The Reform of the International Financial System[1]

The crisis is the result of **excesses on the part of all** participants in the system, and the result of years of **surplus liquidity during periods of prosperity** as a consequence of an unnecessarily loose-fitting monetary policy. The crisis is also the outcome of a great collective error: the **underestimation of systemic risk**, which is that risk affecting the entire economy and its financial system. Once the crisis broke out, and in the light of its magnitude and development, international authorities embarked upon a frequently **improvised political turmoil** with no further criterion than that of **preventing collapse**. Nonetheless, there is room for a different approach.

1. **Renovated instruments of financial regulation** are needed for their application in cases of **systemic crises**. Financial bailout plans should be devised as **contingency plans** expressly envisioned in the law for **periods of systemic crisis**, with the aim of protecting the legitimate interests of the population.

2. **Monetary policies** are currently being implemented in a general context of **loss of effectiveness** caused by a variety of complex factors. The solution to this loss of effectiveness is not returning to homogenous and highly intervened national banking markets. The problem with the design of monetary policies is similar to the design of tax policies, and lies in guaranteeing its **adequacy in times of prosperity**, because it is then when **imbalances** and the type of market agent behaviour that subsequently end up in crisis, tend to grow.

3. Since **bubbles** are only created when **monetary and credit-growth conditions** are sufficiently **permissive**, the following measures are proposed:

- **The ECB** should restore the importance of the **money supply growth target.** Other world central banks should rapidly advance in the definition of a **monetary pillar** in their monetary policy strategies.
- Defining and implementing **simple and transparent early warning indicators, such as credit growth**, which may herald risks to financial stability over the medium term.
- **Central banks** should be accountable of their monetary policy measures by means of **explicit "correct or explain" clauses** whenever the **early warning indicators** exceed the defined maximum reference values.

[1] The proposals laid down in this document are drawn from the FAES Strategic Report "La Reforma del Sistema Financiero Internacional. Una propuesta con las lecciones de la crisis". The complete report is available at www.fundacionfaes.org.

4. **Monetary policy** has a **two-fold objective**: **price stability** and **financial stability** – objectives that are not always that compatible, even on a national scale. There was a time when it was strongly argued that this duality suggested separating both functions into two independent institutions, the central bank and the financial supervisor. However, the evidence of this crisis is conclusive: it does not seem adequate today to separate both functions into two different regulating entities. **Monetary authorities that are also supervising entities have worked better**. As a result, we propose **the Eurosystem** –with the ECB at its core– to be in charge of the **regulation and supervision** at least those **financial institutions having systemic significance in the Euro area**.

5. The quality of **financial regulation** must improve in order to include the lessons from the crisis, but it is necessary to **avoid the danger of an interventionist re-regulation process that would end up "killing the messenger"**; i.e., invalidating the effectiveness of the early warning indicators about the soundness of the financial system. A timely and determined application of the regulations currently in force –such as the **Basel II** prudential treatment for off-balance sheet risks, or the accounting standards regarding the consolidation of securitisation funds– would have staved off some instances of regulatory arbitrage and many of the excesses that led to the crisis.

6. Any **reform** concerning financial regulation should **provide incentives** for the upsurge of a needed **self-correcting process** in the market, leading financial entities to:

- improve the **quality** of their **risk management** models and procedures;
- carry out their activities under an **effective supervision**, regardless of their legal nature and jurisdiction;
- and adopt **business strategies and models** that promote greater **financial stability** by the **internalisation of the contribution of their activities to systemic risk**.

7. One of the greatest challenges currently confronting financial regulation is that of **transforming the results of the macro assessments on the accumulation of systemic risk into specific instruments of micro-prudential regulation**. To achieve this, we propose that all financial institutions with activities that contribute significantly to the increase of systemic risk should be made subject to a **new pillar of macroprudential regulation** built into solvency standards. This additional pillar would be **superimposed to the three existing pillars of international standards on the regulation of minimum capital requirements**. Capital requirements demanded for this new fourth pillar of macroprudential regulation would be proportional to the marginal contribution of each financial activity or financial product to global systemic risk.

8. Another important lesson from this crisis is the **greater instability of wholesale financing** in the money markets, as compared with traditional deposits. Thus, it is urgently necessary to provide a **stabilizing mechanism for wholesale money markets** to inoculate them against panic, with the purpose of sustaining their operations in the event of systemic crises and prevent them from turning into mechanisms of massive contagion.

