become an important focus of the supervisory authorities' conversations with banks, notably to make board members more aware of the risks involved with the business model. The 'recovery' element must outline how a bank expects to weather a crisis if it is exposed to one. It must be able to show that it has in place plans – contingency funding, business lines it can sell, and so on – that are not predicated on the taxpayer bailing it out. The resolution element, for its part, must ensure that a bank can be wound up in an orderly fashion if it comes to that. The bank must demonstrate that its structure does not make it 'too complex to resolve'.[24]

[24] *Andrew Bailey, 'Recovery and resolution plans', Bank of England, November 17th 2009.*

Remuneration: Heads bankers win, tails taxpayers lose?

Since the crisis broke, no issue has been the focus of more public anger than that of remuneration. Why it has done so is not hard to understand. It is a less technical issue than, say, counter-cyclical provisioning, and it lends itself easily to moral outrage. No surprise, then, that it has also attracted the attention of politicians. The American and French governments, for example, have appointed

'bonus tsars' to monitor bank compensation practices. And the treatment of bonuses was one of the top items on the G20 agenda at its summit in Pittsburgh in September 2009. The public debate over compensation has tended to conflate two issues that are really distinct. One is whether the way banks remunerated their staff contributed to the crisis. The other is whether levels of pay are justified.

Judging by political rhetoric, it is tempting to conclude that poorly structured pay incentives were the root cause of the financial debacle. Does the evidence support this belief? It is true that traders and chief executives earned huge rewards for 'fake alpha' – activities that seemed profitable in the short term but damaged their institutions in the long term. An internal report by UBS, a Swiss bank, concluded that misaligned risk-taking incentives did contribute to the disastrously large exposures it built up to collateralised debt obligations. But it is one thing to say that misaligned incentives may have been a contributory factor in a number of cases. It is quite another to make the stronger claim that the financial crisis would not have occurred if bankers had been rewarded differently.

Consider the relationship between incentives and bank behaviour. Employees at institutions that ran into difficulties during the crisis – Bear Stearns, Lehman Brothers and Merrill Lynch, to name just three – had an interest in the long-term survival of their firms because they owned large stakes in them. Yet, as the Turner review points out, these stakes "did not seem to result in any greater awareness of or concerns about the risks the firms were running." Meanwhile, lending standards were relaxed at stolid institutions like British building societies with no short-term bonus cultures to speak of, while supposedly bonus-driven executives at JP Morgan stood back from the seemingly profitable business of packaging CDOs because they concluded that this line of business posed too big a risk to the bank.

In short, the evidence suggests that what banks did was primarily determined by the strength (or weakness) of their internal risk management, rather than by bonus-driven short-termism. Yet curbing the 'short-term bonus culture' has become a dominant focus of policy in the G20 and the EU. The UK Financial Services Authority has published a code on remuneration. Although it is voluntary, banks that fail to comply with it could be forced to hold more capital. France has drawn up new rules that will limit guaranteed bonuses to one year, with half the payments deferred to a later date and a third of the deferred portion being paid in the bank's shares. And the German financial regulator has introduced rules that will force bonuses to be returned if these are derived from exposures that turn sour.

Regulators and supervisory authorities have a legitimate interest in the way people are paid in the financial sector. One is to make sure that pay structures do not encourage employees to subordinate the long-term safety of their firms to the quest for short-term rewards; the other is to ensure that banks and their employees bear the cost of their behaviour, rather than shift it on to the taxpayer. Some of the measures being introduced in EU countries may help in this respect. But it is important to understand the limits of these measures. Even if they make bank employees internalise more of the cost of their behaviour, the financial system will not necessarily be less crisis-prone: after all, many of the firms that went under in 2008 operated the very same practices that all are now being invited to follow.

It is also important to be clear about the purpose of rules and codes on bankers' pay. Public anger has generally focused on the 'obscene' levels of pay in the sector. But finance is hardly the only sector where levels of pay are well above the median. The task of rules and codes on remuneration in the finance is not to deliver broader goals of social justice (a task which is best left to the tax system). It is to correct an injustice that is specific to the financial sector: the fact that it externalises so much of the cost of its behaviour on to the rest of society. Rules on financial-sector pay should not be about redistributing income, but about curbing socialism for the rich.

