The Pillars of Financial Reform

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The crisis has laid bare some critical flaws in the regulation and monitoring of the financial system, and left us with more questions than answers as to which path to follow next.

In a new paper about the role of regulation in the financial crisis, IESE Prof. Xavier Vives argues that identifying and analyzing where and why the regulatory mechanisms failed may help us design more appropriate rules for the future.

The financial system is an important component of economic growth. For this reason, regulators face the daunting task of making the financial system more resistant and stable, without impeding its development. They need to preserve globalization and protect both the public interest and innovation.

At the same time, the financial sector must restore confidence and repair its reputation. It must also adapt to a stricter environment. After all, the sector has benefited from returns as excessive and disproportionate as the risks it assumed.

Desirable guidelines

What core principles ought to shape the regulatory reform that is already under way? Perhaps most crucial of all is to avoid the major flaws that led to and exacerbated the crisis.

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That will require reforms based on three fundamental pillars.

First, central banks should have an established term to ensure their financial stability. This demands specific, macroprudential measures that provide for the evolving capital and liquidity requirements throughout the economic cycle, such as the dynamic provisions of the Bank of Spain.

Second, regulation and supervision should be extended to all institutions that carry out the functions of banks.

Third, the expected losses from the government's secured liabilities should be covered by insurance premiums that reflect the levels of risk taken on by the institution in question.

Moreover, those institutions that occupy a central position in the financial system should be closely regulated, so as to minimize the potential external effects of their bankruptcy.

Considering the presence of these institutions at the heart of the global markets, the new regulatory standards should be uniform and subject to internationally coordinated supervision.

This crisis has shown that a piecemeal approach to financial regulation does not work. It is, therefore, necessary to develop a coordinated system to establish capital and liquidity requirements, as well as the degree of market liberalization.

There should be an alignment of incentives within the system in general, and at every step along the way — from the decisions made in the boardroom, to the actions taken by executives, analysts, vendors and risk-rating agencies.

Finally, mechanisms need to be implemented to ensure that the supervisor's intervention is not delayed while the financial institutions' balance sheets decline and capital dwindles.

First tentative steps

The reform processes undertaken in the countries hardest hit by the crisis and the proposals of Basel III shed some light on the future of financial regulation.

Generally speaking, the proposed measures are consistent with the principles of reform as outlined above. As Vives says, the main issue at hand is whether the reform will be ambitious and effective enough.

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It is still too early to answer this question with any real certainty, although there are already ominous signs that some areas of the reforms could be diluted.

With respect to the proposals set out in Basel III, Vives underscores the fact that many specifics remain to be defined. We will have to wait to see whether the capital and liquidity requirements established are sufficient and not distorted.

For instance, the initial proposals could penalize joint ventures in banking, and have a potentially negative impact on the benefits derived from new market entry and the exchange of knowledge and good practices. Financial institutions may also face restrictions on their geographical diversification in segments such as insurance.

Even more complex is the foreseeable impact on the line separating the brokerage and the market. The expected liquidity requirements on the assets side will make loans less attractive and bonds more so. That could result in a disintermediation of assets and a reintermediation on the liabilities side.

Regarding the reforms in the United States, the Dodd-Frank Act leaves it up to the regulator to implement the regulations. Their effects will, therefore, depend on how things are defined and put into practice.

Greater transparency, greater confidence

It is important to point out that the confidence destroyed as a result of the crisis has considerable implications for the future of the financial markets, with less investment in risky assets, a possible reduction in diversification, more short-term financing and less reliance and delegation toward intermediaries.

In order to restore confidence, there needs to be a new deal between the banking industry and consumers and investors, to eliminate conflicts of interest and achieve greater transparency for the client. According to the author, the issue is whether or not the regulation will be up to the task of promoting that new deal.

Meanwhile, the regulatory reform could have a considerable impact on the level of internationalization in the banking industry. Financial innovation has played a controversial role, since it has facilitated regulatory arbitrage, as with the use of securitizations to avoid capital requirements.

Nonetheless, says Vives, the problem is more about faulty regulation than innovation itself

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(see "Financial Regulation, Not Innovation, the Real Culprit").

The consequences of the regulatory changes will also be critical for defining the business model, and for the internationalization strategy of the financial intermediaries. Although the level of uncertainty is currently high, due to the lack of concretization of the reforms enacted, it appears that the reform process is headed in the right direction. However, we will have to wait to see the specifics in order to assess their level of effectiveness.

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