- The **guaranteeing mechanism** would be **contingent** in nature; i.e., it would only be activated in the event of **systemic crisis**, and in no case because of liquidity problems in individual entities.
- The activation of the guaranteeing mechanism would automatically establish **temporary public coverage** for all short-term wholesale bank liabilities and **access to emergency liquidity**.

- This coverage would be exclusively available to those financial entities subject to **additional capital requirements arising from the application of the fourth pillar of macroprudential regulation**.
- Although the coordinated international implementation of a mechanism of this type would be desirable, we consider it is of particular importance in **Europe** to move resolutely forward in the creation of **a single financial market that reinforces the benefits arising from the single currency**.

9. The problem with the compensation received by some high-executives of financial institutions does not lie in its magnitude. The problem was an incentive system that excessively focused management on short-term profit. **Executive compensation** schemes should be **revised** in order to:

- achieve a **greater participation of shareholders** in the establishment of wage conditions of managers;
- promote **the most absolute transparency** in the decisions affecting the **total retribution**, pertaining or not to salary, of its managers;
- promote the **contractual extension of the effective limit of monetary liability** for the top management by establishing a time lag of a few years for the liquidation of variable compensation exceeding a certain percentage of the fixed compensation.

10. **Rating agencies** have been mostly blamed for the crisis before public opinion. In reality, their rating methods were not designed to capture the increase in systemic risk. A methodological challenge for the these agencies is to **enrich the rating system** in order to provide **two-dimensional ratings** that, in addition to giving information on the probabilities of default for each asset, should also reflect the correlation between individual defaults and give an aggregate measurement of the overall default risk. Regulatory agencies could promote these improvements by their use in the design of the proposed macroprudential pillar in solvency regulation.

11. In order to **reinforce market transparency** and the significance of accounting figures, we propose to maintain an **homogenous valuation criteria for assets throughout the cycle**, leaving the task of accommodating cyclical effects to the regulations on minimum capital requirements. It is completely inconsistent to defend the temporary abandonment of market value accounting for some assets -or the cyclical adaptation of their valuation regulations- and to demand a greater transparency.

12. The cushioning impact of **the anti-cyclical provision** –**successfully** implemented as a **pioneering** measure in **Spain** in **2000** – has shown on a worldwide scale the **need for regulatory reforms reinforcing minimum capital requirements during periods of expansion and relaxing them in periods of contraction**. A macroprudential pillar would do this.

13. A great challenge of financial supervision would be generating instruments capable of easing an **early and effective management of financial crises**. To achieve this, the following are needed:

- An adequate **inspection** system and of information delivery on a regular basis.
- A system of **on-site supervision**, with **regular and/or continuous physical presence of supervisors** at the facilities of the supervised entities should become a standard for better international practices.

- A **permanent analysis of the foreseeable evolution of solvency** in the supervised entities in relation to different future macroeconomic and financial market scenarios. ***Stress test*** **exercises** should become a normal part of **regular supervisory activity**.

14. However, **interventions** will continue to be necessary. For this reason, it is imperative to facilitate their implememtation by all parties, including the supervisors, with sufficient **speed and legal security**. The **definition of failure** itself –traditionally, a negative net accounting value– must be re-specified and extended to include those objective circumstances justifying **pre-emptive action by the supervisor**, such as those that pose an obvious threat, albeit perhaps not immediate, to the **solvency of the entity** or to the **stability of the financial system as a whole**. Increasing the margin of supervisory discretion, would require an even greater increase of their obligations of transparency and accountability.

15. **Recapitalisation plans** must explicitly form part of **contingency plans** that would be temporarily activated where the need arises, to guarantee the stability of the financial system.

- Plans must **specify** the possibilities and modalities of **intervention**, the **liabilities** of managers and the **cost** that shareholders and bond holders are obliged to assume.
- Plans must obey the basic principle of **rewarding the prudent behaviour** and **benefiting** those entities that **have neither incurred in excesses** nor required support from public funding. There is serious doubt that this has been the case in the current crisis.
- The bailout of insolvent entities gives rise to an excellent opportunity to **reward the prudent** through the **auction** of **deposits**, **financial assets,** or **branch networks** of **failed entities**.
- It would have been desirable for **G20** meetings to have fully considered the design of a **coordinated bailout strategy for financial entities**.
- It would also have been desirable that this subject had been tackled with more than **vague declarations of principle**, at least within the European Union, and doubtless within the **Monetary Union**.

