After the G20: Time for Realism in Global Financial Regulation

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While the noisy arguments about macroeconomic imbalances and exchange rates dominated the publicity at the recent G20 summit, the participants in Seoul also marked an important milestone for financial regulation. They symbolically closed a cycle of intense global discussions that started two years earlier with the first G20 summit in Washington. The most prominent item was the endorsement of the Basel 3 accord on bank capital and liquidity, which was completed in September. That agreement significantly tightens earlier requirements and provides a convenient opportunity for world leaders to declare “mission accomplished” and move on to other topics.

In many respects, the scope for global financial reform is becoming narrower. In the US, the adoption of the Dodd-Frank Act in July signaled the end of major legislative activity in this field. Most emerging countries are neither willing nor ready to take the baton of global leadership. Formally, several financial regulatory items remain on the agenda. But it was significant that French president Nicolas Sarkozy, who just took over as president of the G20 process, did not mention any of them, apart from commodities markets, in an August speech outlining his priorities. This stands in striking contrast with two years ago, when financial reform dominated the G20 agenda and many leaders, particularly in Europe, enthused about worldwide harmonization of financial rules.

Global finance cannot realistically be submitted to a single rulebook. The Basel accord itself sets a minimum standard, not an optimum one. Several jurisdictions, from Switzerland to China, are considering higher requirements. Processes for preventing and managing large banking failures remain heterogeneous, as the Financial Stability Board (FSB), which coordinates the world’s financial regulators, acknowledged in a report to the Seoul summit. Global accounting standards convergence is likely to be much more protracted and diverse than generally anticipated before the crisis. All this is not necessarily disastrous, even though it means that some competitive distortions and regulatory arbitrage will remain endemic. Not all regulation needs to be global, as many financial activities, particularly in retail banking, are mainly developed within national borders, or in the case of the EU, regional ones. In this somewhat constrained environment, the next phase of global financial regulatory discussions will be shaped by three broad requirements.

First, the system of global institutions needs to be strengthened and adapted. As in individual countries, the technical nature of financial regulation justifies its delegation to specialized expert bodies. But these can be effective only if their authority is accepted by their many stakeholders. As the financial world becomes more multi-polar, emerging economies must be better empowered in their governance. While public attention has focused on such reform at the International Monetary Fund (IMF), other important institutions such as the Bank for International Settlements (BIS) and International Accounting Standards Board (IASB) are even more behind the curve in giving adequate representation to China, India, Brazil and the like. Several actors also suffer from insufficient transparency or accountability. Thus, the IASB needs to regain the trust of the community of investors, whose concerns it has often appeared to neglect in recent years; the Basel Committee on Banking Supervision needs to open itself to more external scrutiny; and the FSB needs to clarify its role and status, including its relationship with the BIS, which at this point remains ambiguous.

Second, efforts are needed to sustain the worldwide integration of capital markets, a process that brings significant economic benefits to savers and borrowers alike. The ongoing re-regulation of key transactional and informational infrastructure, including trading and clearing platforms, rating agencies, and audit firms, was made necessary by the crisis but also carries risks of fragmentation. These risks are likely to become more apparent with time. The aim of cross-border market inter-operability suggests a higher degree of global regulatory and supervisory integration for these market players than, say, for retail banks. In this spirit, the FSB is right to suggest a specific regulatory regime for the most globally active investment banks, which play a crucial role in cross-border capital market intermediation.

Third, the capacity for public monitoring of the global financial system needs dramatic improvement. This is necessary both to keep track of vulnerabilities in the system, and to verify that global commitments are properly implemented. Strikingly, no appropriate process exists to guarantee that global standards on accounting or bank capital are consistently enforced by those countries committed to them. The IMF, BIS, and FSB all play a role but many loopholes remain, partly because of lack of adequate public disclosures by individual firms and governments.

The harsh realities of the post-crisis world leave little space for airy rhetoric about radical reinvention of the financial system. The above listed requirements may be seen as defining a fairly narrow agenda. Even so, G20 leaders will deserve much praise if they succeed in meeting them in the next few years.

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