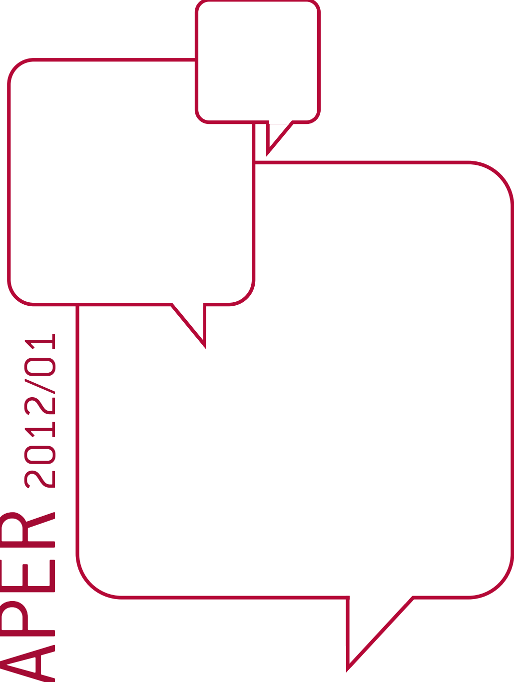

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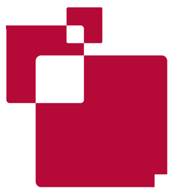
FINANCIAL REFORM AFTER THE CRISIS: AN EARLY ASSESSMENT*



1 Introduction

Financial reform has been a core dimension of the initial global policy response to the financial turmoil of 2007–2008. At the first G-20 summit of heads of state and government in November 2008, more than four-fifths of the action points in the final declaration were about financial regulation (Rottier and Véron, 2010). Obviously, the crisis is not over at the time of writing, and the cycle of financial reform it triggered is very far from complete. But it can be said confidently that the crisis has been transformational for financial regulatory policy, at least in the United States (US) and Europe.[1]

One of the key lessons of the crisis is the interdependence between the detailed features of financial systems and macroeconomic outcomes. Thus, the tight separation of financial and macroeconomic issues, which is entrenched both in academia and in the policymaking community, needs to be overcome. Initiatives to better analyse 'macro-financial' linkages and to conduct 'macroprudential' policy have mushroomed since the start of the crisis, although they generally fall short of a fully joined-up framework. From this perspective, the focus of this chapter is financial regulation in an old-fashioned sense, understood as a cluster of interrelated policies designed to ensure the proper functioning and integrity of financial systems. This scope includes public regulation and supervision of bank capital, leverage, liquidity, and risk management; control of moral hazard and financial industry incentives; protection of customers of financial services; and the regulation of capital markets. Other reform areas such as capital flow controls, prevention of money laundering, and the taxation of financial activities can overlap with this agenda, but are not considered here part of it in a strict sense.

The general impetus of financial reform as a reaction to the crisis, in the US and Europe, has been toward more regulation, or re-regulation. This is admittedly too simplistic a generalisation: this policy area is multidimensional and cannot be reduced to a simple choice between less or more regulation. Nevertheless, there was a clear turning point in 2008, with the renewed realisation that financial systems, including banking systems, could not be left to their own devices, both because of the large potential economic cost of financial crises and because public expenditure is often a key component of their resolution. This age old wisdom was neglected in the preceding decade in both the US and Europe, for different reasons, more than in the rest of the world, including Australia, Canada, Japan, and emerging economies.

Financial regulation is a complex thicket of highly technical policy challenges, often subject to the use of mutually incomprehensible jargons even as they are mutually interrelated. The devil is generally in the details, and elegant quantitative modeling of policy trade-offs is rarely available. Analytical frameworks tend to be similarly fragmented across different academic silos, including economics, financial research, accounting, political science, and sociology. From an economic research perspective, this is a less mature field than other policy areas such as fiscal, trade or labour policies. Hopefully, the crisis itself will result in new avenues for research, the results of which might start to become available in a few years' time.

[1] The sequence of financial events that started in the summer of 2007 and is still unfolding at the time of writing has been referred to under various monikers including the subprime crisis, the late-2000s financial crisis, the Great Recession, or the global financial crisis. As none of these is fully satisfactory

subsequent rulemaking in individual member states. According to the Basel Committee on Banking Supervision, by September 2011, implementation of the Basel II Accord was complete in 21 of the committee's 27 member countries, with at least two more countries planning to join in 2012 (BCBS, 2011b).

Since the start of the crisis, financial reforms resulted from a sometimes complex and iterative combination of discussions and initiatives, at both the individual jurisdictions and international levels.

