Post-Crisis Financial Reform: A Trans-Atlantic Scorecard

By J. Paul Horne

Three years after the worst financial-economic crisis since the 1930s began; a new international financial, regulatory and fiscal architecture has emerged. Although incomplete, not yet implemented and inadequately coordinated between major countries, the new structure is due to be ratified at a summit of G-20 countries in Seoul on Nov. 11 and 12. The leaders will naturally put a positive spin to the new measures, and indeed much has been accomplished.

Ahead of the summit, strains in foreign exchange markets have forced the G-20 leaders to focus on coordinating their countries' macro-economic policies, hopefully with an eye to reducing excessive global imbalances. These efforts strive for progress toward more equilibrium in trade balances and mitigation of the impact of excessive capital flows. These ideas, promoted by Washington, are unlikely to be met with anything beyond vague commitments. The same issues may also be framed in the context of integrating key emerging market economies, notably China, into the newly emergent financial-fiscal framework.

At Seoul, world leaders are likely to agree on an "early warning mechanism" to police excessive trade deficits and surpluses. The G-20 will be able to congratulate itself on the recent agreement to change the IMF's voting weights and capital structure to expand the role of the BRICs (Brazil, Russia, India and China) while reducing those of the U.S. and Europe. The move marked a long-overdue shift to help cooperation between the old G-7 countries and the large emerging markets, which include not only the BRICs but also more advanced economies such as South Korea and Mexico.

What can be said with certainty is that much will remain to be done to solidify the barriers against a new crisis in the future. Meanwhile, however, the summit's impact can be measured in the short run by how much it achieves in consolidating consensus behind what has been achieved in identifying the old problems and fixing them in ways that enable the emerging new system to work.

Here is a summary of what has been done and what remains to be settled in three areas:

- monetary policy
- financial regulatory structures
- fiscal policy challenges

A fully detailed item-by-item comparative list of all the proposed changes in financial services in the EU and the U.S. can be found in this well-presented survey from the Bertelsmann foundation.

Monetary Policy

Extraordinary measures taken by the Federal Reserve and the European Central Bank (ECB) since 2007, together with swift action by the U.S. and European governments, saved the world's banking and non-banking financial system. The survivors included some of the Too Big To Fail (TBTF) institutions. In many analysts' view, this issue needs to be revisited, and debate continues, notably about proposals for an EU-wide rescue fund that would put the costs of a rescue on banks and not on taxpayers. The Fed and ECB have also cut short-term interest rates to historically low levels and then, when interest rates could go no lower, resorted to "quantitative easing" i.e., injecting vast amounts of low-cost money into the world economy in the form of cheap credit for banks. This massive monetary stimulus, combined with governments' fiscal stimulus, avoided what could have been an economic depression at the price of a nasty recession in 2008-2009.

But monetary authorities face major continuing and new challenges. Despite record low interest rates, the global credit system balks at providing the additional credit needed to boost today's slow economic growth and job creation. This reluctance is conspicuous at bailed-out U.S. and European financial institutions that are now reporting record profits – while refusing to help jump start business expansion by providing enough credit. This means the central banks' extraordinary monetary ease is not getting through to the real economy. Instead, at a time when the Fed and ECB continue to minimize the cost of capital, the financial industries on both sides of the Atlantic are again concentrating on the pursuit of the highest-possible rates of return on investment, even if this focus leads to excessive risk.

Markets and regulators worry

they must at some point to prevent future inflation. A longer-term concern is the "moral hazard" in a situation where major financial institutions continue taking excessive risks, capable of destabilizing the system, because they are convinced that they are Too Big To Fail and will be bailed out again by central banks and taxpayers if they get in trouble.

Another component of the new regulatory structure is the recently-added "Basel III" provisions that will require the world's major banks to raise their ratios of capital-held to liabilities incurred to seven percent by 2015, and to increase the quality of the assets used to meet those ratios. The aim of this rule – adopted by the Basel Committee on Banking Supervision at the Bank for International Settlements (BIS) in Basel, Switzerland – is to better protect banks from future crises by requiring them to hold a bigger cushion against trouble. The new system will also require banks to build up reserves ("capital buffers") during good times to be used in bad times. Already, even though Basel III will not be fully implemented for some years, banks are complaining that they cannot be more generous in lending money in a situation where they are gradually being required to set aside more capital to meet the new standards.

Financial Regulatory Structures

The U.S. and EU have taken dramatic action to curtail the laissez-faire regulatory policies of the last several decades.

In the U.S., the most important restructuring of U.S. financial regulation since the 1930s, the Dodd-Frank Wall Street Reform and Consumer Protection Act, was signed into law by President Barack Obama in July 2010. Named for the Senate and House leaders who pushed through the legislation, Dodd-Frank aims to promote financial stability by:

> boosting accountability and transparency in the financial system;
>
> setting up a "resolution mechanism" for TBTF institutions to lend credibility to leaders' vow not to tolerate moral hazard or repeat taxpayer bailouts;
>
> implementing the 'Volcker rule' to limit risk-taking by financial institutions; to increase transparency of derivatives (requiring most to be listed on exchanges);
>
> strengthening investor protection; a major innovation is a Bureau of Consumer Financial Protection to shield consumers from abusive bank and financial services practices.
>
> providing that the Fed can be authorized by the Treasury to extend credit in "unusual or exigent circumstances" to banks and non-banks.
>
> tightening accounting standards and subjecting credit-rating agencies to still-undetermined supervision.

