I Update on Regulatory Issues in Respect of the Credit Crisis (Dr K P Follak)

The regulation of the finance industry is a complex subject. To a large extent, it is very technical in nature. Since our report has been finalised – end of May 2010 - a great deal of these technical details have been further developed. In the US, the so-called Dodd-Frank Wall Street Reform and Consumer Protection Act has finally been adopted. As far as the Basel Committee on Banking Supervision is concerned, the Group of Governors and Heads of Supervision have reached broad agreement in July 2010, to be finalised by end of this year. Within the EU legislatory process, there are more open questions remaining, in particular in respect of the competencies of the future common authorities. Nevertheless, the so-called ECOFIN of European Finance Ministers has achieved further progress in mid-July 2010, as required by the European Parliament. It should be finalised in autumn, and the aforesaid authorities should hopefully be able to take up their new responsibilities in January 2011.
Instead of further extending on the details, I'd prefer to take up a few broad tendencies which, in my view, will be continuous factors during the next few years.

First of all, I would like to recall the main driving factors of the crisis:

- a tremendous volume of traded risks, by far exceeding the underlyings in the real economy, due to synthetic structures and index-linked products;
- related leverage, in particular due to the activities of unregulated financial entities;
- the absence of harmonisation of prudential liquidity regulation. Liquidity requirements had been reserved for central banks as instruments of monetary policy.

Everything else is more or less a matter of second round effects or global imbalances which have not been caused by the crisis.
Regulators are tackling these issues, but they will have to take care that these efforts are not watered down.
In particular, the problem of bail outs or rescues will have to be further addressed: how can one avoid moral hazard incentives caused by bail out expectations? Politically, excluding national discretion would not be realistic. Nor would a step backwards to separated specialised banking like a revival of the Glass-Steagall Act be suitable in respect of the complex role of global financial intermediaries. But at the very least, supervisory coordination and burden sharing should be mandatory in the treatment of large cross-border instituions. Further, stringent conditions on non-compliant instituions are necessary, such as moratoriums on their activities.
In respect of specific practices in the finance industry, I'll leave it at these few comments. Topics regarding financial architecture will be addressed by my co-rapporteurs.

Secondly, a few remarks on the rule of law in financial regulation:
The crisis has brought the limits of soft law regulation to light. There is no treaty-based authority in the area of financial regulation and supervision. We have been heavily relying on voluntary coordination via multiple non-treaty based fora such as the Financial Stability Board, the Basel Committee etc.
What is necessary?

- Minimum harmonisation of regulation to achieve consistency and a level playing field;
- co-operation of supervisors including mandatory intervention in specific cases.

An early intervention framework should include moratoriums in respect of cross-border transactions of non-compliant institutions. These issues have also been addressed by the previous session on Lessons for Future Global Economic Governance and Financial Supervision.

Thirdly, the scope of global regulatory harmonisation has to be taken care of.
We are confronted with two differerent structures worldwide:

- application of the requirements stipulated by the Basel Committee to the whole finance industry. Basically, this is the concept of the EU;

or

- application of these requirements to a few systemic cross-border institutions only, whereas the rest of the industry would be subject to national regulation. This is the concept of the US under the Dodd-Frank Act, which will apply the Basel Committee frameworks only to some 20 of the largest institutions.

I would like to conclude with a few remarks on Islamic Finance.

The concept of ethical (or religious) principles in international finance has been addressed by the session on Islamic Finance and Influence of Religion on Law on Monday. We should not forget that the neglect of ethics or even basic principles of sound legal practices and of common sense has been one of the drivers of the credit crisis.

But also certain practical principles of Islamic Finance deserve more attention. Basically, Islamic Finance institutions have not been much affected by the first round core crisis, because they are much less exposed to the systemic drivers of the liquidity squeeze. This was mainly due to the closer links of Islamic Finance instruments to the real economy. There is just less leverage in the Islamic Finance system.

There is no denying that traditional banking will continue to play a major role in the global financial system. But the traditional financial centers would be well advised to better accommodate Islamic Finance structures. Otherwise they might lose a great deal of their maket share in global finance.