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ECONOMISTS' OUTLOOK

The Global Financial Crisis: Implications for Finance and Financial Regulation

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1. Introduction

During 2008, for the first time since the 1930s, the world economy experienced a systemic financial crisis: on 18 September, the international financial system was on the precipice of collapse and global credit markets essentially ceased to function for the following four weeks. While the ultimate economic impact of the global financial crisis is still unfolding, following a series of dramatic events including the failure of major financial institutions and significant government interventions in the financial system around the world, it is now unlikely that either the global or any major domestic financial system will collapse, causing the onset of an economic depression of the sort unseen since the 1930s. The causes of the global financial crisis are now generally understood, however, and major initiatives are underway around the world to reform financial regulation, with far reaching consequences for the future of global finance.

2. Underlying causes

As is often the case with financial crises,[1] many of the underlying factors leading to the global crisis of 2007-2008 arose from responses to previous crises. In this case, certain underlying factors date as far back as the design of the US financial regulatory system in the Great Depression of the 1930s. However, the most important elements developed primarily from reactions in the 1980s and 1990s to the 1980s developing country debt crisis and the 1990s Asian financial crisis.

One of the underlying causes of the global crisis was a divergence between domestic regulatory structures and the realities of global finance. This was most acutely the case in the United States but also in the European Union and the United Kingdom among others. In the context of the United States, one must look back to the previous major systemic financial crisis and resultant economic collapse: the 1920s and the Great Depression of the 1930s. In addition to its economic interventions, the Roosevelt administration also initiated the wholesale redesign of the US financial system through legislation and regulation. With certain changes, this regulatory system continues to exist. However, the financial and economic environment in which it operates has changed completely, not least as a result of globalisation, technology and complexity. As can be seen, the complexity of this system was certain to produce overlaps and gaps: these were to be brought dramatically to light in 2008.

In 1983, the global financial system experienced its next major episode of systemic risk, but one that did not lead to a systemic crisis in international financial system: the Developing Country Debt Crisis. This crisis essentially destroyed the capital base of the world's largest international banks and led developed country governments (led by the United States and the United Kingdom) to develop a new internationally agreed minimum capital standard, the Basel Capital Accord of 1988.[2]

In 1988, the Basel Committee on Banking Supervision ('Basel Committee'), hosted by the Bank for International Settlements (BIS), reached an agreed approach among the Group of Ten (G-10) developed nations regarding regulation of bank capital of internationally active banks.[3] The 1988 Accord is a fairly simple framework, focusing on one aspect: capital in relation to credit risk in banks. At its heart is an equation: total capital divided by total risk-adjusted assets must equal at least 8 per cent. Overall, this simple framework, while not very precise in term of risk calculation, provides for the majority of economies around

Notes

1 See D. Arner, *Financial Stability, Economic Growth and the Role of Law* (Cambridge University Press 2007).
2 See J. Norton, *Devising International Bank Supervisory Standards* (Kluwer 1995).
3 Basel Committee, International Convergence of Capital Measurement and Capital Standards (Jul. 1998) ('1988 Basel Accord').

the world a central element of bank regulation. It also provided perhaps the major incentive to the development of the 'originate and distribute' model of finance which, when taken to excess, has subsequently come to be seen as one of the most significant underlying causes of the current global financial crisis.

In addition to the 1988 Basel Capital Accord, the 1980s debt crisis also triggered two major behavioural changes in debt capital markets, largely because the crisis had emanated from large syndicated loans. In the aftermath of the crisis, banks began trading loans originating from developing country syndicated loans.[4] These early beginnings of the market for loan trading were the starting point for a major conceptual shift in banking: a bank could make a loan to a borrower but did not necessarily have to hold the loan to term. Rather, loans could be bought and sold amongst first banks and then other financial institutions such as investment funds. Second, because banks had lost money on syndicated loan defaults, they became increasingly interested in bond markets, wherein they could originate loans (and charge fees for arranging the financing) then sell on the risk to a range of investors around the world. The banks were thus insulated from potential defaults. In addition, the eventual resolution programme ('Brady bonds') relied on securitisation techniques, which as a result became more widely known and accepted. This trend was further reinforced by experiences in the US Savings and Loan (S&L) Crisis of the 1980s[5] through its wide use as a tool in the resolution of failed S&Ls by the Resolution Trust Corporation (RTC), thereby reinforcing understanding and acceptance of resulting securities.

