

TESTING TIMES FOR GLOBAL FINANCIAL GOVERNANCE

by
Ignazio Angeloni

BRUEGEL ESSAY AND LECTURE SERIES



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Ignazio Angeloni, Bruegel

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FOREWORD

Over the last ten years, cross-border holdings of financial assets as a percentage of GDP have roughly tripled within Europe and doubled between Europe and North Americaⁱ. Developments of such magnitude amount to qualitative changes in international interdependence. Yet the assignment of responsibilities for financial regulation and supervision has hardly been altered. Confronted with the rapid pace of market integration, policy integration and cooperation have been left behind the curve. As Ignazio Angeloni puts it in this essay, the world is not suffering from excessive financial globalisation but from insufficient regulatory globalisation. This is his first message.

This first message is not a novel one, but it comes from someone who was until recently directly involved in European and global financial cooperation and in this capacity has lived through all the intergovernmental discussions of recent years. His sober assessment and his warning are timely and they carry the weight of first-hand experience.

Ignazio Angeloni's second message is much more original. It is that in spite of the higher degree of integration within Europe and for all the institutional and legislative apparatus in place in the European Union, cooperation at the global level within the framework of the *Financial Stability Forum* (FSF) is proving significantly more effective. Whereas European discussions on the supervision of large pan-European banks have been stalled for several yearsⁱⁱ now, the FSF has been able to define, promote and monitor a coordinated response to a series of regulatory challenges raised by the financial crisis. In other words, the EU level is

ⁱ These are orders of magnitude, based on an extrapolation of data presented in a forthcoming Bruegel Working Paper by Jérémie Cohen-Setton and Jean Pisani-Ferry.

ⁱⁱ On this issue see Nicolas Véron, 'Is Europe Ready for a Major Banking Crisis?', *Bruegel Policy Brief n°2007-03*, August.

being quietly bypassed, in favour of an informal an apparently toothless club of central banks, governments, regulators and international organisations.

Things can obviously change, especially in response to events. But Angeloni's observation is in itself puzzling. Why can a near-ectoplasm devoid of any instrument and decision-making procedure succeed where a near-state is failing? Why are governments apparently keen on cooperating within the FSF and reluctant to agree at EU level?

The answer offered by the essay is that EU member countries are reluctant formally to assign new powers to the EU and therefore prefer the gradualist route, while they are more comfortable with a *de facto* relinquishing of powers to the FSF. Angeloni also points out that the rather ad hoc composition of the FSF makes it able to address global regulatory issues effectively. Finally, he points to the strength of the mandate given by the finance ministers of the Group of Seven (itself an informal institution). Perhaps also the larger member states of the EU are more inclined to discuss with the US authorities, to learn from them and to try to influence them than to negotiate with their EU partners. But whatever the reason, this is an extraordinary and largely unforeseen development with potentially significant implications for the future of the EU.

The third and last message is that the FSF model has strong potential and may provide a template for the future of international financial cooperation. The relevant comparator here is not the EU, but the International Monetary Fund, an institution that is also based on a formal treaty and relies on an elaborate system of governance. Back in 1999, the alternative to creating the FSF was in fact to grant additional powers to the IMF. One of the reasons behind the choice not to do this was to avoid making the Fund excessively powerful. In the event, the Fund has been weakened significantly by a series of developments, not least the rise of financial stability issues and its limited bearing on them.

As the world has started moving towards an overhaul of rules of global finance that will probably result in a significant tightening of the regulatory framework, the question for the future is whether the combination of

political mandate, informality and national enforcement will suffice or whether there will be a need to resort to a more formal international authority. Ignazio Angeloni takes a middle-of-the-road stance on this issue, indicating that the IMF and the FSF will have to cooperate. Perhaps. But they nevertheless represent two alternative ways to organise international cooperation, and two rather different images of its future.

Jean Pisani-Ferry
Director of Bruegel

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INTRODUCTION¹

A year after its start, when some observers were already seeing light at the end of the tunnel, the financial crisis has taken a sudden turn for the worse. Governments and central banks are back in the trenches, their first objectives being to maintain stability and avoid further loss of confidence in the financial markets. Meanwhile, the nature and origin of this crisis are hotly debated by academics and policymakers, some emphasising its unique features while others stress the elements it has in common with past episodes of financial instability. These reflections are helpful, not necessarily to meet today's challenges, but surely to understand how regulators should go about designing a more reliable system for the future.

