FEBRUARY 2010

Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

The Direction of Financial Reform

The global financial crisis and economic recession have been subjected to much analysis and institutional soul-searching. As a consequence, there are numerous calls for a *reformation* and a *renaissance* of the financial system. The concept of systemic risk is the central theme of recent discussions of the financial system that failed the public's trust. The financial crisis has challenged the foundations on which regulatory approaches had been based. In particular, the theory of rational and self-correcting markets has now been shown to be false. In reviewing global banking regulation, a report by Lord Turner, head of the UK Financial Services Authority (FSA), identified three underlying causes of the crisis, namely, deficiencies in bank capital and liquidity regulations, macro-economic imbalances, and financial innovations.

The Turner Review stresses the importance of basing any new form of regulation and supervision on a system-wide "macro-prudential" approach rather than focusing solely on specific institutions. It recommends several areas for reform, including fundamental changes to bank capital and liquidity regulations and to the content of banks' published accounts. The review appeals for increased levels and higher quality of bank capital, with significant increased capital requirements to support risky trading activities. It would also require counter-cyclical capital buffers to be accumulated in good economic times so as to be available to be drawn on during economic downturns. Other calls for reform include a central role for tighter regulation of liquidity, increased reporting requirements for unregulated financial institutions such as hedge funds, and regulatory powers to extend the scope of capital regulation. Credit rating agencies would be regulated so as to limit conflicts of interest and inappropriate application of rating techniques. Another essential reform would require national and international action to ensure that compensation policies are designed to discourage excessive risk-taking. The Turner Review distinguishes between those areas where the FSA can proceed nationally, and those where international agreement needs to be achieved. A global market economy remains viable as the means of delivering global prosperity, but it requires a global banking system focused on serving the needs of businesses and households, not in taking risks to profit from short-term opportunism. The approach to regulatory reform needs to be based on a system-wide perspective, since it is now evident that failure to look at the "big picture" was more a cause of the financial crisis than any specific failures in supervising individual institutions. Reforms should reflect the reality of a global financial system requiring both more intense international cooperation and greater use of national regulatory controls.

More recently, Paul Volcker, former chairman of the US Federal Reserve and currently chairman of the Economic Recovery Advisory Board, has identified specific needed reforms from a US perspective. These include appropriate capital and liquidity requirements for banks and better official supervision, improved risk management, and board oversight for private institutions. He also advocates a review of accounting approaches toward financial institutions. He has also brought attention to the residual moral hazard from efforts of central banks and governments to rescue financial institutions. On this point, Volcker is concerned that the safety-net protecting the stability of commercial banks, including deposit insurance and lender of last resort facilities, has created moral hazards and incentives to risk-taking and leverage, leading to the category of "too big to fail" institutions. Among his proposals for financial reform is the need to establish a new "resolution authority" that would be authorized to intervene in the event that a systemically critical capital market institution is on the brink of failure. This resolution authority would assume control for the purpose of arranging an orderly liquidation or merger. No institution would be deemed "too big to fail"; they would be free to innovate, to trade, to speculate, to manage private pools of capital, and, in accordance with the nature of capitalism, to fail, but failing with a controlled plan of resolution.

Another advocate of reform is Nobel prize-winning economist Joseph Stiglitz, formerly chief economist at the World Bank and chairman of the Council of Economic Advisers. In his just-published book *Freefall,* Stiglitz explains how deregulation contributed to the financial crisis. He recommends establishing a new globally-coordinated financial regulatory system. He endorses a role for the G-20 nations in guiding the Financial Stability Board to address economic issues and regulatory reforms from a truly global perspective. He notes that there are many financial experts in universities, nongovernmental and other organizations who would be suitable choices for appointments to regulatory roles in the United States. He is concerned about the influence of lobbyists for the financial industry and the appointment of regulatory personnel that may represent actual or potential conflicts of interest. Stiglitz also stresses the importance of accounting standards intended to ensure the transparency of the financial system and regulations to ensure its stability and fairness.

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