Has Global Financial Reform Run Out of Steam?

By Nicolas Veron

March 2011

Just after the Lehman Brother collapse, financial regulatory reform was at the top of the global agenda, and it dominated the discussion at the first summit of G20 leaders in November 2008. By contrast, it was little more than an afterthought in the last G20 meeting in Paris last month. Many observers fret that the financial industry has reverted back to its pre-crisis business-as-usual mode. The financial regulatory agenda discourages most non-insiders because of its apparent intractable complexity, enhanced by barriers of jargon and multiple smokescreens put up by financial executives wary of public discussion, and public authorities eager to protect their turf.

Take a step back, though, and there is no reason to despair. The past two years have brought significant achievements. In the United States, the Dodd-Frank Act introduced numerous changes that are far from marginal, and most of its implementing rules are in the process of being completed. In the EU, crisis resolution and financial legislation have been generally slower, but the creation of the three European Supervisory Authorities, in effect the world's first supranational financial supervisors, is a major breakthrough. Capital requirements are being substantially increased, with the Swiss authorities taking particular leadership. Authorities are also improving their ability to understand and monitor financial systems, including through the collection of relevant data.

Even so, the measures adopted so far stop short of an adequate global policy response to the unprecedented shock of the crisis and the chain reactions it triggered. Three monumental challenges require sustained and simultaneous attention.

The first one can be labeled "bad big banks," those whose bankruptcy would be so disruptive that governments prefer to bail them out in a crisis. This problem of so-called too-big-to-fail financial institutions tends to be more actively discussed in the US, but is actually more acute in Europe, as national banking systems are far more concentrated and no consistent bank resolution framework exists at the European Union (EU) level. The United Kingdom has created an independent commission to address it, and the Financial Stability Board carries the discussion at the global level, but no obvious solution is in sight yet.

The second challenge is to avoid unintended consequences of reform in terms of financial fragmentation. Even though the economic impact of financial openness is multifaceted and difficult to quantify, a reversal of the pre-crisis momentum towards financial integration would certainly harm global growth prospects, and should be avoided. But this will require more global consistency in the regulation of key tangible and intangible infrastructures of capital markets. The unfinished saga of international accounting standards harmonization illustrates how difficult such an effort can be.

Third, the re-regulation of financial systems must be achieved without impairing their ability to foster growth. Contrary to much of the financial industry's lobbying discourse, this aspect is not primarily about capital requirements, but rather about competition and innovation to deliver better and economically more productive financial services. In emerging markets, the overall provision of credit is generally insufficient and inefficient. In more advanced economies, credit is typically not directed to the borrowers that could make the best use of it, especially high-growth companies with no physical collateral to pledge. Financial stability concerns must be addressed without repressing useful financial development.

On each of these three dimensions, policymaking is hobbled by major analytical uncertainties, compounded by a surprising scarcity of relevant data and academic research. All three involve major issues of competition policy, which has generally been underdeveloped in finance compared to other industries. None of them can be expected to be comprehensively addressed any time soon.

Moreover, financial reform will be shaped by an increasingly unpredictable interaction with national politics. In many countries, public opinion and elected officials alike want the financial sector to pay a price for the crisis, which explains why so much of the debate is dominated by themes whose relevance is at best limited from a strictly financial stability perspective but which resonate with broader perceptions of unfairness, such as traders' bonuses, naked short selling, rating agencies' conflicts of interest, or the possibility of taxing financial transactions. An additional difficulty is the interplay between different geographical levels of reform. Of the previously mentioned challenges, the first involves a mix of local and global aspects, the second is mostly global, and the third mostly local. This set of issues creates multiple incentives for both public authorities and financial firms to shift responsibility and arbitrage the different levels, making progress considerably more difficult.

Financial reform is a never-ending effort, and the cycle that started with the crisis is far from completed. In furthering the cycle toward progress, policymakers should aim at maximizing the chances of a financial system that combines the desired attributes of stability, openness, efficiency, and fairness. This is likely to require even more policy vision and creativity than have been displayed so far.

Nicolas Véron *is a senior fellow at Bruegel in Brussels and a visiting fellow at the Peterson Institute for International Economics in Washington.*