In this essay I look at the crisis from a different perspective, that of its possible consequences for the governance of global financial markets. For reasons explained below, my main emphasis is on the degree of, and procedures for, international coordination among financial authorities, both in Europe and globally. I examine a sequence of three interrelated questions: are the institutional arrangements shaping financial market policies (banking and financial markets regulation and supervision) satisfactory? If not, what changes are needed? More importantly, what can be expected to happen as a result of the crisis? Before launching in, a warning is in order. Neither the timing (events are still in progress) nor the topic (highly qualitative) allow for systematic or quantified analyses and firm conclusions. These will be possible in the future, perhaps. Here I can only

limit myself to personal views supported by informal arguments and limited information².

In essence my thesis is threefold. First, in today's global financial policy architecture, the quantum of cooperation among national and supranational financial authorities (information exchange, prior consultation, common decision making, etc.) is less than would be desirable. There is a growing conflict between the degree of globalisation reached by today's financial markets and the national bias that still dominates financial regulation and supervision. This is true globally but more strikingly in the European Union (EU) where, owing to a high and increasing level of financial integration³, the existence of an explicit single market goal and the presence of a common currency, we would expect to see a higher degree of cohesion in the design and implementation of financial policies than is the case at present⁴.

Second, the current turmoil deepens this conflict, calling for yet more coordination of financial policies if not their delegation, in part, to supranational institutions. This is most evident in relation to banking supervision on large cross-border financial conglomerates.

Finally, I argue that one consequence of this crisis may indeed consist of precisely this outcome, namely a move towards closer coordination at the global level. Historically, crisis situations have often been catalysts or accelerators of institutional change. The role assumed over the last year by the Financial Stability Forum (FSF) in stimulating and coordinating the regulatory response of all major global financial authorities hints at this; the urgency of the situation and the necessity to act jointly seem to have overcome the elements of resistance that had hampered the Forum's action in previous years. A similar acceleration does not seem to be occurring in the EU decision-making fora, as I will try to explain. Whether enhanced coordination at the global level represents a lasting trend is unclear yet; much will depend on whether the political support behind it is maintained once the emergency is over. The informal coordination arrangements experimented with during the crisis will need to evolve into more stable and lasting institutions.

The discussion is organised as follows. In the first section I review some concepts from the recent political economy literature that suggest when and to what degree economic policies should be centralised or coordinated internationally. It also explains why these concepts are applicable to the case of financial market regulation and supervision. Section 2 argues that certain features of the present crisis are relevant from this viewpoint, in the sense that they suggest that international financial policy coordination should be strengthened. Section 3 deals with a closely related subject, namely the implications of the crisis for central bank policies. Section 4 reviews briefly the existing cooperation arrangements, at the global level and in Europe, making a number of remarks on their limitations. Section 5 describes the role of the Financial Stability Forum after the eruption of the crisis, arguing that this represents progress towards more global governance of financial markets. Section 6 concludes.

BENEFITS FROM INTERNATIONAL FINANCIAL POLICY COOPERATION

Should financial policies be conducted nationally or internationally? Should authorities coordinate among themselves, share tasks, and in what way? In thinking about these questions it is useful first to review some basic concepts and criteria recently proposed in the literature for assigning policy responsibilities among different jurisdictions. In recent years, there has been a revival of political economy research on the assignment of policy functions to different government levels, pertaining to economic policies in general but adaptable to the area of finance as well.

Historical observation suggests that, while national states have traditionally played an exclusive role in the performance of public policies within their own territory, in recent times this function has increasingly been exercised jointly by groups of nations (*international* cooperation) or by separate institutions acting on behalf of nations (*supranational* cooperation). Intuitively, in an integrated world (economically and otherwise), cooperative policymaking helps in achieving common goals better and at lower cost. Theoretical models have been developed showing that centralisation of public goods provision is relatively more beneficial, other things equal, when tastes and preferences are more homogeneous across

countries, when national policies extend their impact across borders, and when there are economies of scale – policy functions being more effective or efficient when undertaken by several countries together⁵. Naturally, in a more interdependent world these three conditions tend increasingly to be fulfilled.

An attempt to measure whether policies are correctly allocated among national and supranational entities, with reference to the EU, was made some years ago by Alesina, Angeloni and Schuknecht⁶. More recently Coeuré and Pisani Ferry⁷ have examined the governance of the EU's external relations in a number of policy areas, including financial markets.

