# Financial Regulation after the Global Financial Crisis

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The Global Financial Crisis (GFC) has prompted a wide range of *ad hoc* government responses internationally involving new forms of government involvement in the financial sector and new forms of financial regulation. Governments around the world adopted a 'belts and braces' response, reflecting the unforecastable unfolding of the crisis, a lack of knowledge about underlying financial market conditions due to the opaqueness and lack of transparency in financial institutions and markets, and inadequate 'crisis planning'.

These short-term responses include measures to: promote investor/depositor confidence (such as government guarantees of bank deposits and debt); 'unfreeze' and restore liquidity to capital markets (such as by government purchases of private sector securities); prevent destabilizing speculation (such as by imposing short-selling bans); resolve troubled/failed financial institutions (such as by partial nationalization). Assessing the merits and demerits of these various responses (as options for use in dealing with future crises) and unwinding the resulting distortions to the financial system are important short term tasks.

But the GFC has also had a significant impact on thinking about optimal financial regulation. To many commentators, the GFC has demonstrated that excessive faith has been placed in the virtues of lightly regulated financial markets, indicating a need to return to greater regulation.[1] To others, the GFC reflects primarily failures in regulation and its implementation, indicating a need for better – but not greater – regulation and implementation. But adherents to both views would probably agree that financial regulation faces a difficult task in a world of financial innovation, where new financial products and techniques are rapidly created to get around regulations which constrain profit opportunities, and where under-resourced regulatory agencies are always playing 'catch-up' dealing with those developments. They would also be likely to agree that governance, risk management, and incentive arrangements in the financial sector have been sub-optimal and needing reform.

How the competing views will influence the future course of financial regulation remains to be seen, although those seeking greater regulation and concerned about the role which vested interests play in determining policy bemoan the lack of immediate longer-term regulatory changes while the financial sector was at its weakest and thus less able to impede 're-regulation'. Around the globe, numerous committees of inquiry and working groups have been established by national governments and international agencies, some of which are considered in the paper in this forum by Robert Eisenbeis.

Within Australia there are (at least) five Parliamentary Committee Inquiries in progress in mid 2009 into aspects of financial regulation.[2] APRA and ASIC have been consulting widely on potential regulatory changes, CAMAC is examining aspects of market integrity, while reviews of the Tax System (led by the Secretary of the Treasury, Ken Henry) and of the Superannuation System (led by former ASIC Commissioner

Jeremy Cooper) will have implications for the structure and regulation of the financial system. Some significant regulatory changes, albeit not necessarily prompted by the GFC, are already underway. One is the shift of consumer finance regulation from the State Government based Uniform Credit Code to the National Credit Code to be supervised by ASIC, which is discussed in the paper in this forum by Deborah Ralston. Another, announced in August 2009, is the transfer of responsibility for stock market supervision from the operator, ASX, to the regulator, ASIC, (with the ASX still responsible for ensuring compliance with its listing rules).

How much, and what type of, change in financial regulation is likely and/or needed in Australia is one of the topics addressed specifically by the papers by Martin Codina and Bob Edgar in this forum. Certainly, the comparatively good performance of Australia's financial system (relative to those of other developed countries)[3] would suggest an *a priori* expectation of less change than elsewhere. Indeed, Codina suggests this comparatively good performance provides an opportunity for the Australian financial system to promote and enhance its international competitive position as a regional financial system – a topic currently being examined by another Federal Government working group, the *Australian Financial Centre Forum*[4], due to report in late 2009.

Both Codina and Edgar (and Eisenbeis in the international context) emphasize that it is important to carefully analyze and understand the causes of the GFC before rushing into regulatory responses. They both point to the need to ensure that regulatory arbitrage opportunities do not plague the system, and that proposed solutions to identified problems with financial regulation in overseas jurisdictions are not inappropriately imported into Australia. Edgar notes in particular the 'unlevel playing field" arising from the unsatisfactory regulation of investment banking activities, and notes that their global scope (and that of commercial banks as well) creates a need for improved international regulatory coordination. He is doubtful about prospects for success in that regard, and this is reflected in Eisenbeis' conclusion that while that need is recognized by governments around the globe, there is little evidence of successful action to date.

Edgar identifies several apparent failings in extant regulation which warrant consideration. He argues that the Basel Accord and International Accounting Standards have impeded the ability of banks to offset cyclical fluctuations and, through inappropriate application of mark - to – market principles, have reduced perceptions of bank soundness.