The importance of reducing the financial sector's externalities

It is easy to assume that because they have imposed massive costs on the taxpayer, financial institutions (and their employees) were deliberately abusing the system by playing 'heads they win, tails the taxpayer loses'. Misaligned incentives may well have contributed to excessive risk-taking in certain cases. But it is harder to make the stronger claim that the crisis would not have happened if these incentive problems had been absent. After all, lending standards deteriorated across the board – including at many small (non-systemic) banks without extravagant bonus cultures. What is unquestionably true, however, is that the financial sector 'externalises' too much of the cost of its own behaviour on to the rest of society. No other sector manages to socialise its losses on such a scale.

The past 20 years have seen two undesirable developments: a huge increase in the risk and leverage of the financial system, allied to a relentless expansion in the scale and scope of state support for the banking system. This is an unsustainable combination – and not just because of the threat it poses to financial stability. Unless this trend is reversed, it will pose a threat to the fiscal solvency of governments and to the wider public's support for market capitalism. The stakes are therefore high. Banks cannot be allowed to continue operating in some netherworld where they are answerable neither to the market nor to the taxpayer. The status quo is not an option: something must give. If banks are opposed to the options proposed by regulators, they should come up with an alternative acceptable to taxpayers.

So far, two types of solution have been floated to reduce the taxpayer's potential liability for the financial sector's activities. One would be to redraw the structure of the industry so as to allow more institutions to fail and not have recourse to public money. The idea has attractions in theory, but the recent crisis suggests that it might not work so neatly in practice. The alternative is to reduce, via a combination of capital adequacy and leverage ratios, the scale of risks for which taxpayers might be potentially liable – and to ensure that banks have recovery and resolution plans that are not predicated on the assumption that if they hit trouble, they will be bailed out by the state. Increasing market discipline is crucial: all firms, large and small, should face the prospect of bankruptcy if they become insolvent.

7 Institutional design: Who should do the supervising?

Previous chapters have discussed the regulatory failings exposed by the financial crisis, and how these should be corrected. This chapter discusses whether these had anything to do with the way the supervisory architecture was designed. In answering the question, it is important to distinguish the national from the international dimension. Although the crisis exposed supervisory cracks in many jurisdictions, there is little evidence to suggest that these were more likely to appear in countries with certain regulatory structures rather than others. What the financial crisis did expose, however, were major deficiencies in the architecture of supervision across national borders. The world and the EU may therefore face a choice: either step up international co-operation, or accept that finance will have to be less global.

The national dimension: Are some models better than others?

Some critics believe that the crisis resulted from flaws in the institutional design of certain countries' supervisory arrangements. The US, for example, has a notoriously fragmented system, with numerous federal and state agencies responsible for supervising different parts of the same institution. These have been blamed for all sorts of supervisory failings exposed by the crisis. In the UK, likewise, some critics have homed in on the 'underlap' which was allowed to develop between the Bank of England and the Financial Services Authority (FSA). The Conservative Party has argued that this underlap resulted from the supervisory architecture, which left no institution in charge of financial stability; and that the solution is to hand responsibility for micro- and macro-prudential supervision to the Bank of England.

Can the failings exposed by the crisis really be explained by the architecture of countries' supervisory systems? Only up to a point. It is true that the fragmented nature of the US system created fissures which detracted from the supervision of systemic institutions like AIG. There is probably scope for rationalising and simplifying supervisory structures in the US. But there is not a particularly strong correlation between supervisory failings and specific types of architecture. The underlap in the UK, where no public institution had responsibility for financial stability, arose in other countries with different institutional arrangements. This suggests that some of the cracks exposed by the financial crisis were more the products of flawed supervisory assumptions than of weaknesses in the design of the edifice.

The international dimension: An increase in host country powers?

Policy-makers have long had to contend with the fact that financial activity crosses national borders, but political authority does not. By and large, they have tackled this tension in several ways. They have drawn up common minimum supervisory standards in international forums like the Basel Committee on Banking Supervision. They have tried to improve information flows between home and host country supervisors. And they have created international 'colleges' – that is, ad hoc groups of supervisory authorities led by the home country supervisor – to supervise large cross-border financial institutions. However, critics have long complained about the inadequacy of these cross-border arrangements. And events at the peak of the crisis in late 2008 have provided plenty of grist to their mill.

