Regulatory reform
Radical reforms needed

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Two parts

I/ Recent financial reforms are too mild

Finance industry is more powerful than ever

Simon Johnson : « A victory for the banks »

II/ The need for radical reforms

- disarm the markets

=> finance working for the general interest

Three major reforms since 2008

I/ EU : new institutional framework for supervision (2009) and market reforms (2010)

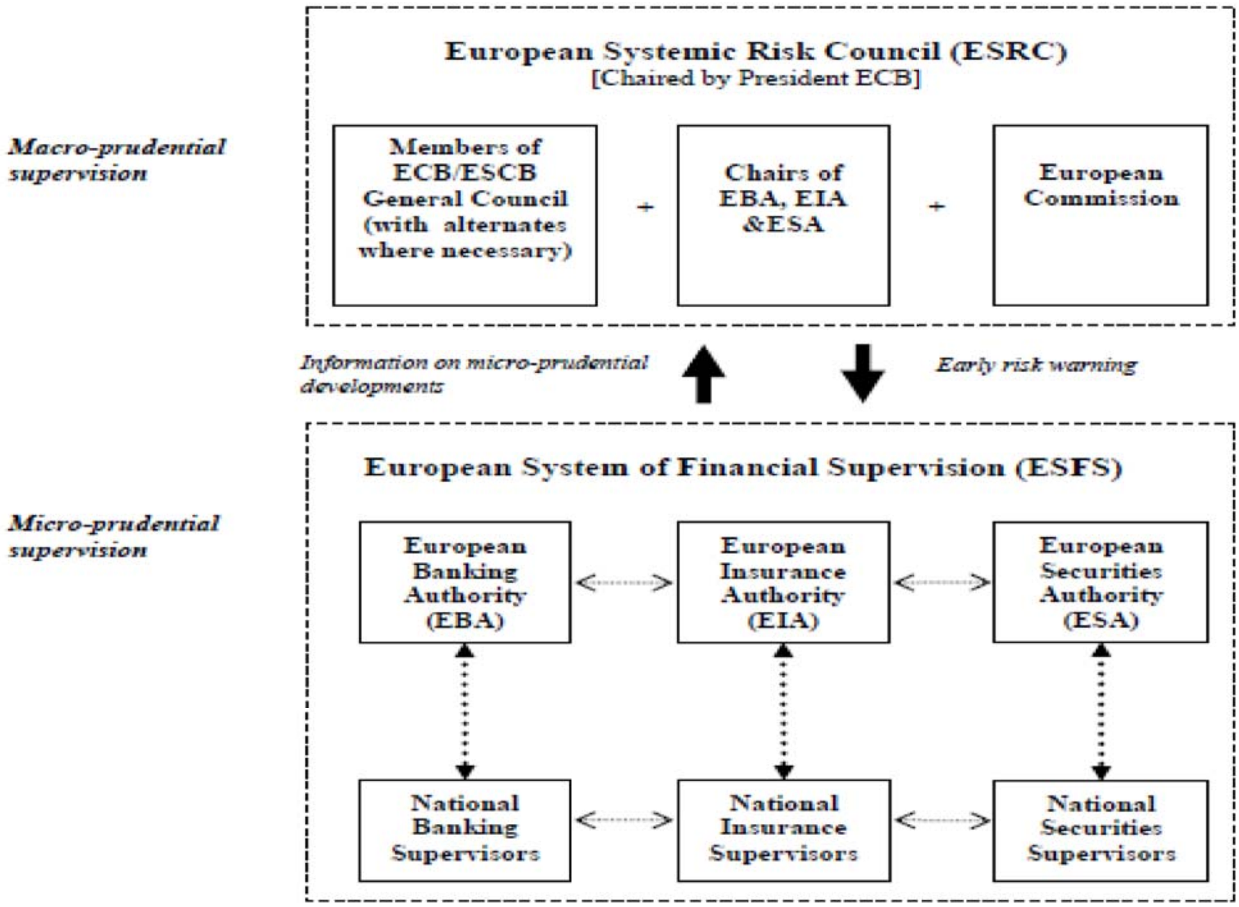
II/ US : Dodd – Frank Act (July 2010)

III/ International : Basle III (September 2010)

I/ EU reforms (2009 – 2010)

A/ New institutional framework of supervision

- **Micro-prudential supervision :** creation of the European System of Financial Supervisors (ESFS), comprised of three new authorities to ensure consistency of national supervision and strengthened oversight of cross-border entities
- **Macro-prudential supervision :** creation of the European Systemic Risk Board (ESRB) to assess systemic risks, recommend and monitor implementation of macro-prudential actions



EU reforms (followed)

B/ Market reform proposals with respect to derivatives and short selling (sept. 2010) :

- All trading in derivatives must be reported to a central bank
- The authority will have the power to suspend short selling
- Derivative traders are to use a clearing-house