On the economic front, the Asian financial crisis can now also be seen as a central to the current global crisis: As a result of the crisis, Asian countries and other emerging market countries, including Japan, South Korea, China and, eventually, India, Russia and Brazil, among others, concluded that the best prevention in the future was export-led growth supported by undervalued currencies and massive accumulation of foreign exchange reserves, greatly exceeding any rational need but viewed as insurance against any future currency, financial and economic crises. Export-led growth in turn relied on consumption primarily in the United States, which exporting countries currencies kept competitive through investment of large portions of their rapidly accumulating foreign exchange in US government and agency securities.

In many ways, the final episode of the Asian financial crisis was a serious domestic financial crisis in Russia in August 1998 which in turn caused the near failure of the world's largest and most famous hedge fund: Long Term Capital Management (LTCM). The US Treasury and Federal Reserve felt that a collapse of LTCM would pose strong potential for systemic risk and organised a private sector bailout of the firm by a series of the world's largest financial institutions. While the firms involved eventually profited significantly, there were two unintended consequences: first, financial market participants came to believe that the US Federal Reserve would not allow a systemically important financial institution (even an unregulated firm such as a hedge fund) to fail; and second, regulators came to believe that the key systemic risks lied not in the regulated institutions but in unregulated investment firms such as hedge funds.

3. Originate and distribute

By the end of the 1990s, this series of underlying events led to the view that a new model of banking had emerged. This model was based on several elements, most importantly universal banking and the originate and distribute business model, both of which received important support from international financial regulatory standards.

Unlike the system of finance established in the United States in the 1930s, the new model of finance was based on a European-style model of universal banking rather than on the US New Deal's strict sectoral separation. This aspect was secured with the repeal of Glass-Steagall in 1999 through the Gramm-Leach-Bliley Financial Modernisation Act of 1998 (GLBA). As a result of this change, competition between commercial banks and investment banks for securities business increased dramatically, forcing the investment banks into ever more risky reliance on proprietary trading – speculating with their own capital and using leverage to increase returns.

Second, the model was based on securitisation, forming the basis of the originate and distribute model. Under the originate and distribute model, financial institutions would originate assets (such as loans) then repackage these and sell them to investors. The resulting funds would be used to originate more assets which in turn would be repackaged and sold, recommencing the cycle. From the standpoint of financial institutions, this model had two benefits. First, it increased profitability by increasing velocity of transactions which in a low interest rate environment relied more on fees charged for origination than on spread based income produced over the life of the asset. Second, it reduced risks of any potential defaults because the originators did not own the assets originated; instead the resulting

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4 See R. Buckley, *Emerging Markets Debt: An Analysis of the Secondary Market* (Kluwer 1999).

5 See J. Barth, S. Trimbath & G. Yago, *The Savings and Loan Crisis: Lessons from a Regulatory Failure* (Cambridge University Press 2004).

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securities were widely distributed in the markets. From the standpoint of regulators, this model likewise had two benefits. First, banks were less risky because they were holding fewer loans and hence were exposed less to default risk in any future economic downturn. Second, by repackaging and distributing credit risks widely into the market, this brought down the charges which lenders had to charge borrowers, increasing home ownership and economic activity. Unfortunately, these benefits, when taken to excess, also turned out to be the greatest weakness of the new model.