Critics point out that not all large cross-border institutions are overseen by 'colleges'; and that where colleges have been set up, they have not worked as well in practice as they should in theory, notably because information flows between supervisory authorities have not been up to scratch (despite commitments entered into in bilateral memoranda of understanding). Moreover, because home countries

are responsible for the consolidated supervision of the banking group as a whole, host countries have not always had a clear picture of how stable banks operating on their territory actually are. Cross-border co-operation, therefore, has proved to be a fragile edifice – particularly at times of crisis, when it has been vulnerable to a rapid loss of trust between home and host country authorities.

The shortcomings of colleges, and their vulnerability at moments of stress, have even been apparent within the EU, where integration and habits of working together are more advanced than elsewhere.[25] The case of Fortis – a bank with large retail deposit bases in Belgium, Luxembourg and the Netherlands – provides a telling example. On the face of it, it was supervised by neighbouring countries with close political and economic ties. When it ran into difficulties, however, attempts to mount a co-ordinated cross-border rescue failed. Instead, the three governments simply nationalised those parts of Fortis that were exclusively in their jurisdictions – a 'solution' that sparked protests in the Belgian media that the Dutch had simply grabbed the good bits of Fortis and left the toxic parts to the Belgians.

[25] *Karel Lannoo, 'Concrete steps towards more integrated financial oversight', Task Force report, CEPS, 2008.*

There is no prospect of world leaders ever agreeing to the creation of a global authority to supervise cross-border institutions. The Financial Stability Board has therefore had little choice but to reassert the importance of cross-border colleges and draw up guidelines for international co-operation in times of crisis. However, it is difficult to see how revamped guidelines will stand up to national political considerations, particularly in emergencies. Indeed, the knowledge that home and host countries can have conflicting interests in a crisis is likely to encourage host country authorities to take steps to protect the interests of local depositors and taxpayers before the next crisis breaks out. Greater international co-operation, in other words, is likely to be accompanied by more 'nationalist' prudential backstops.

This trend can already be detected in a number of countries. One of these is the UK. The country's FSA has made sure that colleges of supervisors have been established to oversee all systemically important cross-border institutions operating in or out of the UK. But it has also signalled that it intends to take steps to ensure that British interests are better taken into account when a foreign bank operating on UK soil runs into difficulties. It has indicated, for example, that it will be more willing to make foreign banks establish subsidiaries in the UK (in other words, force them to operate as separate legal entities from their parents). And it has made clear that it intends to ensure that foreign banks are, where necessary, subject to stringent local requirements on capital and liquidity.

The EU dimension: More Europe or less?

The EU stands in an awkward no-man's land. On the one hand, arrangements for supervising cross-border banks in the EU are not much different (or stronger) to those prevailing internationally – they are still based on ad hoc colleges. On the other hand, host countries have fewer powers inside the EU than they do outside it. The reason is that the EU's single market is based on the principle of mutual recognition (subject to common minimum standards). All financial firms established in the EU can open branches in another member-state, or provide services on a cross-border basis, on the basis of a single authorisation from their home country authority. In effect, the EU 'passport' removes the right of host countries to prevent banks established elsewhere in the EU from operating on their territory.

Events during the crisis have cast doubt on the sustainability of these arrangements. Particularly damaging has been the experience of Icelandic banks. Although Iceland is not a member of the EU, it belongs to the single market by virtue of its participation in the European Economic Area (EEA). In the run-up to the crisis, Icelandic banks attracted deposits in other EU countries by offering market-beating interest rates. However, when these banks ran into difficulties it became clear that they had outgrown the fiscal capacity of the Icelandic state to rescue them; and that the resources of the Icelandic deposit protection scheme were insufficient to compensate depositors in other EU countries. As a result, depositors in the UK and the Netherlands were not compensated by the Icelandic scheme.

