

# Global and regional initiatives to strengthen oversight and regulation of the financial sector<sup>1</sup>

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A bird's-eye view of recent reform proposals to banking regulation is presented. Emphasis is on the Basel Committee's proposed capital and liquidity regulations, but also initiatives from other international organisations like the Financial Stability Board, G20, the International Monetary Fund and EU are presented. Besides capital and liquidity regulation, initiatives regarding resolution of failing systemically important financial institutions, cross border issues and taxation of the financial sector are briefly described.

## 1. Introduction

The financial crisis contributed to the most severe economic downturn since the Great Depression. One of the root causes of the crisis was serious shortcomings in financial regulation and supervision.<sup>2</sup> Since the crisis, strengthened regulation and supervision have been at the top of the policy agenda for the G20<sup>3</sup> and other multinational or regional bodies, and national governments. Despite good progress, important work remains.

This article provides a bird's-eye view of the progress so far on the global and regional initiatives to strengthen oversight and regulation of the financial sector, and indicates the main areas where further action is needed. We also describe the IMF's role, including cooperation with the G20 and other key institutions.

## 2. The bird's-eye view<sup>4</sup>

In this section we first look at the progress in micro-prudential banking regulation, i.e. regulation and supervision in order to ensure that each individual bank maintains sufficient solvency and liquidity. Next, we consider macro-prudential policy. Macro-prudential policy aims at reducing the systemic risks that may still be present even if each institution by itself is solvent and liquid. For instance, if most banks have similar risk exposures, a single event can easily trigger systemic problems. Finally, we discuss systemically important financial institutions and cross-border issues.

### 2.1 *Micro-prudential banking regulation*

Good progress has been achieved in this area. The Basel Committee on Banking Supervision (BCBS) delivered its proposals on new regulation of capital and liquidity, referred to as Basel III, in December 2010. The effective minimum Tier 1 capital ratio (the ratio of primary loss-bearing capital to risk-weighted assets) has been increased to 8.5 per cent. Its loss-bearing capacity has been improved by requiring the predominant form to be common shares and retained earnings (common equity).<sup>5</sup> Banks falling below the effective minimum ratio will face restrictions on the distribution of dividends.<sup>6</sup>

Liquidity regulation will consist of both a liquidity ratio and requirements for stable funding. The former is set to

<sup>1</sup> This article is a somewhat adapted version of an Information note prepared for the Nordic-Baltic Monetary and Financial Committee (NBMFC), which is the head committee for coordination of views on important IMF matters for the countries in the Nordic-Baltic constituency in the IMF. The constituency consists of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. The Norwegian members of the NBMFC are the secretary general of the Ministry of Finance and the deputy governor of Norges Bank. The other countries are represented at a comparable level. The authors are grateful for comments and contributions from the Norwegian Ministry of Finance and from other Nordic-Baltic counterparties, as well as comments from Gunnvald Grønvik and Alexander Vik in Norges Bank.

<sup>2</sup> See IMF (2009a)

<sup>3</sup> The membership of the G20 comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Korea, Japan, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union. The G20 was formed as a new forum for cooperation and consultation on matters pertaining to the international financial system. It studies, reviews, and promotes discussion among key industrial and emerging market countries of policy issues pertaining to the promotion of international financial stability, and seeks to address issues that go beyond the responsibilities of any one organization.

<sup>4</sup> This section draws partly on the BCBS (2010), Report from the Financial Stability Board (FSB 2010) on systemically important financial institutions, and the IMF (2010b).

<sup>5</sup> Tier 1 must at least be 6 per cent. Within Tier 1, common equity Tier 1 (CET1) must be no less than 4.5 per cent of risk-weighted assets at all times. In addition banks must hold a capital conservation buffer consisting of CET1 of at least 2.5 per cent to avoid restrictions on the distribution of dividends.

<sup>6</sup> The constraints will be stricter the closer the bank is to the 4.5 per cent limit.

make sure a bank has enough high-quality liquid and unencumbered assets to withstand a 30-day period of severe liquidity disruptions. The disruptions are calibrated using a scenario based on the experiences from the global liquidity crisis that started in late summer 2007. The latter is being introduced to avoid over-reliance on short-term wholesale funding, setting a minimum ratio of stable funding relative to the liquidity profiles of a bank's assets.

