Building a New International Financial Framework

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Introduction

I would like to focus my remarks on three particular aspects of the international financial framework that is being built:

- *The importance of strengthening current international coordination efforts to pick up the pace on the global reform agenda, wider its legitimacy, and prevent regulatory arbitrages.*
- *The potential impacts of some of these measures on the banking industry, and*
- *The unintended consequences of some of the regulatory measures on EMEs.*

The crisis and the regulatory agenda

We are witnesses to the most severe and extensive international financial crisis since the Second World War. However, this time around the authorities' response has been swift and comprehensive.

A very ambitious regulatory agenda was designed and pushed forward with unprecedented international collaboration between developed countries and EMEs. Several international bodies have been actively involved, working under the aegis of the G20, and with the FSB playing an important coordinating role.

[An acknowledgement should go to Mario Draghi as head of the FSB, who was recently nominated to take over the leadership of the European Central Bank. His leadership played a very important role in starting this process.]

The centerpiece of the agenda is the strengthening of capital and liquidity standards, but it also covers many other issues such as standardization and regulation of derivatives, the improvement of resolution processes, and the implementation of a macro-prudential approach to regulation and supervision, including changes in institutional arrangements.

Diversity of interest

Unfortunately, some of the economic imbalances that help explain the severity of the crisis are also leading to an increasing diversity of interests and reform priorities among countries.

- *Advanced countries are focusing on fiscal reforms to ensure medium-term fiscal sustainability.*
- *Many emerging-market countries are struggling to manage large capital inflows.*
- *Middle- and low-income countries in particular have been hit hard by commodity price increases.*
- *Europe is focused on crises in some Eurozone members.*

Reshaping the international financial landscape

Both the crisis and the international reform agenda will leave a profound footmark in the international financial landscape.

- *First, banks might try to seek greater diversification for their revenue streams in the form of greater geographic reach and more stable revenue streams, such as retail banking and payment services.*

- *Second, the increase in the quality and quantity of capital will certainly diminish banks' profitability and induce banks to reduce their capital-intensive activities, like structured finance and securitization operations.*

- *Third, the reform agenda incorporates a capital surcharge for banks considered to be systemically important. One of the main criticisms of this measure is that it may promote morally hazardous behavior.*

Unintended consequences of the reforms: impacts in EMEs

Since the crisis originated in the developed economies, most proposals are intended to address weaknesses identified in mature markets.

However, some of the proposed reforms could have important unintended consequences for some emerging market economies (EMEs) despite the fact that EMEs were very successful in weathering the crisis.

Loss of liquidity in their debt and OTC derivative markets. Basel III incorporates important additional capital charges for some trading book risks. A likely result from this reform, as well as from the Dodd-Frank Act will be a move away from proprietary trading or "casino-like" activities.

However, an unintended consequence of this measure could be a reduction in liquidity in EME domestic financial markets. In many EMEs, banks are the main financial intermediary. Banks' trading activities are a very important source of liquidity for EME domestic sovereign debt and derivative markets. If banks become less willing to take positions in those markets as a result of the higher capital charges, liquidity in EMEs markets might suffer and price volatility increase.

Unintended consequences of the reforms: impacts in EMEs

- **Recalibration of sovereign risks.** The international crisis is developing quickly into an international debt crisis, particularly for some countries in Europe.
- This would lead to a recalibration of sovereign risks on the balance sheets of banking institutions. Banks will prefer to hold domestic sovereign debt (perceived as a risk-free asset) instead of foreign sovereign debt.
- This poses a particular dilemma to global banks since they treat their foreign subsidiaries' holdings of domestic debt as if they were foreign debt.
  - *The re-pricing of sovereign risks (the preference for domestic debt) and higher capital charges for trading activities will create incentives for global banks to disinvest their subsidiaries from their debt holdings.*
  - *But Basel III's new liquidity regulations will force their overseas subsidiaries to increase their holdings of host-country sovereign debt.*
- The effect will be: an increase in the costs for investing in overseas retail banking activities and an increase in sovereign debt costs for host countries with a large foreign bank presence.

Unintended consequences of the reforms: impacts in EMEs

- **Unequal distribution of costs and benefits between home and host**. Capital surcharges for global banks could give rise to an asymmetric distribution of costs and benefits between home and hosts jurisdictions.

- Global banks are comprised of a constellation of branches and subsidiaries which consolidate their balance sheets at the parent bank or holding company level. Hence, if the capital surcharge is applied at a consolidated level, <u>the costs of holding more capital would be borne by all entities belonging to the global group</u>. However, their benefits will serve to protect home-country stakeholders as parent banks are not subject to any legal obligation to shield their overseas subsidiaries.

- To avoid such an asymmetric treatment, a policy for capital surcharges should establish that the surcharges be held by each of the legal entities conforming a financial group in the same proportion in which each of them contributes to the consolidated risk.

Unintended consequences of the reforms: impacts in EMEs

- **Asymmetric sharing of information**. Supervisory colleges and crisis management groups have been set up for each of the major global banks.
- Since the crisis originated in the most important developed economies, which are also home to most global banks, these supervisory mechanisms were designed to address the concerns of home supervisors. Hence, they are organized and coordinated by each home supervisor, which decides on the membership.
- Some host authorities have not been invited to participate in colleges of global banks that may be "systemic" in their own jurisdictions but are less "relevant" from the home-country perspective.
- In the same vein, home supervisors have agreed to share among themselves all information pertaining to global banks. However, they are very reluctant to give host authorities access to relevant information.
- We need to revise the criteria for membership on supervisory colleges and revise the agreements on information sharing.

Concluding remarks

The global regulatory agenda will reshape the international financial system, making the world a safer place by inducing banking institutions to become a more diversified and self-insured business.

Nevertheless, it is of paramount importance for the international community to review its priorities and regain the consensus that characterized the reform agenda at its outset.

For the reforms to succeed, it is imperative that the international setting bodies are no longer perceived to address the concerns of the most developed nations. They need to recover their legitimacy.

The reform agenda should take into consideration some facts regarding the regulation and supervision of global banks:

- *Supervision plays a key role in preventing financial crisis. National supervisory processes should be internationally assessed.*

Concluding remarks

- The leading role of home supervisors should be revised. Global banks operate as single economic units, but they are comprised of entities subject to different legal jurisdictions. Host countries cannot rely on home supervisors when protecting their citizens and financial systems. Each domestic financial authority is ultimately responsible for its banks and depositors and accountable to taxpayers.

- Global banks could be a source of strength but also of contagion. It is key to stress the importance of having in place business models that limit contagion among the different components of a global bank and facilitate the spin-off of subsidiaries and business lines in a resolution process. Resolution processes are essentially territorial (they do not have cross-border reach). The Spanish model of "stand-alone subsidiaries" operating at arm's length is a good example of this.

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