Importantly, international regulatory changes provided significant incentives for these changes. In the context of the 1988 Basel Capital Accord, over time and in reaction to various international banking crises, it was modified in certain significant ways through a variety of 'amendments'. Of most significance are four: First, the Accord was amended in July 1994 to redefine countries which can qualify for OECD weighting, disqualifying countries which have rescheduled external debt within the previous five years. This amendment reinforced procyclical effects of the Accord in encouraging lending to emerging market OECD members but dramatically reducing it following any restructuring. Second, the Accord was amended in April 1995 to, of most significance, recognise netting in the treatment of off-balance sheet items. Specifically, regulatory recognition of netting underpinned netting as one of banks' most significant tools to reduce counterparty credit risk exposures. This move towards collateralisation of counterparty risks through marketable securities accelerated in the wake of the failure of LTCM. Unfortunately, however, the premise rests on two assumptions:

(1) that the exposure or collateral can be valued and

(2) that collateral can be sold (i.e., that the securities are liquid).

Both assumptions were to fail in 2008 for the majority of collateral. Third, the Capital Accord was amended in January 1996 and modified in September 1997 to incorporate market risks. Previously, the 1988 Accord only dealt with credit (i.e. counterparty) risk. However, following the failure of Barings Bank in 1995, regulators became acutely aware of banks' exposures to securities activities and therefore moved to address such risks ('market risk') through two alternative approaches: a standardised approach and an internal models-based approach. The internal models-based approach allowed banks to develop their own internal quantitative models to determine capital to be held against market risks. Regulators believed such models (especially those of the largest and most sophisticated banks), based on proprietary mathematical structures derived from modern finance and other disciplines such as physics, to be superior to any possible regulatory standard. While excessive reliance on quantitative modelling was tested by the failure of LTCM, regulators continued to allow banks to hold capital for market risks solely on the basis of their own internal models.

Fifth, the Accord was amended in April 1998 to reduce the risk weighting for claims on regulated securities firms, subject to certain conditions, and substituted 'loans' for 'claims' in parts of the text. Essentially, the view was that by the end of the 1990s, securities firms (especially the major international investment banks) had become sufficiently regulated to merit similar treatment to banks in the context of capital requirements relating to interbank lending. As a result, securities firms (and major financial centre banks) came to rely ever more heavily on short-term funding interbank, money market and capital market funding mechanisms rather than on traditional deposits.

These changes also had important consequences for investment banks. Traditionally, investment banks had relied on advisory, fee-based transaction arrangement and advice – 'merchant banking'. This sort of business is relatively low risk because the financial institution is not putting its own capital at risk. Following the Second World War, this business was bolstered with the addition of brokerage, which until 1975 was highly profitable and low risk in the context of a system of fixed commissions. Following May Day and the gradual encroachment of commercial banks into traditional investment banking business (in which they were bolstered by availability of deposits and interbank financing), especially in the wake of the repeal of Glass-Steagall, investment banks found that in order to maintain and increase profitability they had to have access to their own capital (hence the rush to list across the 1990s) and that they had to put their capital at risk, especially through proprietary trading in the late 1990s, and increasing leverage prior to 2008.

The combination of proprietary trading, leverage and the originate and distribute model would prove toxic to the many of the largest, most famous and seemingly most sophisticated international financial institutions in 2008.

From the late 1990s, the majority of large international banks and investment banks came to adopt the new model of originate and distribute universal banking. During the 2000s, this model was taken further, with the development of an essentially manufacturing model of debt securities. Under the 'originate to distribute' manufacturing model, financial institutions would on a continual basis either create or purchase underlying assets from other originators. The assets would be packaged together into structured pools of risks designed to appeal to various classes of investors. Such pooling would take place either on-balance sheet or off-balance sheet through separate (though often not truly independent) entities such as conduits and structured investment vehicles (SIVs). Pools where necessary would be supplemented by synthetic credit