2.1 The G-20

The emergence of the G-20 as 'the premier forum for [...] international economic cooperation'[2] is a significant development that crystallised in the first few weeks following the collapse of Lehman Brothers and the ensuing wholesale market panic (Price, 2009). The G-20 format traces its origins back to the aftermath of the Asian crisis of 1997–1998, but it was adopted as a forum for meetings of heads of state and government only in 2008. G-20 summits have been held in Washington (November 2008), London (April 2009), Pittsburgh (September 2009), Toronto (Juntinderpann 7Cil Ths pla

that the authority of the heads of state and governments effectively made binding. This was seen in the negotiation of the Basel III accord on bank

2.3 Individual jurisdictions

The pattern of financial reform initiatives has been extremely different from one jurisdiction to another, notwithstanding the coordination efforts deployed in G-20 summit and FSB initiatives. Multiple factors converge when explaining the differences of approach, including longstanding variations of institutions, culture, and economic stvariatioicisis itself. m005 Tc 131s 100 d [(The Da

2011), revision of 2003 directive on market abuse (proposed October 2011), another revision of credit rating agencies (proposed November 2011), and framework for bank crisis management and resolution (forthcoming), to name only the most important pieces. Inevitably, the fact that so many different pieces of legislation are debated and decided upon while the financial crisis continues raises risks of legislative inconsistency and of short-term considerations prevailing over longer-term ones.

Moreover, in the EU important financial legislation is also set at the national level, under various patterns of coordination with EU-level legislative initiatives. This has been particularly the case with

Switzerland, and at the EU level, financial reform initiatives elicited a level of opposition from the financial industry without equivalent in recent memory. Among other episodes, this shift was illustrated when JP Morgan Chase CEO Jamie Dimon described the Basel Committee's proposed capital surcharges on Global Systemically Important Banks as 'anti-American',[4] or when the Director General of the Confederation of British Industry, John Cridland, referred to the proposals of the UK Independent Commission on Banking as 'barking mad'.[5] This is not an absolute shift: there were instances of autonomy of public financial policymaking from the private sector before the crisis, including the US Sarbanes-Oxley Act of 2002; and there are examples of private-sector capture of the policy process since the crisis started, such as when the European Commission in October 2008 forced the IASB to amend its IAS 39 standard on financial instruments to help banks escape the early recognition of crisis-induced losses, or when the US FASB eased its criteria for asset impairment in early 2009 under pressure from US Congress. There are also many grey areas. Nevertheless, the general trend so far appears to have been a sharp reduction of the private sector's influence over the financial policy process.

Second, within public policy decision-making, there has been a general shift toward more politicisation. Policy issues that were previously

particularly those from large West

3 Challenges and outlook

It is far too early to present a desc picture of post-crisis financial reforms and their impact on the global financial system. Huge challenges remain and it is still unclear how they will be met. First and foremost, the crisis has not yet been resolved, and the interaction between crisis management and longer-term reform creates uncertainties of its own. Second, in spite of widespread calls for 'macroprudential' approaches, the interaction of financial-sector policy with other dimensions of economic policymaking remains largely unsettled. Third, how to effectively regulate cross-border financial firms remains a fundamentally unsettled question. Fourth, other reforms will be difficult to implement in an internationally consistent manner, raising concerns about the possible fragmentation of the global financial space. Fifth, the reforms will affect the financial system's contribution to economic growth in multiple ways, which on the whole remain poorly understood.

3.1 Ongoing crisis management

The most obvious uncertainty is that the financial crisis is far from over. Although it was partly overcome in the US in 2009, it is still worsening in Europe and could again spill over to other parts of the world. This creates a triple risk of forbearance, populism, and irrelevance.

Concerns about financial instability in jurisdictions where the financial crisis remains unresolved, including much of continental Europe at the time of writing, can easily lead to excessive forbearance as has been the case in several episodes of systemic banking fragility, such as in Japan in the 1990s. For example, large continental European countries such as GermanyoncernoTj 0.rtal EuropeS 8.77

and in Belgium, it is also chaired by the central bank's governor but is legally autonomous and includes representatives of multiple public entities. In the US and in France, it is chaired by the Finance Minister, suggesting further

best way to reach this objective is unlikely to become a matter of usual consensus in the short or even the medium term.

3.3

Ratio, to be introduced in 2018). The G-20 leaders endorsed Basel III at the Seoul Summit in November 2010 and committed to implement it in their respective jurisdictions. At the time of writing, most jurisdictions are still at a relatively early stage of this process, but concerns have already emerged about the consistency of implementation in jurisdictions including the EU, where the proposed legislation (fourth Capital Requirements Directive and Capital Requirements

encourage or limit competition among financial intermediaries, innovation in financial services, and the allocation of capital to risky new ventures, remains poorly understood, especially given the large number of interrelated recent or ongoing financial reform initiatives.

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