The BCBS foresees gradual implementation of the new global capital and liquidity regulations in the period to 2019. The main EU priority is timely and consistent implementation of Basel II and Basel III measures by all G20 countries as well as other jurisdictions globally.<sup>7</sup> However, the EU Commission will likely present its proposal for a new Capital Adequacy Directive during summer 2011. In the Nordic-Baltic region, both Norges Bank and Sveriges Riksbank have hinted at an earlier implementation in their countries than proposed by the Basel Committee. The Swedish minister of finance has also hinted at stricter capital regulation for Swedish banks.<sup>8</sup>

The BCBS has calculated that the full implementation of Basel III will have only a modest negative impact on annual global GDP growth (0.03 p.p), dwarfed by the significant but hard to measure benefits from reducing the probability and impact of a future crisis.

The Financial Stability Board (FSB)<sup>9</sup> has set out to make countries compete – by a strong “peer review” process – at being best at promoting financial stability, rather than using weak regulations to make their financial institutions more competitive. The FSB is considering the option of publishing the names of non-cooperative jurisdictions, possibly also non-FSB member countries. Moreover, the EU now has higher ambitions with regard to harmonising regulations than just setting minimum standards.

## 2.2 *Macro-prudential policy*

So far macro-prudential policy has largely focused on surveillance of the overall health of the financial system, while few policy instruments have been available. The

BCBS has recommended a countercyclical buffer of 0–2.5 per cent common equity Tier 1 in addition to the effective minimum Tier 1 ratio of 8.5 per cent.<sup>10</sup> Such a capital buffer will in principle be set at its high level when regulators recognise that the economy is experiencing a credit boom, while it will be removed if the economy moves into a recession. The challenge of global cross-border banking has been addressed since the buffer requirement in one country will also apply to foreign banks that extend credit in that country. Countries must still decide which of their national authorities should be responsible for the implementation and oversight of the countercyclical buffer instrument.

Properly set up, the system of crisis resolution can reduce moral hazard and provide incentives for each financial institution to avoid leveraged growth that leads to a buildup of systemic risk. Most countries have legislation in place that allows the financial authorities to intervene and if necessary close a failing bank in their jurisdiction. It has, though, proven difficult to make creditors shoulder losses in a large bank that fails without closing the bank and risking a severe impact on the overall economy. The EU Commission has circulated a communication document which proposes the introduction of such crisis management instruments in all member countries. In October 2010 Denmark put in place a national bank resolution framework that provides an option for the orderly resolution of failing banks.

The authorities enforce compliance with the regulations at the individual institutions through supervision. However, the supervisory mandate should also encompass systemic concerns, rather than being restricted to individual institutions. So far, some progress has been made in setting up institutions responsible for oversight of systemic risk. The EU has set up the European Systemic Risk Board (ESRB) responsible for the macro-prudential oversight of the financial system within the EU. Correspondingly, the European Supervisory Authorities (ESA) is set up to deal with micro-prudential supervision. In the US the Federal Reserve System has under the Dodd-Frank Act been given the supervisory authority over all systemically important financial institutions as well as a responsibility for maintaining financial stability. This would bring shadow banks under the supervision of the Federal Reserve to the extent they are systemically important.

Attempts to ensure more transparent and resilient markets have been put forward, e.g. the use of central counterparties in derivative trading outside organised marketplaces. Reforms on securitisation have also been introduced, including more information about the underlying pools of loans and the techniques used by credit

<sup>7</sup> Basel III complements Basel II as it builds on many of the elements of Basel II.

<sup>8</sup> Norges Bank (2010), a speech by the governor of Sveriges Riksbank 1 February 2011 and presentation by the Swedish finance minister in the Riksdag 1 March 2011.

<sup>9</sup> The Financial Stability Board has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It consists of national authorities from the G20 countries as well as international organisations such as the IMF, OECD, BIS and others.

<sup>10</sup> See footnote 5.

agencies to rate a product, as well as retention of a portion of the loans by the originators.