The fault-lines exposed by the financial crisis confront the EU with some awkward choices. Current arrangements are unsustainable. Host countries cannot be expected to allow foreign banks to 'passport' on to their territory if they have doubts about the ability of the home country to honour its legal commitment to depositors. It is hard to imagine an arrangement more likely to undermine EU citizens' faith in the single market than one which exposes them to the risk of losing their savings. Equally, it is difficult to see how the EU can continue encouraging financial integration in the region if member-states do not trust each other or cannot work better together. If co-operation between the Benelux states can break down ignominiously in a crisis, what chance is there for other groupings of supervisors?

If the status quo is not an option, the EU can head in one of two directions: less Europe, or more Europe. Less Europe would mean re-examining the way responsibilities are currently divided between home and host countries and accepting that host countries should have more powers than they have been allowed under the passport directives. This would be a retreat from the single market, because a reassertion of host country powers over EU banks would reopen the door to the restrictions and discriminatory treatment that the single market was designed to eliminate. What more Europe might entail is a little vaguer. It would essentially be any arrangement that falls between the current one and the establishment of a pan-European body with responsibility for authorising and supervising EU banks.

In 2008, at the height of the financial crisis, the European Commission appointed a high-level group of experts, headed by Jacques de Larosière, to come up with some ideas on how the current unsatisfactory arrangements might be improved upon.[26] The report which the de Larosière committee came up with in February 2009 was emphatically not a federalist blueprint. It did not propose for banking supervision what the Delors committee had done for currencies. It took great pains to reconcile the need for greater supervisory effectiveness with hostility in countries like the UK to deeper institutional integration. Thus, it proposed to leave day-to-day responsibility for supervision firmly in the hands of national authorities; and it saw no role for the European Central Bank in micro-prudential supervision.

[26] *Jacques de Larosière, 'Report of the high-level group on financial supervision in the EU', February 25th 2009, Brussels.*

The de Larosière committee proposed the creation of two new bodies: a European Systemic Risk Council, responsible for macro-prudential surveillance in the EU (see Chapter 5); and a European System of Financial Supervisors (ESFS). The ESFS would essentially beef up the EU's current 'Level 3 committees' (which co-ordinate regulatory approaches across the EU) by turning them into authorities with greater resources and responsibilities. The new authorities – for banking, securities and insurance – would not supplant national supervisors, but tighten co-ordination between them. Their tasks would be to develop a common rule book; mediate between national supervisory authorities when conflicts arise; settle disputes if mediation fails; and co-ordinate risk management.

In September 2009, the Commission proposed a directive which, barring a few details (such as the name of the macro-prudential surveillance body, which will be called a Board, not a Council), uses the de Larosière proposals as its blueprint. The directive commands the broad support of the member-states, including the UK. In early December, EU finance ministers approved the Commission's proposals, subject to stronger safeguards to ensure that the new EU authorities do not impinge on the fiscal sovereignty of member-states (for example, by instructing them to recapitalise an ailing bank). However, the proposals still need to be approved by the European Parliament, where they will not necessarily receive an easy ride. In addition, they could also be affected by political developments in the member-states – and particularly by a change of government in the UK.

Britain: Between institutional and economic integration

The regulatory and supervisory shortcomings highlighted by the crisis raise more awkward questions for the UK than for perhaps any other EU member-state. It is only a slight caricature to describe the UK's general stance within the EU as enthusiasm for economic integration and hostility to most forms of institutional integration. In the financial sector at least, it is no longer clear that this Janus-faced position is still tenable.

If, as is now widely expected, the Conservative Party replaces the Labour Party in government in 2010, it will need to decide where it stands. The status quo is not an option. If the Conservatives defend the passport while blocking any attempts to improve supervisory arrangements at EU level, they will have to explain how British depositors will be protected in the future from a repeat of the Icelandic banks saga. If, on the other hand, they advocate a wholesale reassertion of host country powers so as to ward off closer co-ordination at EU level, they will have to admit that they have turned their back on the single market.

8 Conclusion

One year after the financial system came close to collapse, policy-makers in the EU and the US can hardly be accused of having sat on their hands. Extensive regulatory changes are afoot, covering everything from capital and liquidity requirements, to the way hedge funds and private equity firms are regulated, OTC derivatives are traded, and financiers are paid. This report has argued that while many of these changes are desirable, political pressures are resulting in too much misdirected energy. So the regulatory burden is set to increase. But policy may not be following the optimal path to greater stability. As a result, the financial system which emerges may not strike a sensible balance between stability and economic growth. The reform agenda as a whole needs to be guided by a clearer sense of priorities. What should these be?