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risk through credit default swaps (CDS) to meet the requirements of complex quantitative models designed on the basis of portfolio theory to reduce risk and enhance return, including those of ratings agencies. Pools then would be used to back a structure of a securities rated by external credit ratings agencies. Resulting securities would be sold or held ('warehoused') depending on prevailing market conditions, with purchasers including banks and investment banks (both of which viewed highly rated securities as desirable investments and also useful for regulatory and risk management purposes, including collateralisation), insurance companies, and pension and investment funds, including hedge funds (all of which viewed the products as desirable investments and useful collateral). Funds resulting from sales of securities (which might in turn be repackaged into collateralised debt obligations (CDOs) and eventually CDO²s etc.) would be used to collect new assets, thus continuing the process, so long as investors continued to be willing to purchase the resulting securities. As noted above, rating agencies played a key role in supporting the advanced originate and distribute model.

Significantly, these excesses received regulatory support through the replacement for the 1998 Basel Capital Accord – Basel II. Basel II incorporates a number of significant elements, including a menu-based approach to capital charges, greater use of both credit assessments by rating agencies and through banks' own internal models, increased recognition of a variety of risk mitigation techniques, a new charge for operational risk, and new requirements relating to supervisory review and new market disclosure obligations imposed on banks. Overall, three elements of Basel II provided the most significant incentives to the excesses of the final years preceding the crisis of 2008: greater recognition of quantitative risk modelling, reliance on credit ratings, and regulatory recognition of credit risk mitigation techniques, especially credit derivatives.

First, while the LTCM episode highlighted the potential dangers on overreliance on quantitative modelling for risk management purposes, Basel II adopted many of the techniques developed for market risk and allowed those to be applied not only to market risk but also to credit and operational risk capital requirements, albeit with greater limits than in the context of market risk. Under the Basel II framework, banks were encouraged to develop internal risk models for all major categories of risks, with regulators setting minimum parameters in which these models were to operate and be recognised for regulatory purposes. The intention was to bring regulatory, economic and accounting capital into alignment. The result was to place enhanced reliance on quantitative risk management techniques which proved to be less robust than previously though when subjected to circumstances of extreme stress.

Second, Basel II, especially in the context of the standardised approaches, relies heavily on external credit ratings for assignment of risk weights to varying categories of assets. The intention was that use of external ratings would reduce the arbitrariness of the 1988 risk weightings and enhance their reasonableness from a market standpoint. The result was that rating agencies received a substantial regulatory enhancement of the usage of their products and increased market confidence therein. At the same time, as with the earlier amendment dealing with risk weighting of restructuring OECD members, reliance on credit ratings enhanced the procyclicality of capital regulation: in good times, ratings were high with lower capital requirements and higher demand for highly rated products. When the cycle turned, credit ratings were downgraded aggressively, leading to higher capital requirements and need for capital.

Third, Basel II, in increasing regulatory recognition of risk mitigation techniques (based largely on the experiences of the earlier amendment to recognise netting) increased the use of both collateral and credit derivatives, especially CDS. In relation to collateral, recognition was extended beyond traditional high quality government bonds to a range of other highly rated debt securities. Such recognition increased the demand for such securities, especially among regulated financial institutions; however, during 2008, many of the securities proved difficult to value or valueless and illiquid, thereby greatly reducing their value as collateral and at the same time impairing capital of regulated institutions. Perhaps more significantly, Basel II recognised CDS from two angles: first as a credit risk mitigation technique and second as a means to acquire credit risk for portfolio purposes. As a credit risk mitigation technique, financial institutions received strong incentives to use CDS to manage credit exposures, thereby providing an important incentive to market development. At the same time however this dramatically increased counterparty risks among financial institutions and the major dealers (which were assumed, incorrectly, to be not allowed to fail, on the basis of LTCM experiences). Most significantly, Basel II through a combination of regulatory recognition of CDS and internal risk modelling provided a strong incentive for financial institutions to view credit on a portfolio basis (as had traditionally been done with market risk, such as equity securities). Where banks were unable to purchase the credit risk (through loans or bonds) necessary from the standpoint of portfolio construction, they were able to use CDS to acquire synthetic credit risk. While a portfolio approach to credit is probably the correct approach for a complex institution, the use of CDS brought with it counterparty risk to the major dealers, such as Lehman and AIG. Such regulatory recognition also supported the use of CDS in the context of structured finance, for example in the context of CDOs.

