

20100218 IMF: Reject Ad Hoc, National Financial Reforms (article by Dominique Strauss-Kahn)

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A Commentary by Dominique Strauss-Kahn, Managing Director, International Monetary Fund

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As countries around the world get down to the serious work of reforming their financial systems, the need for greater international co-ordination looms large. The imperative to fix the failed regulatory model behind the crisis has been an important driver, but so too is public indignation over the spectacle of outsized bonus payments by banks even as unemployment is rising. Whatever the motive, there is evidence of new thinking in recent financial sector reform proposals that go beyond the technicalities of capital requirements and accounting conventions to tackle excesses in size, complexity and compensation structures.

The complication is that national financial systems are part of a larger global network. While there is a process of collaboration to bridge the problem of local regulators dealing with global banks, many countries are approaching bigger-picture reforms from different directions and at different speeds. In the process, a central lesson of this crisis is being forgotten: that co-ordination works better than unilateralism.

A simple example. A number of countries have decided that foreign banks, even if they are operating as foreign branches, should maintain higher liquidity locally to withstand a potential freeze in access to local funding. On the face of it, this is prudent. But major banks manage their funding and lending risks globally. If banks have to lock up pools of liquidity in every national jurisdiction, their capacity for intermediating capital across borders could fall, and their charges for doing so rise, to the detriment of the world economy. Such considerations need to be thought through and debated at the multilateral level prior to agreeing reforms, even ones that seem perfectly reasonable, in any one particular direction.

One reason locally reasonable but globally myopic initiatives are on the rise is that regulators so far have been unable to agree on a convincing burden-sharing mechanism when cross-border conglomerates run into problems. To be sure, this is a formidable challenge, the place where the fact of national-level fiscal authority and bankruptcy law collides with the reality of global banking.

Until we come close to a global charter of the kind that applies to shipping accidents, countries will inevitably try to limit the potential liability of their own taxpayers by insisting on local prudential rules. Meanwhile, institutions approaching bankruptcy will inevitably rush to transfer assets home at the cost of a more efficient global solution – which, after all, is what current laws require.

This is part of a larger gap in the regulation of the large complex financial institutions that dominate finance. Imagine a financial holding company that owns a commercial bank, an investment bank, an insurer and a derivatives dealer. In good times, only the consolidated entity matters. In bad times, each subsidiary in trouble must be sorted out individually with rules and procedures that vary by the legal form of the subsidiary and that might work to the detriment of the consolidated entity, financial system and economy. Now imagine trying to deal with a conglomerate with 100 subsidiaries across numerous jurisdictions and you will be closer to the complex reality that was Lehman.

Recent proposals for “special resolution authority” and “living wills” to handle the failure of complex financial institutions at the parent level are thus hugely important. But even as they seek a middle option between bail-out and catastrophic collapse, the ambit of these mechanisms does not always extend to subsidiaries outside the home country. Nor do all jurisdictions have such resolution authority over financial holding companies. Pending a global agreement, we have a system with holes and go-it-alone national approaches.

The global process of reaching agreement on prudential policies under the Basel Committee and the Financial Stability Board is thus an extremely important undertaking that deserves the full

backing of the international community. The work of these bodies, and of other financial standard setters, must be accelerated to harmonise rules that limit excessive risk-taking and to tackle some of the broader challenges, such as providing liquidity beyond the confines of the formal banking system (in this crisis the run was not so much on bank deposits as on wholesale funding by international investors).

Time is of the essence in reaching an international agreement lest political patience with regulatory conclaves runs out and we enter a cycle of unco-ordinated policy, distorted capital flows and regulatory arbitrage. The International Monetary Fund, for its part, will work to draw out the systemic and macroeconomic implications of financial sector reforms – and, if it comes to it, the implications of a failure to converge on a common solution.

The author is managing director of the International Monetary Fund

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