★ Reverse the terms of trade between state and banks

One of the most urgent challenges facing policy-makers – vastly more important than, say, clamping down on hedge funds – is to reverse the longstanding deterioration in the 'terms of trade' between the state and the financial sector. Over the past two decades, the risk and leverage of the financial sector has increased, while the state's safety net has progressively widened. This is a noxious combination. The banking sector cannot be allowed to continue living in suspended animation between the market and the state. No other sector enjoys such an exorbitant privilege. A status which allows banks to privatise rewards and socialise costs threatens the solvency of states – and will ultimately destroy public support for market capitalism. Banks must wake up to how important the stakes are.

Banks cannot have it both ways. They cannot simultaneously oppose attempts to reduce their leverage or increase their capital, and continue organising themselves in a way that makes it impossible for the state to allow them to fail. Yes, size is a measure of past success – and international banks with large footprints in, say, Asia weathered the crisis better than smaller ones which were exposed to their home markets in the US and in Europe. But neither of these observations is an answer to the central problem: the fact that certain institutions might leave taxpayers with an intolerable liability if they were to run into difficulties. Reducing the scale of that potential liability is critical if the financial system is to be placed on a more stable footing, and public support for 'free markets' is to be preserved.

★ Measure the combined impact of regulatory changes

The 'social contract' between states and the financial sector needs to be fundamentally redrawn. But that does not mean that banks and other financial firms should be subject to an avalanche of new regulations for their own sake. Poorly-designed, populist measures are crass, whether the egregious behaviour of financial firms invites such measures or not. It is not enough to avoid cheap populism. After a crisis, there is an understandable temptation among policy-makers to tighten all sorts of regulatory screws to avoid a repeat of the cataclysm. But there is no free lunch. A fail-safe financial system can probably be designed. But such a system would be incapable of performing its most basic function – channelling money from savers to borrowers. The policy challenge is to get the balance right.

Will the regulatory response to the crisis achieve this balance? It is too early to tell. But banks and other financial firms are right to worry that the pendulum could swing too far. One reason is that no-one yet has a clear idea of precisely how much more capital banks should hold (should it be increased by a fraction or a multiple?). Another reason is that little attention is being paid to the overall

impact of all the proposed changes. It follows that measures that make sense individually – like imposing higher capital requirements on large banks or for trading book exposures – could easily pile up and collectively go too far. This risk must not be dismissed just because it is being flagged by the financial sector. Policy-makers must develop a clearer understanding of the combined impact of all the changes underway.

★ Make sure the regulatory response is properly calibrated

An important consequence of the financial crisis is that more entities are going to be brought under the supervisory net. Given the role that shadow banking entities played in the run-up to the crisis, this seems desirable. Less desirable has been the way the debate in the EU has come to be dominated by the issue of hedge funds. Hedge funds are more lightly regulated than banks and it makes sense to subject the largest of them to better oversight. But it is absurd to turn the regulation of hedge funds into some kind of litmus test, as some EU politicians seem determined to. Hedge funds did not cause the crisis. And huge numbers of them have folded over the past year without making any call on the taxpayer. Hedge funds may be less regulated than banks. But they have not externalised their losses on to society.

As the supervisory net is widened, policy must be properly calibrated. Supervisory oversight should be proportionate to the risk which an entity poses to the rest of the system. Obsessing with hedge funds will not achieve this. Not only will it produce disproportionate legislation in certain areas, but it will also distract attention from issues that are equally or more important – like ensuring that the clearing houses through which trading in credit derivatives is to be channelled are financially sound (an issue which has attracted far too little attention to date). Policy-makers should really be spending more time worrying about regulated banks than about hedge funds. Why? Because the banking sector is more concentrated, more highly levered, has lower rates of entry and exit, and socialises more of its losses.

