

In the aftermath of the banking crisis, five types of reform proposals can be identified. Here, **ROSA LASTRA** outlines them and provides an analysis of the key steps that should be taken

A check book the banks cannot bounce



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The financial crisis has triggered a revolution in regulatory thinking. Once relegated to the obscure universe of the specialist, financial regulation has now come to the forefront of economic and policy debate. The crisis has shown that markets cannot always be trusted to deliver what is good for society, since the pursuit of the private interest has proven at times to be greatly misaligned with the pursuit of the common good.

Lord Turner has claimed that some trading activities are socially useless, while much anger has been vented towards the compensation policies of bankers. Others have directed their criticism at activities that appear to feed instability in times of crises, such as short-selling practices or an implicit bias towards default in CDS (credit default swaps) protection.

There are so many proposals for reform in the aftermath of the crisis that we will soon be reaching the point of saturation. Worse, in the midst of such a flurry of regulatory reforms, the window of opportunity for achieving and consolidating meaningful reform may close.

The proposals currently being discussed could be divided into five groups. The *first group* looks at the substance of regulation, at what to regulate, with new rules (or proposed rules) for capital, liquidity and other indicators of banking and financial soundness.

In this group we can include the new Basel

proposals (sometimes referred as Basel III) and other proposals that look at ways of enhancing the quality or quantity of regulation (from dynamic provisioning and rules to prevent excessive leverage to rules regarding bonuses, compensation schemes, rules on insolvency and early intervention).

The *second group* of proposals looks at the structure of supervision and regulation, at the how and the who, and the intensity of supervision. Though different proposals in several countries are currently under consideration, the fact remains that all ‘architectures’, whether one authority, twin-peak or many regulators, failed to prevent the crisis.

In the US, the role of the Federal Reserve System in particular has been the subject of much controversy. In the UK, criticism has been mostly directed towards the Financial Supervisory Authority; the Banking Act 2009 granted new resolution powers (with regard to the Special Resolution Regime) to the Bank of England. The issue of whether or not the central bank — as part of its financial stability mandate — should have an enhanced supervisory role is key to the understanding of this debate.

Another issue concerning the structure of regulation and supervision refers to the scope of institutions that should be regulated and protected, in particular the problems of non-banks’ systemically significant financial institutions, which leads to the discussion of the bank structural reforms mentioned below.

Caption: above, Paul Volcker, Obama’s Economic Recovery Advisory Board Chairman, testifies on Capitol Hill, February 2010

The *third group* of proposals concern the behaviour of the banking industry and bank managers, whether through better risk management, or through corporate governance or simply the responsibility that comes with the banking job and the need to internalize the costs of protection. In this respect one can include the proposals by Deutsche Bank CEO Josef Ackermann (advocated in Davos in January 2010) to establish a European Rescue and Resolution Fund largely financed by the banking industry.

A *fourth group* of proposals focus on the fiscal side. The problem of ‘extracting rents’ (rather than merely profit taking) in a banking and financial market which has been largely subsidized both by governments’ rescue packages, and by their monetary and fiscal policies, raises a great deal of controversy. Acute moral hazard problems persist. Governments have targeted the compensation problems so far mostly via taxation (e.g. the 50 per cent one-off bonus tax on bonus pools of a number of financial institutions in the UK).

A *fifth group* of proposals are the bank structural reforms (currently favoured in the US by the Obama administration and in the UK by the Conservatives)

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which aim to tackle the structural problems of the banking industry and the balance sheet structure of commercial banks and other financial institutions, to separate ‘utility banking’ from ‘casino banking’.

There are at least three major proposals in this regard. The first one is the so-called Volcker rule, the second refers to the ‘mutualisation’ of the financial industry (as advocated by Laurence J. Kotlikoff), and the third proposes a return to a Glass-Steagall style separation between commercial banking and investment banking.

A common denominator of these proposals is the need to circumscribe the scope of institutions (to some sort of narrow bank) that receive governmental protection (via lender of last resort, deposit insurance and other policies). Paul Volcker in his eponymous rule (endorsed by President Obama, though likely to face opposition in the US Congress) proposes that commercial banks will no longer be allowed to own, invest or sponsor hedge funds, private equity funds or proprietary trading operations for their own profit unrelated to serving their customers. Volcker’s rule seems to have found favour with the Shadow Chancellor, George Osborne, even though the legal details of such a rule need to be fleshed out.

Though many of the proposals outlined above are nationally-based (the Basel rules are international ‘informal rules’: they need to be incorporated into

national legislation/regulation to be enforceable), it should be noted that global problems — and the crisis was indeed a global problem — require global solutions.

We need to devise better frameworks for the regulation, supervision and resolution of cross-border banks and other financial institutions; we need better co-ordination of policies internationally, greater harmonisation of national policies (not only on capital and liquidity, but also on compensation structures and other issues that can otherwise trigger regulatory arbitrage), and we need to aim to build an international institutional framework that can adequately respond to the needs of global financial institutions and markets. National, European (essential for the proper working of the single market in financial services) and international responses must be aligned.

There is much for a UK government to do at the national level too. Since the banking and financial industry is inherently unstable, the authorities need to be prepared to confront the possibility of future crises or problems through a number of preventive and remedial instruments.

Ex ante measures to strengthen the financial system should comprise a mix of better regulation and supervision, responsible risk management and improved corporate governance. *Ex post* mechanisms should continue to include the lender of last resort role of the central bank, a well designed deposit insurance scheme, as well as early intervention, contingency planning and credible resolution procedures (including insolvency proceedings) both for banks and for non-banks, thus tackling the too-big-to-fail problem and the multiple variants of this doctrine during the crisis (too interconnected to fail, too many to fail, too complex to fail, too big to save, etc.).

Given the multiplicity of proposals, it might be sensible to follow a step-by-step approach that considers what is essential to maintain financial stability while preserving competition on the one hand, and what is feasible on the other hand.

Though crises have always been and will always be with us, the magnitude and speed of the recent crisis suggest that we need to prevent the build up of excessive leverage and to ensure that banks have sufficient (buffer) capital to confront their problems.

And then we must fight the moral hazard incentives that are embedded in any rescue programme. The number one policy priority should be to establish an appropriate framework for the resolution of cross-border financial institutions, including rules on burden sharing. The alternatives to an orderly framework — either a chaotic framework or a bail-out — are unacceptable.

As I pointed out in my contribution to *Parliamentary Brief* in December 2009, capitalism relies on the lure of wealth (privatisation of gains) and the discipline imposed by the fear of bankruptcy (privatisation of losses). It is imperative to reinstate a credible fear of bankruptcy for systemically significant financial institutions to reconnect the incentives of bankers with the interests of society.

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