The first of these papers examines the scope of EU policymaking across several policy domains. It attempts to evaluate whether the transfer of policy responsibilities from member states to the EU is appropriate in light of normative criteria and of the preferences expressed by European citizens. One of these policy areas comprises monetary and financial policies, as well as taxes and public budgets. The conclusion is that in Europe the desirable degree of centralisation in this area is high and not matched by the present arrangements. Europeans seem to support a stronger EU role in this field. The essay by Coeuré and Pisani Ferry examines a similar set of policy areas but with a different question in mind, specifically whether the appropriate model of governance is delegation to an autonomous entity or coordination by national states. While their evidence supports the notion that EU activity in this area is limited and could be strengthened, their preference seems to be for cooperative models of governance (international) rather than for delegation of the task to a supranational body.

These ideas are highly relevant for financial market policies. In no other area have globalisation and integration progressed in recent years more quickly and forcefully than in finance. The exponential growth of cross-border asset flows and holdings by both non-financial investors and banks, especially after the generalised removal of capital controls in the 1970s and 1980s, has been well documented. For example, data by Lane and Milesi Ferretti⁸ suggest that among industrial countries total cross-border assets plus liabilities as a ratio to GDP has increased, in the last 20 years, from about 100 percent to over 300 percent, with a sharp acceleration in

this latter period relative to the earlier one. Among emerging countries financial integration has been lower, though still significant, probably due to their less advanced financial market structures. Lane and Milesi Ferretti conclude that 'the dramatic increase in international financial integration has been one of the salient global economic developments in recent years'.

The question is, has this indeed translated into more cross-border externalities from domestic financial policies and hence benefits from coordinated policymaking? Simple reasoning suggests a positive answer. Finance differs from other economic activities on account of the presence of asymmetric information between borrowers and lenders. Lenders put their money at risk without the benefit of the same information on the quality of the project and of the counterpart that borrowers enjoy. The more information is asymmetric, the more the financial sector is inefficient and risky. Regulatory and supervisory policies have a major impact on the size and the nature of informational asymmetries; for example, disclosure requirements for securities, bank capital regulation, bank supervisory practices and the like all contribute to influencing (and hopefully to improving) the risk/return characteristics of investment located in the country where such policies are in force.

Information asymmetries are stronger across frontiers, since countries possess individual legal systems, supervisory arrangements and social and moral habits that are relatively unfamiliar to foreigners. Information asymmetry is, in fact, frequently quoted as an explanation for home bias in portfolio allocation. However, financial integration is not necessarily associated with more informational asymmetries in the system as a whole. There are counterbalancing forces. The presence of international investors typically improves market practices and strengthens transparency. Information and analysis available to international investors tends to increase with demand. Large financial conglomerates, responsible for a large part of cross-border asset holdings, are also specialised in gathering and processing information on local markets. And, besides, causation could be reversed: cross-border integration itself is often spurred by lower information barriers. But whatever the information properties of global financial markets may be, cross-border portfolio diversification should unambiguously strengthen international spillovers stemming from

financial policies, because the latter, formulated and implemented domestically, affect a broader pool of international investors. This argument should hold equally for securitised as well as over-the-counter and banking markets, since all are subject to 'home country' control rules of some sort.

Financial integration therefore needs to be accompanied by growing 'internationalisation' of financial policies (a catch-all expressing a mix of information-sharing, cost-sharing, common or coordinated decision-making) to reap the benefits of globalisation and avoid an undesirable increase in systemic risk. There are, however, powerful forces resisting a transfer of policy responsibilities to the international, and even more to the supranational, sphere. One comes typically from national administrations, whose role and influence are threatened. Their resistance is powerful because normally they sit at or influence the negotiating tables where such transfers need to be agreed upon and implemented. The reaction of the financial industry is typically mixed. Large players tend to gain from a more international organisation of financial regulation and supervision, since reporting duties on international operations become simpler and less costly. Smaller and more domestically oriented banks on the other hand feel more at ease and protected by domestic regulations and supervisors.

SOME FEATURES OF THE CURRENT TURMOIL

The preceding section concluded that the increasingly global character of finance in recent times strengthens the case for supranational conduct of such policies or at least close cross-border coordination among authorities. The financial crisis, due both to features it has in common with previous episodes of financial instability and to its specific characteristics, strengthens the tendency towards a more integrated international financial system and therefore makes the case for a global approach to financial policies more compelling. Seen from this angle this crisis is not a new phenomenon but an acceleration of an existing trend.