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4. The role of securitisation

In essence, the current financial crisis resulted from an unprecedented period of excessive borrowing, excessive lending and excessive investment incentivised by a series of significant economic and regulatory factors.[6] Excessive borrowing and lending most directly arose in the context of the market for subprime residential mortgages in the United States, especially during 2005 and 2006. However, excessive borrowing and lending were prevalent in virtually all asset classes globally, including commercial real estate, corporate lending (especially for mergers and acquisitions and private equity transactions), commodities and international (especially emerging markets) equities. These excesses were not limited to the United States; they were truly global, impacting almost every market and asset class. This broad based excessive borrowing and lending were fuelled by excessive investment from a wide range of investors around the world.

Excessive borrowing, lending and investment were inextricably interconnected through a range of transaction structures derived from well understood techniques of securitisation. At its simplest, securitisation makes a great deal of sense: it allows the distribution of risks to a wider pool of investors, thereby reducing the cost of borrowing for ultimate borrowers and reducing the risk to lenders of defaults on underlying loans. At the same time however the structure has the potential to provide significant incentives to abuse, and this in many ways lies at the heart of the current credit crisis. Especially in the United States and the United Kingdom, loans came to be made not by banks with an on-going interest in their repayment but instead by specialists – mortgage brokers for real estate and a range of financial institutions, especially investment banks, for corporate loans – intent on profiting from charging to arrange loans and with no intention of maintaining an interest in the ability of the borrower to repay in the future.

Securitisation was thus the central linkage between excessive investment in credit securities and excessive borrowing and lending. Excessive investment was largely the result of two economic factors: first, the period of low interest rates in Japan in the wake of the onset of its banking crisis at the beginning of the 1990s and in the United States following the bursting of the dot.com bubble in 2001; and second, the imbalances in saving and investment between the Anglo-American economies, especially the United States and United Kingdom, and the rest of the world, especially Japan, China and the major oil-producing countries such as Russia and Saudi Arabia. The combination of low interest rates and large volumes of investment funds from outside the United States and the United Kingdom supported massive investment in debt securities in New York and London designed to produce an appealing combination of perceived safety and attractive yields.

In addition to issues which arose in the context of relatively simple securitisation transactions, the technology of securitisation was expanded over the past decade to encompass a range of ever-more complex techniques and structures, including SIVs and conduits, CDOs, collateralised loan obligations (CLOs), synthetic securitisations and a range of other exotics such as CDO^{2}s and synthetic CDOs. Many of these took the technology of securitisation (pooling of risks, off-balance sheet structure, capital markets funding) and combined it with that of over-the-counter (OTC) derivatives, especially credit derivatives such as CDS. While such transaction structures in hindsight may seem an obvious source of risk, in fact, in the period leading up to the global credit crisis, such techniques received important support and developmental incentives from regulators around the world, especially through the internationally developed and globally implemented Basel Capital Accords. This combination of debt capital market technology, regulatory incentives, excessively low interest rates and massive global investor demand set the stage for the crisis.

5. International responses

Initially, international activity centred on the Group of Seven (G7) Industrialised Nations, the centre of global economic and financial policy coordination for the previous two decades and also the forum comprising the major economies suffering from the systemic financial crisis in the global financial system.

5.1. Early responses

During the week of 6-10 October 2008, a comprehensive global response emerged. While not sufficient to prevent the systemic financial crisis or significant economic damage, the response has been sufficient to resuscitate the US and global financial systems. Announced by the G7 on 10 October, the comprehensive approach included the following elements:[7]

(1) use of 'all available tools to support systemically important financial institutions and prevent their failure';

Notes

6 For detailed discussion, see D. Arner, 'The Global Credit Crisis: Causes and Consequences', (2009) 43 *International Lawyer* 91.