★ Understand the limits of regulation

Although many of the regulatory reforms working their way through the pipeline are desirable in principle, it helps to be clear about the limits of regulation. It is tempting to believe that future crises can simply be legislated out of existence. This is unrealistic, unless one is prepared to accept that all risk should be removed from the financial system – an outcome that could only be achieved by preventing the system from carrying out the task for which it is actually designed (which would be absurd). A degree of risk, and consequently the potential for periodic crises, is inherent to the financial sector. The task confronting policy-makers is not to abolish future crises. It is to mitigate the scale of future crises, while striking an acceptable balance between financial stability and economic growth.

Many politicians in the EU seem to think that financial stability is a task for regulation alone. The result is that regulation is being tightened in all sorts of areas. But some of the broader macroeconomic factors which fed the crisis are not being tackled. So the world may well emerge with a more regulated financial sector that is still exposed to the same macroeconomic strains. Will this result in a more stable system? At the margin, perhaps. But an important lesson of the crisis is surely that well-designed regulatory regimes can be overwhelmed by large capital inflows or an excessively cheap cost of borrowing. It is odd, therefore, that some countries have expended so much energy in the G20 on trying to curb bankers' bonuses, while blocking attempts by other countries to discuss issues like global imbalances.

★ Reduce structural global macroeconomic imbalances

Correcting the deep-seated, structural imbalances that still afflict the global economy must become a higher priority than it has been to date. If these structural imbalances are to narrow, deficit countries (particularly in the profligate Anglo-Saxon world) must save more and spend less, while surplus countries (like China and Germany) must do

the reverse. A strengthened multilateral surveillance role for the IMF might help such an adjustment, and set the international financial system on a more stable footing. But past experience invites caution: global imbalances exploded after a similar initiative in the late 1990s. The problem is that countries with large external surpluses are not committed to eliminating structural global imbalances, and that the IMF has no power over its members' policies.

China and Germany must therefore be persuaded that they save too much and spend too little – and that running unsustainably large trade surpluses cannot be in their long-term interests. China's attempts to stem the appreciation of the renminbi have plunged it into a dollar trap and provoked growing tensions with its trading partners. Germany can hardly be accused of currency manipulation. But the reluctance of its political leaders to discuss global imbalances in the G20 suggests they remain wedded to export-led growth. The irony is that the strength of the euro, allied to the size of Germany's trade surpluses, is causing growing strains within the euro area. These could come back to haunt Germany if Ireland and Spain are pushed into prolonged depressions and suffer fiscal and banking crises as a result.

★ Pay more attention to the implications for central banks

More attention needs to be paid to the implications of the crisis for central banks. The objectives of central banks are set to become more complex and less amenable to simple targets. One reason is that central banks will have to pay closer attention to asset prices than they have done in the past. Another reason is that they are being given new, explicit responsibilities for financial stability (or 'macro-prudential surveillance'). It is strange that there has been so little public discussion about how central banks should discharge their expanding responsibilities because central banks will have to meet two objectives – monetary stability and financial stability – which may sometimes conflict (a decision to cut interest rates to support financial stability in the short term may push inflation above target in the longer term).

Central banks, in other words, are moving from a world in which they used a single instrument to pursue a relatively narrowly defined target (like the inflation rate), to one in which they have greater policy discretion and pursue several targets at the same time. In short, they are set to move on to increasingly political territory. Politicians must therefore pay more attention to how central banks discharge their responsibilities in this new world. If central banks are going to be expected to meet several objectives at the same time, they will need to be given more than one instrument. And if they are going to make contentious trade offs – like precipitating a shallow downturn in the short term to avoid a more painful one over the longer term – then politicians must satisfy themselves that they can live with it.

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HOW TO RESTORE FINANCIAL STABILITY

Philip Whyte

In 2008, the global financial system came close to collapse. Ever since, policy-makers have been busy overhauling the way it is regulated and supervised. Will this flurry of activity produce a more stable financial system – and if it does, at what cost? Many of the changes afoot are desirable. But the reform agenda suffers from three flaws: side-issues are getting more attention than they deserve; regulation is doing all the heavy lifting; and not enough attention is being paid to the combined impact of all the changes underway. The regulatory burden is rising, therefore, but policy may not be taking the optimal path to greater stability. To do so, the reform agenda needs to be guided by a clearer sense of priorities.

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