Policy Issues in Global Financial Reform

Report of a seminar on international governance issues arising from the current financial crisis.

Co-sponsored by the Centre for Trade Policy and Law, the Centre for International Governance Innovation and the National Capital Branch of the Canadian International Council.

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Introduction

Since 2008 the global financial system has been in what is possibly the worst crisis since the Great Depression. On June 10, 2009, the National Capital Branch of the Canadian International Council (CIC), the Centre for International Governance Innovation (CIGI), and the Centre for Trade Policy and Law (CTPL) co-sponsored a one day seminar addressing the challenges and opportunities of global financial reform. The seminar brought together economists, political scientists, and lawyers to discuss policy proposals concerning the financial crisis. Since the beginning of the crisis, a number of proposals have been made to deal with the problem of regulatory arbitrage. The crisis has vividly illustrated the far reaching impact of a financial collapse and has propelled the search for regulatory remedies to an international plane. It is important that such remedies be designed to serve a wider purpose than simply rectifying the last calamity. The impact of the financial crisis has been so grave that preventive regulatory measures must be considered and carefully evaluated in order to avert any future financial catastrophe.

The seminar benefited from the attendance of members of the Warwick Commission on International Financial Reform. The Commission was in Ottawa finalizing its much anticipated report on how international financial reform can move beyond questions of policy recommendations and towards building a consensus. The Commission's report focuses explicitly on the politics of the crisis and its links to the real economy in OECD countries, as well as the issue of representation for Emerging Market Economies in international financial reform debates.

The participants did not attempt to arrive at a consensus but exchanged a varied assortment of ideas and opinions throughout the day. The discussions included causes of the crisis, governance structures and institutional reforms, and Canada's role on the road to recovery.

Causes of the Crisis

The precise cause(s) of this financial crisis are highly debatable, although banks and their investment vehicles are at the centre of the debate. The crisis is a product of its own unique set of circumstances. Before implementing any financial regulatory policy, it is imperative that the factors that contributed to the financial collapse be identified. There are many such factors but during the seminar participants identified three fundamental issues:

1) *Misunderstanding Liquidity.* The crisis illustrated one problem of employing internal risk models for calculating capital requirements. The specific issue was increasing reliance on "liquidity through marketability," i.e., assuming that contractually long investments could be funded with short-term instruments because they could always be sold rapidly if needed.

2) *Misguided View of Risk.* Financial institutions engage in a large variety of activities and each activity carries its own level of risk. However, during this crisis there was a huge flaw in the way international financial institutions viewed risk. Risk was perceived as homogeneous and capable of being easily divided. Banks, hedge funds, and other institutions had become over-confident, thinking they had figured out how to manage risk and make more money. There are many different types of financial risk including credit risk, liability risk, and interest rate risk. *Risk must be put in the right place*, as determined

by its type. By looking at risk in a homogenous way, the financial industry created more risk rather than reducing it.

3) *Loss Spiral.* The loss spiral is a result of asset price effects. If many financial institutions suffer a similar funding shock, all of them have to cut back on their positions. This depresses the price level of the assets, leading to a further erosion of wealth, which forces the institutions to cut back on their positions even further. Before the crisis everyone believed that, in order to make the system safe, individual institutions should be protected. In a crisis, however, people always act to protect their own interests. *When everyone attempts to reduce risk at the same time*, macro risk actually increases.

Addressing Governance Concerns

The current crisis has raised a series of interesting questions. Does the financial industry require global regulation or should individual countries only be interested in protecting their own markets? Is global finance really global? And finally, who governs financial reform?

Macro-prudential regulation vs. micro-prudential regulation. Participants in the seminar addressed the role that regulation played in the current crisis. A common response thus far has been a call for regulation - more regulation - and stronger regulation. Seminar participants, however, considered that the objective should not be more regulation but better regulation, with a particular focus on macro-prudential regulation.