7 G-7 Finance Ministers and Central Bank Governors, Plan of Action, Washington DC (10 Oct. 2008).

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(2) ensuring that financial institutions 'have broad access to liquidity and funding';

(3) establishing recapitalisation schemes so banks can 'raise capital from public as well as private sources';

(4) ensuring 'robust and consistent' protection for depositors; and

(5) taking action to 'restart the secondary market for mortgages and securitised assets'.

Clearly, the focus at this point was directly on addressing the systemic financial crisis and halting its collapse. The statement and plan was rapidly reaffirmed by the full membership of the IMF and World Bank,[8] as well as the Financial Stability Forum and the European Union, with actions directly following the agreed approach.

In addition, the world's major central banks announced their first globally coordinated interest rate cut, with the US Federal Reserve, European Central Bank (ECB), Bank of England, Bank of Sweden, Swiss National Bank and the Bank of Canada all cutting interest rates and issuing a coordinated statement for the first time. Further, the Federal Reserve dramatically increased the provision of liquidity in dollar to the world's major central banks, agreeing to provide unlimited dollar liquidity to a range of central banks, including the ECB, Bank of England, Swiss National Bank and Bank of Japan.

In the realm of financial regulation, the FSF met again in October in the context of the G7 and IMF/World Bank annual meetings. In its report,[9] it reaffirmed the contents of the April 2008 report and extended its attention to four new areas:

(1) international interaction and consistency of emergency arrangements and responses (an issue which had clearly become important by this time);

(2) mitigation of pro-cyclicality, including in the context of capital, loan-loss provisioning, compensation and valuation / leverage;

(3) addressing the scope of financial regulation to emphasise currently unregulated aspects; and

(4) better integrate macroeconomic oversight and prudential supervision.

While significant in terms of content, this report was subsequently largely subsumed in the November 2008 G20 statement.

5.2. Group of Twenty responses

In November 2008, the leaders of the G20[10] released a declaration[11] which discussed the causes of the crisis, committed to supporting an open global economy and defined a range of actions to be taken to reform financial regulation to avoid future crises. While the majority of press and market attention focused on the various global economic aspects (and the general lack of tangible success in this respect), the most significant aspects relate to reform of financial regulation. In this context, the G20 established five main principles to guide reforms:

(1) strengthening transparency and accountability;

(2) enhancing sound regulation;

(3) promoting integrity in financial markets;

(4) reinforcing international cooperation; and

(5) reforming the financial architecture.

For each of these five principles, the leaders established a detailed action plan,[12] incorporating immediate actions (to be taken by 31 March 2009) and medium-term actions. The detailed action plan establishes the core content of the refinements to international financial regulatory standards to take place. In addition, the leaders tasked finance ministers to give highest priority to six areas:

(1) mitigating against pro-cyclicality in regulatory policy;

(2) reviewing and aligning global accounting standards, particularly for complex securities;

(3) strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of the OTC markets;

(4) reviewing compensation practices as they relate to incentives for risk taking and innovation;

(5) reviewing the international financial architecture; and

Notes

8 Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, IMF Press Release No. 08/240 (11 Oct. 2008).

9 FSF, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience: Follow-up on Implementation (Oct. 2008).

10 The G20, formed in 1999 in the wake of the Asian financial crisis, comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States, European Union, IMF, and World Bank. In addition, the United Nations Secretary General and the FSF Chair, among others, were invited to attend the Nov. 2008 and Apr. 2009 meetings.

11 G20, Declaration: Summit on Financial Markets and the World Economy, 15 Nov. 2008 ('G20 Declaration').

12 G20, Action Plan to Implement Principles for Reform, 15 Nov. 2008 ('G20 Action Plan').

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(6) defining the scope of systemically important financial institutions and determining their appropriate regulation and oversight.