Views about the nature of the mortgage crisis are divided between those who stress its novel character ('what's new') and those who emphasise

the many things it has in common with previous episodes of financial instability ('what is the same'¹⁰). What is new is quite evident. This crisis originated from an unprecedented mix of real estate finance and securitisation. Traditionally, real estate finance (in particular, home purchase finance) had been carried out through relatively unsophisticated financial instruments (fixed or floating rate mortgage loans, typically extended domestically and remaining in the bank balance sheet until maturity) and characterised by a close link between borrower (a household) and lender (a bank). This scheme had the advantage of maintaining a close link between new credit flows and bank capital availability and of facilitating the scrutiny potential and ex-post monitoring of borrowers. The new model of home finance, started in the US and which gradually spread elsewhere, is characterised instead by a very rapid (often simultaneous) transition of mortgage risk from the originating bank to other investors, often off balance-sheet vehicles (special investment vehicles, or SIVs) created ad hoc, through a complex chain of asset-backed securities and related derivatives. In principle, this 'originate-to-distribute' (OTD) model served the useful purpose of reallocating risk to investors more willing and better equipped to hold it. A widely shared feeling among financial authorities before the crisis was that, though the OTD model perhaps made the distribution of risk less transparent, it nonetheless improved its allocation, hence making the financial system both more efficient and more resilient to shocks. In practice, however, the model rapidly evolved into a mechanism allowing banks to extend mortgages to increasingly risky homeowners, using SIVs to escape a proportionate increase in their capital. Another consequence was an underestimation of risk by the originator, since the investment was quickly securitised and passed on to other investors. The final investor in mortgage-backed securities and related financial instruments was typically unaware of the nature and the location of the underlying risk, and for this reason tended to rely increasingly on the evaluation of 'benevolent' credit rating agencies.

At the same time, several authors have pointed out that some features of the current crisis are reminiscent of previous episodes of financial instability. Two are of particular importance for us our argument here. First, as stressed for example by Reinhart and Rogoff¹¹, the present financial turmoil resembles past experiences in that it was preceded by a prolonged

period of asset price inflation. In particular, with the only exception of the correction of the *dot.com* bubble at the beginning of this decade, stock and real estate markets at the global level experienced an almost continuous price increase in the ten years preceding the outbreak of the crisis in August 2007. Prolonged asset market booms, driving prices above reasonable equilibrium ranges, tend to be self-perpetuating because expectations are often formed through extrapolative mechanisms, and because it is riskier for portfolio managers to bet against a general trend in the market. As a result, investors in boom periods may not pay proper regard to fundamental asset values and may underestimate their underlying risk.

Asset market booms were historically preceded and accompanied by expansionary monetary policy, coupled with fast growth of money and credit aggregates. This crisis is no exception. In virtually all developed and many emerging market economies money and credit grew fast (often at double-digit rates) for most of the 1990s and 2000s. Bank credit has typically been used to finance leveraged positions in asset markets, most notably in real estate.

All these features, both old and new, suggest an increase in the degree of interdependence of the international financial system. Take the originate-to-distribute banking model, which, despite its shortcomings and the need for tighter regulation, will in all likelihood become a permanent feature of the financial landscape (we know from experience that financial innovation, when arising spontaneously as a response to market needs, is seldom reversible). Its presence means that the international financial system will be permanently characterised by a higher degree of capital mobility and risk transferability than has been the case in the past. Much of this will be across frontiers; this is witnessed already by the fact that a substantial part of the risk related to the below-prime mortgage segment in the US (as much as 40 percent according to recent estimates) is ultimately borne, often inadvertently, by investors in Europe and elsewhere. This means that to an increasing extent the regulatory and supervisory environment of the originator will affect the risk profile of foreign investors; their local authorities have no power over it except if they can influence the authorities on the originating side.

Analogous reasoning applies to the other features of the crisis. Asset markets booms and busts tend to transmit easily across frontiers and across markets; research in the last decade shows that international asset price linkages have increased, in particular across the Atlantic. Therefore, policies that generate or perpetuate booms in a country or area will affect asset market conditions in other areas as well. Such policies can be in various fields. Regulatory and supervisory policies in the financial sector are the most relevant example here, but the same could be said for monetary policies; in a highly integrated system, liquidity creation in one area affects monetary and financial conditions in other areas and globally. In theory, exchange rate flexibility should afford shelter from external monetary shocks. But experience shows that the 'insulation properties' of floating exchange rates have provided little protection, and the international transmission of monetary as well as asset market shocks has remained substantial (and has indeed increased) since the transition to floating exchange rates in the 1970s and thereafter.