The IMF has suggested a tax on banks' uninsured debt, so as to correct for the "too-big-to-fail" implicit guarantees. Taxes on bank's liabilities have been introduced in various fashions in Iceland, Sweden, Germany, UK and some other EU member states.

The IMF has also mentioned a financial activity tax (FAT), levied on profits and the salary expenses of financial institutions. In principle such a tax can correct some of the distortions created by the inability to levy VAT on financial services. In February 2011 the EU issued a consulting paper on FAT as well as a financial transaction tax.

### 2.3 Systemically important financial institutions (SIFIs)

More work remains on how regional and national authorities should deal with systemically important banks and cross-border banks. The French G20 Presidency aims at reaching agreement on a comprehensive package by the Cannes Summit in November 2011. To reduce the probability of governments bailing out creditors and maybe even some shareholders of systemically important banks, the BCBS has suggested that systemically important banks should have loss absorbing capacity beyond the proposed Tier 1 common equity requirement of 7 per cent.<sup>11</sup> In addition the BCBS has suggested that these banks should issue subordinated debt that would be converted into common equity if the Tier 1 common equity ratio falls below a certain threshold, without being specific on triggers or other aspects of such an instrument. These instruments are referred to as contingent convertible capital or cocos.

Another suggestion is the use of so-called bail-ins, where the supervisory authority can convert subordinated debt discretionally into Tier 1 common equity as part of an early intervention. So far only the Swiss authorities have introduced specific proposals for the use of cocos.

Large financial institutions can be required to set up living wills, i.e. plans showing how to handle a crisis situation without resorting to assistance from the government or the central bank, and potentially how the institution can be wound down in an orderly fashion.

Finally, to limit the degree of complexity and risk-taking, constraints on size, legal structure or activities of financial firms have been proposed. One example is the so-called Volcker rule, whereby banks that take retail deposits would not be permitted to engage in proprietary trading that is not directly related to the market making and trading they do for customers.

<sup>11</sup> See footnote 5.

### 2.4 Cross-border issues

So far, little progress has been achieved on how to effectively resolve failures in banks that operate across various jurisdictions. In a report on SIFIs in October 2010, the FSB recommends sharing of information between jurisdictions for global SIFIs (G-SIFIs), elimination of provisions in national laws that hamper cross-border cooperation in resolution, and institution-specific cooperation agreements between home and host authorities for each G-SIFI.

The EU plans to assess the need for further harmonisation of bank insolvency regimes by 2012 and the need for integrated resolution regimes including a single European Resolution Authority by 2014.

The Nordic-Baltic ministries of finance, supervisory authorities and central banks agreed in August 2010 on a cooperation agreement on cross-border financial stability, crisis management and resolution. The agreement, which is not legally binding, is an extension of a corresponding MOU for the EU and EEA. The Nordic-Baltic countries have established the Nordic-Baltic Cross-Border Stability Group with representatives from supervisors, ministries and central banks in the eight countries. The group will meet at least once a year to foster a process for cooperation in financial crisis prevention and resolution.

## 3. The IMF's contribution and cooperation with the other central institutions

In discussing the IMF's role in financial system oversight after the financial crisis, it has been duly recognized that the IMF cannot realistically cover all financial sector issues, nor should it try to become a global regulator.<sup>12</sup> Still, the IMF could – with substantial collaboration with expert bodies such as the FSB and Bank for International Settlements (BIS) – take the lead in identifying and prioritising macro-systemic risks through its macro-economic, early warning, and macro-financial analyses. By contrast, the FSB and BIS could take the lead on the more specialised work of micro-prudential and regulatory oversight.

The Nordic-Baltic Constituency<sup>13</sup> supports a strong and central role for the IMF, as it is uniquely positioned to take a leading role in analysing and giving guidance on macro-systemic issues related to financial regulation and supervision and assessing the factors driving stability and instability in the financial system.

The IMF continues to promote a global approach to

<sup>12</sup> See IMF (2010a)

<sup>13</sup> See footnote 1.

regulatory reform that is nationally relevant and internationally consistent, through its three main areas of activity<sup>14</sup>: (1) multilateral and bilateral surveillance; (2) financial support for members' programs for economic reform; and (3) technical assistance.