While much of the detail had been previously addressed by the FSF, the November G20 Declaration established the general framework for the content of financial regulation going forward.

In April 2009, the G20 leaders met a second time to address issues relating from the financial crisis and resulting economic crisis. In their communiqué,[13] the leaders revisited many of the issues discussed in November 2008, pledging 'to do whatever is necessary' to:

(1) restore confidence and growth;

(2) repair the financial system;

(3) strengthen financial regulation;

(4) fund and reform the international financial institutions;

(5) reject protectionism and promote global trade and investment; and

(6) 'build an inclusive, green and sustainable recovery.'

If the Washington communiqué provided the outline of the content of international financial regulation going forward, the London communiqué provides the outline of the system of international financial regulation as well as additional detail regarding content. At the same time, details of the reform of the international financial institutions such as the IMF is left for the next leaders' summit (to be held in September 2009 in Pittsburgh).[14]

In relation to financial regulation and supervision, the leaders committed to building a stronger, more globally consistent, supervisory and regulatory framework. In this regard, the leaders argued that regulation and supervision must be designed to:

(1) promote propriety, integrity and transparency;

(2) guard against risk across the financial system;

(3) dampen rather than amplify financial and economic cycles;

(4) reduce reliance on inappropriately risky sources of financing; and

(5) discourage excessive risk-taking.

Significantly, the leaders committed to continued implementation of the November Action Plan, with substantial progress in all areas relating to financial regulation,[15] and also extended their commitments in nine major areas.[16] First, the FSF was renamed and reconstituted as the Financial Stability Board (FSB), including all G20 countries, FSF members, Spain, and the European Commission.[17] This is the foundation of reform of the system of international financial standards as opposed to their content, the focus of the Washington meeting. Second, the FSB and IMF were directed develop appropriate early macroeconomic and financial warning systems. Third, leaders committed to reshaping regulatory systems to address macroprudential risks. Fourth, regulation is to be extended to all systemically important financial institutions, instruments and markets, including systemically important hedge funds. While the first part of this statement is a reiteration of the agreed approach from November 2008, it is significant that the commitment (and with it, regulation) has now been explicitly extended to hedge funds. Fifth, the leaders endorsed the FSF's new principles on pay and compensation[18] and committed to supporting 'sustainable compensation schemes and the corporate social responsibility of all firms.'[19] The result is the basis of a globally agreed approach to financial sector compensation and its regulation – potentially one of the most far-reaching consequences of the credit crisis. Sixth, in the context of eventual recovery, the leaders agreed to improve the quality, quantity, and international consistency of capital, including with regulation to prevent excessive leverage and require buffers of resources to be built up in good times. Seventh, the G20 committed to take action against non-cooperative jurisdictions, including tax havens.[20] Eighth, the G20 called on accounting standard setters to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards.

Notes

13 G20, The Global Plan for Recovery and Reform, 2 Apr. 2009 ('G20 Leaders' Statement').

14 Issues concerning reform of the international financial architecture are beyond the scope of this chapter. For detailed discussion, see D. Arner & R. Buckley, 'Redesigning the Architecture of the Global Financial System', AIIFL Working Paper No. 7 (Sep. 2009), available at <www.aiifl.com>.

15 See G20, Progress Report on the Actions of the Washington Action Plan, 2 Apr. 2009.

16 G20 Leaders' Statement, above n. 13, para. 15. See also G20, Declaration on Strengthening the Financial System, 2 Apr. 2009 ('G20 Financial System Declaration').

17 For detailed discussion, see D. Arner & M. Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?' (2009) *UNSW Law Journal*.

18 FSF, FSF Principles for Sound Compensation Practices (Apr. 2009).

19 G20 Leaders' Statement, above n. 13, para. 15.

20 The statement takes a very firm line in this context: 'The era of banking secrecy is over.' Ibid. In this respect, the G20 'noted' the publication by the OECD of a list of countries assessed by the OECD's Global Forum on Taxation vis-à-vis international tax information exchange standards. Ibid. See OECD Global Forum on Taxation, A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard (Apr. 2009).