Eisenbeis provides an international perspective on the causes of the GFC and provides an overview of the regulatory responses to date which, he argues, involved an initial miss-assessment that lack of liquidity rather than insolvency concerns was the major problem. He notes the problems arising from the widespread bank debt and deposit guarantee programs (also discussed by Codina in the Australian context) and the apparent lack of urgency among policy-makers in unwinding these market distortions.

Eisenbeis outlines the main features of the regulatory reform agendas in the US, UK and European Union and notes a common element in the perceived need for some rearrangement of regulatory agency responsibilities. But he argues that there is little attention being paid to the role of macro monetary and fiscal imbalances as an important cause of the GFC in regulatory reform proposals (which Edgar also identifies as an area warranting attention).

Particular emphasis is given by Eisenbeis to the role of incentive structures for regulators, and for financial institution managers arising from moral hazard associated with ‘Too Big To Fail’ or implicit and explicit guarantees (which have been increased globally in response to the GFC). There is an interesting contrast here with the view of Edgar, who argues that losses and penalties faced by executives and managers of failed financial institutions (even when those institutions are rescued by governments) are sufficient to offset incentives to deliberately take on excessive risks.

Finally, Eisenbeis notes that improved protection for consumers of financial products is on the reform agenda worldwide – reflecting the exposure of failings in this area in the fallout from the GFC. Much of the attention has been on where regulatory responsibility should abide, rather than on the details.

Deborah Ralston takes up this topic and provides a brief overview of those international developments before examining in more detail the current Australian situation. At the international level, increased emphasis on financial literacy programs, requiring responsible lending practices and greater transparency of financial contracts are common features (as well as the allocation of regulatory responsibilities referred to by Eisenbeis).

In the case of Australia, Ralston points out that a program of reviewing consumer protection and rationalization of regulation – most significantly the replacement of the State based Uniform Consumer Credit Code by a national scheme managed by ASIC - was already in train when the GFC struck. The losses incurred by, often highly leveraged, retail investors in, often complex, financial products, have raised questions about the balance between *caveat emptor* and consumer protection implicit in the current Australian regulatory approach. Thus, as well as the incorporation of previously excluded activities such as margin lending into the new national scheme, and the introduction of a new licensing system for credit providers, attention is being focused upon whether further regulatory changes are needed. Foremost among these are such issues as the duties of financial advisers and their remuneration arrangements.

In conclusion, the papers in this Forum highlight how the GFC has prompted an international reassessment of financial regulation involving a wide range of issues. While there is undoubtedly some shift globally in the predominant political view away from ‘financial liberalization’ and towards an increased role for regulation, there is little agreement yet on what a new optimal regulatory structure might look like (or what is politically achievable). But greater emphasis on achieving better incentive and remuneration structures (both for financial market players and for regulators), improved allocation and effectiveness of national regulatory powers, and enhanced international regulatory coordination, are all centre-stage.

Draconian re-regulation seems unlikely, although the widening of ‘safety nets’ through government (implicit and explicit) guarantees and apparently increasing relevance of ‘too-big-too-fail’ institutions raise important questions about how best to deal with the moral hazard and competition problems thereby created. For Australia, where the GFC experience of banks and other prudentially regulated institutions was less traumatic than for most other nations, addressing these questions, rather than more wholesale regulatory restructuring, appears particularly important.

## REFERENCES

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[1] The Economist (2009) presents a strongly argued case for the failures of the Efficient Markets Hypothesis and modern "classical" macroeconomics underpinning pre-GFC approaches to financial regulation, and elicits a robust response to the contrary from Robert Lucas (2009).

[2] The Senate Economics Committee had inquiries underway into the *National Consumer Credit Protection Bill, Aspects of Bank Mergers,* and *Bank Funding Guarantees.* The Joint Committee: Corporations and Financial Services was inquiring into *Financial Products and Services* and into *Agribusiness Managed Investment Schemes* and the House Economics Committee completed an inquiry into *Competition in the Banking and Non-banking Sectors* in November 2008.

[3] Brown and Davis (2008, 2010) and Stevens (2009) provide overviews of the Australian experience in the GFC.

[4] Information about the forum can be found at http://www.treasury.gov.au/afcf/content/default.asp