Criteria for financial regulatory reform

Stephany Griffith-Jones
Jose Antonio Ocampo

Initiative for Policy Dialogue
www.policydialogue.org

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Causes of financial crises

a) Inherent flaws in how financial markets operate, e.g. their pro-cyclical (boom-bust) nature.

b) Insufficient, incomplete and often inappropriate (e.g. pro-cyclical) regulation, especially in light of rapidly and changing financial sector.

Three broad principles

a) Counter-cyclicality

Key market failure in finance:

Pro-cyclical behavior, leading to excessive risk-taking in good times.

Regulation (e.g. Basle II) accentuates pro-cyclicality.

Key principle for efficient regulation is counter-cyclicality

As current trends (e.g. securitization, consolidation) particular urgency to introduce.

Counter-cyclical regulation

- For bank regulation, counter-cyclicality could be introduced via capital (e.g. Goodhart-Persaud proposal linked to growth of bank assets) or via provisions (Spanish-Ocampo proposal)
- Issue of timing. Good to approve now (greater appetite for regulation), but introduced later (to avoid putting pressure on already weak banks).
- Should regulation of instruments (e.g. derivatives) and non-bank entities (e.g. hedge funds) also have counter-cyclical elements?

b) Comprehensiveness

i) Reasons

- Domain of regulator same as domain of market regulated.
- Parts of financial system not regulated create more problems (e.g. SIVS)
- LOLR extended to new actors and instruments; necessary equivalent regulation to avoid moral hazard.

ii) Comprehensiveness in:

Transparency. For example, OTC Derivatives should be standardized and channeled through clearing house based exchanges.

Comprehensive and equivalent regulation, for liquidity and solvency, for all actors (e.g. hedge funds) and instrument (e.g. SIVS) that invest or lend on behalf of other people.

Equivalent leverage for all actors and transactions.

c) Need for international coordination of regulation

Discussion of a global financial regulator urgent.

Increased coordination among national regulators.

Key issue: participation of developing countries in regulatory bodies, e.g. Basel Committee. Role for the G-24, other groupings of developing countries, to make the case and suggest specific proposals for this increased participation.