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Ninth, leaders agreed regulate and supervise credit rating agencies.[21] These final two commitments largely reiterate November commitments but with some reinforcement. In relation to other commitments, an annex to the leaders' statement provides greater detail.[22] Specifically, the G20 Financial System Declaration provides additional detail in eight major areas:

(1) Financial Stability Board,

(2) international cooperation (focusing on financial institution failures),[23]

(3) prudential regulation,

(4) scope of regulation,

(5) compensation,

(6) tax havens and non-cooperative jurisdictions,

(7) accounting standards, and

(8) credit rating agencies.

6. Looking forward to a return to a new normal?

Perhaps as early as the autumn 2009 G20 and FSB meetings, it may be possible to being to see the outlines of the agreed pattern for the international financial architecture and international financial regulation. At the same time however the pattern will take at least another year to work its way its systems of international institutions, treaties, standards and domestic laws and regulations.

While the eventual outlines are unclear, a number of implications appear certain. First, policymakers will focus on enhancing the linkage between finance and the real economy, thus reducing the financialisation which became characteristic of global finance in the years immediately preceding the crisis. In broad terms, finance will become less significant in the global economy. At the same time, there is likely to be a divergent approach between individual jurisdictions, with some jurisdictions determining that financial institutions will not be allowed to fail. The corollary of this is restrictive regulation in terms of products and activities. Other jurisdictions will continue to allow a more permissive approach to finance, and it is these jurisdictions which eventually will emerge as the major global financial centres. Second, for at least a number of years, financial institutions and transaction structures will become significantly less complex and significantly more transparent. While securitisation and covered bond structures should return, the more complex products such as CDOs are likely not to become common again in the foreseeable future. Financial institutions themselves will also become significantly less complex. These two factors will significantly reduce the role of off-shore jurisdictions, except to the extent that global finance moves to these centres due to the restrictive versus permissive divergence highlighted above. Third, unregulated portions of the financial system will become regulated, with the focus on OTC derivatives and hedge funds. The former are likely to move increasingly to central counterparty structures and/or exchange-based platforms, while the latter will face increased disclosure requirements and leverage restrictions. In this context, individual jurisdictions will reform domestic financial structures along lines appropriate to the activities to be allowed to take place within their respective financial systems. The highest profile example of regulatory structure reform will likely be the United States; significant structural changes are also likely in the euro area. For off-shore jurisdictions, this will mean that even if they continue to adopt a more permissive approach, they will be forced to meet minimum international regulatory and transparency standards emanating from the FSB. Fourth, quantitative finance, especially risk modelling, will receive much less regulatory trust. This will extend to rating agencies and their models but also has important implications for the future of financial education and the requirements of financial institutions and regulatory agencies. Finally, as a result of cooperative efforts, international cooperation and related institutional structures will have an increasing role, either as a result of a continued mandate for economic and financial globalisation or as a result of any possible decision to limit the role of global finance.

Notes

21 See IOSCO Technical Committee, Code of Conduct Fundamental for Credit Rating Agencies (May 2008); IOSCO Technical Committee, International Cooperation in Oversight of Credit Rating Agencies – Note (Mar. 2009); IOSCO Technical Committee, A Review of Implementation of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (Mar. 2009). See also IOSCO, 'IOSCO Update on Progress Made in Addressing G-20 Concerns', IOSCO Media Statement IOSCO/MS/05/2009 (3 Apr. 2009).

22 G20 Financial System Declaration, above n. 16.

23 For discussion of problems relating to the failure of global financial institutions, see D. Arner & J. Norton, 'Building a Framework to Address Failure of Complex Global Financial Institutions', 39 *Hong Kong Law Journal* 95.

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