II/ US : Dodd – Frank Act (July 2010)

- Prudential supervision : the Fed in charge of systemic entities, Systemic Risk Council chaired by Treasury
- Banks : « Volker rules » to limit speculative trading and the financing of hedge funds
- Consumer protection strengthened under the supervision of the Fed
- Rating agencies under the supervision of the SEC
- Hedge funds over 150 millions $ must register at the SEC

The EU lagging behind the US …

- The Dodd – Frank reform is very mild and will not change drastically the US financial system
- The EU reforms fall short of the US reform on four major fields :
  - No binding powers given to the ECSR
  - Banks : no limitation of speculative activity within universal banks
  - No agreement to regulate hedge funds
  - No proposal to control rating agencies

III/ Basle III guidelines (sept. 2010)

- Risk-weighted capital ratio is raised to 7 per cent :
  - 4.5 per cent, more than double the current 2 per cent level;
  - plus a new buffer of 2.5 per cent

- These new standards are to be implemented only by 2019 (!)

Evaluation of Basle III

- These new ratios are the children of Basle II, which has been discredited by the crisis
- The 2019 deadline is laughable : by then, the world will probably have seen one or two financial crises …
- Bank regulation mainly by capital adequacy ratio is dangerous because :
  - It leads to regulatory arbitrage : business will move the unregulated (shadow banking system)
  - It gives a hudge advantage to large banks in rich countries
  - A sharp increase the capital adequacy ratio (M. Wolf) is not a good solution because it will lead to « narrow banking » and reduce the capacity of banks to finance the economy

Conclusion of part I

- The power of finance has not been reduced by the crisis and by recent reforms, quite the contrary …
- The speculative capacity of finance is still there, as shown by recent speculative attacks on Greece, public debt and the euro
- Although it has been discredited by the crisis, the previous prudential supervision regime, based on capital adequacy ratios, is reinforced
- The major improvement in the regulatory system has been the introduction of macro-prudential supervision
- But, as it stands now after the reforms, the new regulatory system will not stop future crises.

The need for radical reforms

A/ Reform the ECB operating framework

B/ Muffle the big banks

C/ Change the existing prudential system

D/ Eliminate « black holes » in the regulatory system

E/ Develop global taxation of financial transactions

A/ Reform the ECB operating framework of the ECB

- Financial stability must be a major target of central banks, as much as monetary (macroeconomic) stability
- The ECB should be in charge of macro-prudential supervision
- The ECB should guarantee the liquidity of the government bond markets
- This new role of the ECB requires increased coordination with other authorities (including governments) and with other central banks
- => Reconsider the independance of the ECB

B/ Muffle the big banks

- In the EU, there are today 45 – 50 large banks which raise three series of problems :
  - Political economy : the big size of banks gives them the power to stop any radical reform (lobby)
  - Moral hasard : these « systemic entities » are « too big to fail » and are inclined to take excessive risks
  - Economic problem : existing evidence does not show that large size of banks leads to greater efficiency

Proposals to tame big banks

- Put a limit on the size of banks
- Organise the separation of investment banking & retail banking : a new « Glass & Steagall Act » ?
- Deal with the insolvency of « systemic entities » in an orderly manner (prompt corrective action)
- Change the governance of banks : « stakeholder » instead of « shareholder »S governance for banks to promote general interest
- Develop a « non capitalist » banking sector with public and cooperative banks

C/ Change the existing prudential regulation system

The Basle committee approach to prudential supervision is flawed :

- Too market friendly : market discipline does not work (banking sector is oligopolistic) => get rid of the theoretical representation of finance based on market efficiency
- Too much emphasis on capital adequacy ratios (pilar 1) => use more binding instruments : compulsory reserves, limits on the use of risk taking instruments (derivatives, securitization)
- Too much emphasis on banks internal control (self regulation) (pilar 2) => tighter external control

D/ Eliminate « black holes » in the regulatory system

Two major « black holes »

1/ Hedge funds : the EU has not been able to reach an agreement on this matter => extend the supervision to all financial institutions and to limit speculative activity

2/ Tax havens : the G20 proposal to use the OECD black list to fight tax havens is a big smoke screen => need to stop banking secrecy and capital flight by a multilateral approach with a comprehensive exchange of information : this type of approach is already experienced at the EU level with the European Savings Tax Directive (Eurodad)

E/ Taxation of finance

Two series of proposals :

A/ Taxation of banks

- National taxes : Germany, UK
- IMF : (a) Financial stability contribution on systemic institutions (FSC); (b) financial activity tax (FAT)

The IMF proposals were not adopted by the Toronto G20 summit

Taxation of banks raise two series of problems :

- duplicate existing deposit insurance systems
- moral hasard

B/ Taxation of financial transactions

Recent proposal : Group of 12 countries : « Globalizing solidarity : the case for financial levies » (2010)

Debate : tax on forex transactions vs taxation of all financial transactions