The IMF has published comprehensively and broadly on a number of initiatives. Both regulatory and supervisory aspects of micro-prudential, macro-prudential and international issues have been covered as topical themes mainly in the *Global Financial Stability Report*, but also in the *World Economic Outlook* in recent years.<sup>15</sup> Further, the IMF has participated in various working groups together with other international organisations in preparing reports on key initiatives for submission to the G20. Finally, the IMF staff has promulgated policy-related analysis and research in the publication series *Staff Position Notes* that was introduced in late 2008.

More directly on the IMF's core responsibility in bilateral surveillance of member countries, the IMF strengthened its macro-financial surveillance as early as in September 2009 when the Financial Sector Assessment Program (FSAP) was revamped in close cooperation with the World Bank, based on lessons from the financial crisis.<sup>16</sup> In September 2010 the IMF decided to make FSAP mandatory every 5 years for 25 jurisdictions with systemically important financial sectors.<sup>17</sup> These assessments would cover (i) the source, probability, and impact of risks to macro-financial stability; (ii) the financial stability framework; and (iii) the capacity to manage and resolve financial crises.

The IMF is also actively discussing policies to address too-important-to-fail institutions and implementation issues in macro-prudential policies.

The G20 has called upon the IMF, both on its own and in collaboration with other organisations, to undertake a number of tasks.<sup>18</sup> In 2009 the IMF was asked, in collaboration with the FSB, to develop an early warning exercise (EWE).<sup>19</sup> More recently, it solicited the IMF's advice on the most effective ways to ensure that the financial sector contributes to the costs of ensuring its viability.<sup>20</sup>

In addition to the EWE, the IMF is collaborating with the FSB and the BCBS in assessing the macroeconomic

implications of implementing the Basel Committee's proposals to strengthen global capital and liquidity regulations. The IMF has also worked jointly with the FSB and BIS on a report for the G20 on guidelines for assessing the systemic importance of financial institutions, markets, and instruments, and on identifying and addressing gaps in data and information revealed by the crisis.<sup>21</sup>

The IMF has also participated actively in the European Bank Coordination Initiative (the so-called "Vienna Initiative"). The IMF, along with a number of other multinational institutions (most notably, the European Bank for Reconstruction and Development and the European Commission) has sought to remedy the lack of a framework for a coordinated response in the face of a potential, crisis-driven outflow of capital from emerging Europe. The initiative played a substantial role in stabilising the situation and settling market expectations and created a dialogue between the private and public sectors.

## 4. Concluding remarks

Generally speaking, best progress has been made on international agreements on micro-prudential regulation of capital and liquidity for banks. The challenge now is consistent and timely national implementation. Although macro-prudential regulation and supervision is also duly recognised as vitally important, less has been accomplished so far in terms of concrete measures. The same also arguably applies to the perimeter of regulation, the treatment of non-banks, and the development of strong supervisory and resolution frameworks both across and within countries.

The IMF is central in the ongoing work, continuously called up on to contribute within its core areas of competence. As the focus now is increasingly shifting from micro- to macro-prudential issues, the IMF's role could be expected to expand further. The IMF also has a particularly strong position as a de facto secretariat for the G20 in preparing inputs to its meetings. Finally, the IMF has attached top priority to financial issues in all of its main areas of responsibilities – strongly supported by the Nordic-Baltic Constituency.

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<sup>21</sup> See Financial Stability Board and IMF (2010)

<sup>14</sup> See IMF (2010b)

<sup>15</sup> Both are published twice a year, spring and autumn. See <http://www.imf.org/external/pubs/ft/weo/2011/01/index.htm> and <http://www.imf.org/external/pubs/ft/gfsr/2011/01/index.htm>

<sup>16</sup> See IMF (2010c)

<sup>17</sup> See IMF (2010d)

<sup>18</sup> See IMF (2010e) The IMF also works closely with other organisations, such as the World Bank, the regional development banks, the World Trade Organization, and UN agencies.

<sup>19</sup> See IMF (2010f)

<sup>20</sup> See IMF (2010g)



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