16. It becomes indispensable to address the **final recapitalisation of the financial system** with transparency and determination in every country. For this reason, we propose that the Financial Stability Board should prepare recommendations for the immediate implementation of a **coordinated plan to restore the solvency** to the international financial system along the following lines:

- **Total transparency** in the use of **public funds**.
- Fully transparent valuations by means of **competitive procedures**.
- **Efficiency** in the use of **public funds**.
- **Maximum taxpayer protection**.
- **Minimum political interference** in the management of financial institutions.
- The need for a **clear exit strategy.**

17. As regards to **bailout programs**, the design of a **Public-Private Partnership mechanism** is proposed; this would attract **private capital** to the **recapitalisation** of financial entities beset by problems, through the **state leverage of private funds**. By this mechanism, preferential shares would be subscribed by the public sector by the hand of an indispensable private investment that would signal the viability of the financial institution with no permanent public subsidy. If **no private investor** is **willing to invest** her money in an

institution with problems, the State should proceed to its **orderly liquidation** in a transparent way, applying market mechanisms and guaranteeing, in any case, the **legitimate interests of its depositors**.

18. In order to **minimise the cost for taxpayers and maximise the efficiency in the use of public funds**, these funds should not be allocated to:

- keeping in operation those financial entities with solvency problems that are **incapable** of demonstrating their **future viability** on the market.
- Improving the situation of viable financial entities **lacking** any **solvency** problems.

19. The **European Union**, and most certainly the **Euro zone**, must advance with determination toward the creation of an authentic **financial market without regulatory barriers** between Member States. With this purpose in mind, we suggest the drafting of an ambitious action plan, including as its final aim the appointment of the **Eurosystem** –comprehending the national central banks of the Euro-countries, with the ECB at its core– as the entity in charge of **regulating and supervising**, at least, those **financial entities of systemic importance in the Euro zone**, with regard to both individual solvency (microprudential supervision) as well as the solvency of the financial system as a whole (macroprudential approach).

20. The **regulatory harmonisation** of banking regulations applicable to all systemically important banks in the EU is a precondition for the **Eurosystem** to assume **inspection capacities**. The great obstacle to an integrated supervision of systemically important financial institutions in Europe is the fact that the Eurosystem would have to have access to potentially high amounts of public funds from the Member States for managing potential crisis. That would only be possible through a binding system of contributions previously agreed on that would enable the Eurosystem to have a **non-inflationary bailout capacity that would be credible *ex-ante***.

21. From the viewpoint of international financial architecture **it does not seem necessary to create new international financial institutions** –and G20 leaders seem to have understood it thus–, but rather, to better use the capacities and know-how of those already in existence.

22. The crisis has restored to the **IMF** a great part of the leading role it had lost. However, adapting it to the new situation requires **changes** in a series of issues such as:

- **Increasing and redistributing quotas and voting rights among countries** to avoid under-representation of emergent countries and others (like Spain). A European single voice at the IMF with voting rights similar to the US will facilitate the process.
- **Revising its financing sources**, enabling it to capture resources directly from the **private market**.
- Specifying and expanding its **supervisory responsibilities** with the explicit end of including financial supervision, **crisis prevention** and the preparation of an **early warning system**.
- Reinforcing some of its **traditional capacities**, such as its role of publicly evaluating the policies of systemically significant countries, and imposing an obligatory nature and mandatory publication of Financial Sector Assessment Program country reports (FSAP).
- And adapting the structure of the institution to its new tasks, which demands a **revision of its Articles of Agreement**.

23. With all its limitations, the **Basel Committee on Banking Supervision** is, without a doubt, the international reference with regard to banking regulation, a capacity that it is mandatory to maintain. For this reason, reforms in its internal organization are necessary. In this sense, and in line with the process of harmonising the internal financial regulations of the EU, we propose that the **European Union** speak with **a single voice in the Committee**. In addition, we suggest the **creation of an Executive Commission** comprehending a limited number of representatives and that would be responsible for the drafting of **proposals**.

24. The **Financial Stability Board** is the agency that will remain in charge of coordinating the preparation of regulations, standards, and better practices for the financial sector. In line with this, we propose that it should take charge of:

- coordinating the development of a **new pillar of macroprudential supervision** for the regulations governing **minimum capital requirements**,
- drawing up the **report** that would trigger the **guaranteeing mechanism** of the **money markets** in the event of **systemic crisis**, and
- preparing **recommendations** for an internationally coordinated plan to **recapitalise the financial system**.