To head off future systemic risks, Dodd-Frank creates the Financial Stability Oversight Council (FSOC), which must identify threats to financial stability, promote market discipline, and respond to emerging systemic risks. Meeting at least quarterly, the FSOC will include the Fed and other regulators and be presided over by the Treasury Secretary. A new Office of Financial Research will facilitate generation and coordination of research bearing on financial stability for the FSOC.

In the European Union, even more sweeping action has been taken to supervise the financial system across EU borders. The European Parliament gave final approval in September to legislation that will make fundamental changes in supervision of EU banks, securities markets and insurance companies starting in 2011. Three European supervisory authorities (ESAs), to be based in Frankfurt, will include: the European Banking Authority (EBA), the European Insurance Authority (EIOPA) and a European Securities and Markets authority (ESMA). The ESAs will police financial institutions and are mandated to protect consumers.

A European Systemic Risk Board (ESRB), chaired by the ECB President, will also be established to monitor and warn of excessive risk in the EU financial system and economy. It will develop common indicators to permit uniform ratings of the riskiness of cross-border financial institutions. It will have to notify the European Parliament and the three ESAs of an imminent emergency. Major financial institutions will have to contribute to a European Deposit Guarantee Fund and a European Stability Fund, to salvage private and public institutions in trouble without resorting to taxpayer bailouts.

(For details of these new structures, see European Institute's reports earlier this year in February and May .)

The new regulatory architecture in the U.S. and EU is impressive, but caution is warranted. The Dodd-Frank and EU legislation must be implemented over the next few years. Its myriad regulations will affect the vested interests of all financial institutions and their political allies, and they are already fiercely resisting. No one should be optimistic that the new U.S. regulatory framework will be able to survive the financial industry's power to avoid regulation. And there are the questions about getting a real grip on the moral hazard of the TBTF banks.

On a scorecard, the EU's new architecture must be rated as "very significant": it is the first major move toward an effective trans-EU regulatory structure since the creation of the ECB. In comparison, the Dodd-Frank legislation is more a reshuffling of the regulatory patchwork and may not address the underlying structural problems.

Fiscal Policy Challenges

The financial crisis and ensuing recession revealed massive public debt and deficit problems in the U.S. and in Europe. These revelations, notably in Greece, put the euro to its first severe test. International bond markets went into a tailspin as the "bond market vigilantes" were stung into action to dramatically hike the cost of borrowing for countries with lax fiscal policies. In the U.S., the bond market has behaved differently because of the Fed's pressure (via renewed "quantitative easing") to keep down the cost of Treasury bonds -- despite the huge budgetary deficit. It is unclear how long the Fed can maintain this situation of financing a growing U.S. budget deficit.

The "eurozone" (and by extension the whole EU) has emerged strengthened by the showdown over Greece and other EU countries with unsustainable budgetary policies that were being pushed toward default by the "bond vigilantes." EU political leaders overcame major political differences to agree with the International Monetary Fund on a EUR 110 billion bailout for Greece and a combined EU-IMF mechanism that makes up to EUR 750 billion available for a new European Stabilization Fund (ESF) to help EU countries in trouble. Individual countries, notably Greece, Ireland, Portugal, Spain, France and, most recently, the UK, implemented draconian austerity programs to cut their deficits over the next several years. Bond markets have calmed, but wariness remains about the potential backlash from voters against austerity measures.

In late October, EU government leaders agreed tough new budget rules to protect the eurozone from another Greek-style debt crisis. A permanent EU fund will be set up to support the euro when it comes under pressure, and the EU and EC will have new powers to scrutinize the 27 national budgets and to impose fines. The new fiscal policy will limit the EU's own budget.

The financial and sovereign debt crisis thus pushed the EU toward greater fiscal cooperation far sooner than would have been the case without a crisis. Budget austerity, together with new EU fiscal surveillance mechanism (if it can be approved without a new divisive debate), will be the much-needed complement to the EU's very successful monetary union, even if remains far short of any long-term goal amounting to "economic governance" for the EU.

This degree of European cooperation is also critical to advancing global financial reform, a process promised by G-20 nations.

The G20 Summit in Seoul

The G20 finance ministers agreed in late October that the summit must give top priority to:

- implementation of the Basel III bank capital and liquidity framework;
- the Financial Stability Board's increased supervision to mitigate risks with TBTF institutions;
- consensus on implementing the new architecture in an internationally consistent manner, including regulation of derivatives, compensation practices, accounting standards and reducing reliance on credit rating-agencies.

Progress at the summit will depend on progress on these matters. In any event, in the broader context around the summit, the bigger picture shows a new architecture that no one could rate as ideal and which remains largely to be implemented. Even with these caveats, both the U.S. and the EU -- and the G-20 -- have been able to make such significant progress in bridging some important conflicts of interests during a time of slow economic growth and high unemployment. Without the crash, none of this new architecture would have been put in place. Crisis has produced progress – so far.

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