Financial crashes do not occur randomly but generally follow booms. This crisis is no different. Most recently, authorities have been concerned only with micro-prudential regulation. This approach implicitly assumes that the system as a whole can be made safe by simply ensuring that individual banks are safe. This is sound in theory, but in practice is highly misleading. Trying to become safer, banks and other highly leveraged financial intermediaries have a tendency to behave in a way that collectively undermines the entire system.

Micro-prudential regulation focuses on the responses of an individual bank to exogenous risk. By design it does not account for endogenous risk. Furthermore, it ignores the systemic importance of such factors as size of individual institutions, degree of leverage, and interconnectedness with the rest of the system. This is why we need to complement micro-prudential regulation with macro-prudential regulation, which concerns itself with the stability ofthe financial system as a whole. The objective of macro regulation is to serve as a countervailing force to the natural decline in measured risks in a boom and the subsequent rise in measured risks in a collapse. Macro-prudential regulation recognizes the phenomenon of endogenous risk.

Economic Cycle. It is important to determine where in the economic cycle different countries are positioned. Countries have never grown at the same pace and therefore are at different stages of the cycle. The financial relationships developing countries have with the global market should not be assessed with the same criteria as in the case of developed countries. For example, under the current system in order to determine a country's default rate there needs to be seven years of financial data. Due to the often poor data sets available for developing countries their default rates are often approximations and therefore should not be compared against the default rates of other economies. In order to understand the system-wide risk that emerges during the various stages of economic cycles it is necessary to understand where individual economies fall within the economic cycle; it is only then that the use of either macro-prudential regulation or micro-prudential regulation can be effective. Some have suggested that global regulation should work towards managing macro financial risk while domestic regulation should address the concerns that arise from being in a particular stage of an economic cycle for that particular nation. In order for this to occur, there must be harmonization and symmetry between the two types of regulation and regulatory reform.

What Does This Mean for Canada?

The size of Canada's economy prevents it from setting the agenda. However, because of the resilience of the Canadian financial system Canadian experts have been recognized and called on to provide feedback and recommendations for a global solution. Canada's financial system has been relatively less affected by the global financial crisis than those of other OECD countries such as the United States and Great Britain. In the fall of 2008, the World Economic Forum ranked Canada's banking system as the soundest in the world, ahead of Sweden and Luxembourg. Canadian banks are profitable, well-capitalized, and well-positioned to withstand economic shocks. Furthermore, the regulatory framework for Canada's financial sector is both more responsive and more prudent, in some respects, than that of the United States. Let's not discount, however, that while the Canadian financial system seems to be doing better than those of other countries, Canada's economy is feeling the effects of the global economic slowdown. The economic difficulties experienced by Canada's largest trading partner, the United States, are resulting in weaker Canadian exports and further problems, particularly for the manufacturing industry. Furthermore, the strong Canadian energy and natural resources sector is likely to suffer as the world economic slowdown brings about lower demand and weaker prices for commodities.

That being said, the Canadian financial system will be a role model for other nations as they work to strike the right balance between the public and private sectors in the wake of the credit crunch. In a previous G20 meeting of Finance Ministers, Canada and India co-chaired one of four working groups on enhancing sound regulation and strengthening transparency in the financial sector.

From 2001 to 2007 household debt increased by 40 percent. An increase of the same proportional magnitude prior to 2001 took 40 years. The global financial industry has finally reached the point that momentum is being generated behind a complete overhaul of the financial sector. In the past, the rules surrounding the financial industry were loose in order to attract institutions. In light of the current situation, they must be tightened. The rules must be framed so as to adapt to market innovation and respond to the fluid nature of the sector. A combination of micro and macro-prudential regulation is necessary in order to protect against both internal and external risk. Any promising solution to the crisis must include mechanisms that strike a balance between stability and efficiency. Canada will be hosting the upcoming G8 meeting and, given our resilience to the crisis compared to our neighbour's, Canadian banks have the potential to establish the benchmark for a stable financial sector. This country's political backdrop allowed for greater stability during this time of economic crisis. Canada will be seen as a leader. Let us now hope that we can take positive steps in the direction of financial recovery.

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