Having argued the need for enhanced cooperation and joint decision-making among banking and financial regulators, we now move on to the impact of the crisis for central bankers, then consider how cooperation works in practice. We first review cooperation arrangements at the global level and in Europe. Thereafter we consider the special role acquired by the Financial Stability Forum in coordinating policies to strengthen the resilience of the financial sector after the outbreak of the crisis.

THE CRISIS AND CENTRAL BANK POLICIES

Though our main focus is on financial regulation and supervision, the crisis has also important implications for central banking. As lenders of last resort (LOLR), central banks are the first line of defence for financial stability in crisis situations. Financial globalisation and the growing importance of large banking conglomerates operating cross border have increased the need for information-sharing and concerted action among central banks; LOLR has become increasingly international. For this reason, the channels of, and opportunities for, contact among central banks, formal and informal, have grown, and they were used intensively in

managing the crisis during the concerted money market interventions launched in December 2007, repeated on several occasions since. These episodes have strengthened the market perception that central banks are responsive to critical circumstances and capable of agreeing quickly on joint action as and when it is needed.

Significant changes are emerging in several aspects of central bank policies, seemingly suggesting a tendency towards broadly similar operational and conceptual frameworks. The most visible one relates to operating procedures. Two kinds of approach have prevailed in recent decades that one can label respectively 'narrow' and 'broad' central banking. Narrow central banking means that the central bank conducts open market operations with only a limited number of financial instruments and counterparties, in extreme cases only treasury paper and a few large commercial banks or primary dealers. This approach implies lower financial risk for the central bank but requires a smooth-running money market so that liquidity can reach market participants without direct access to the central bank. Broad central banking, on the other hand, means that central banks accept a wide range of collateral and deal with a large number of bank and perhaps non-bank counterparties. In doing so, the central bank relies on markets to a lesser extent, but accepts more risk in its balance sheet. As money markets ceased to function properly in the most acute phases, and narrowly defined collateral became relatively scarce, pressure mounted on all central banks to broaden their approach to open market policy. The Fed increased the range of acceptable collateral (including, notably, mortgage-backed securities) and counterparties; the ECB did not need to do this because its internal rules were, for historical reasons, already sufficiently flexible to accommodate a broad range of counterparties and collateral. A generalised move towards broad central bank refinancing practices seems inevitable: the crisis has demonstrated that liquidity strain can originate anywhere in the system and money markets cannot be expected to work efficiently at all times. But in the long term there are risks for central bank balance sheets, and potentially for their independence.

A second area where evolution can be expected is the role, and the rules, of LOLR. The classical doctrine – lend only to sound banks, at penalty rates and against good collateral – is increasingly questionable, or at least

difficult to apply in practice. In modern financial markets, a bank with good collateral hardly needs to borrow from the central bank at a punitive rate. At least, the judgement on whether a bank is solvent or not will need to go hand in hand with a separate judgement about whether the collateral it offers is good or not. Both are likely to depend on market conditions. The classical theory of LOLR needs rethinking, or at least reinterpreting, both conceptually and in its practical application.

A third issue is whether latter events in financial markets require a rethinking of our monetary policy frameworks. Recent years have witnessed the growing popularity of ‘direct inflation targeting’ strategies, prescribing that the central bank should adopt as a target its own inflation forecast defined with reference to a relatively short horizon (say, 18 to 24 months), and use its best information to calculate and achieve such a target. The ECB, on the other hand, has always advocated a more elaborate strategy, also taking into account monetary aggregates and in general the condition of money, credit and financial markets. One consequence of this crisis may be to reopen the debate on how to conduct monetary policy, which seemed to have lost much appeal in the economics profession. Economists at the BIS have advocated adopting a broad macro-prudential framework, to which monetary policy would contribute. The balance seems to be tilting against strict inflation-targeting and in favour of more elaborate frameworks, responding to money, credit and financial market indicators in a more systematic way.

OVERVIEW OF FINANCIAL POLICY COOPERATION ARRANGEMENTS

Supranational institutions which design and implement regulatory and supervisory policies (either globally or regionally) do not exist at present, and their creation is unlikely to feature on international policy agendas in the foreseeable future. Formally, national authorities retain full power to regulate the financial industry and act, when and as needed, to prevent and resolve financial crises.

This is also largely true in the EU, in spite of treaty provisions assigning a key role in financial market legislation and its enforcement to the EU level.

This is because passing legislation in this area is subject to the rather demanding qualified majority voting requirement under the treaty¹².

While this is the formal state of play, in practice a variety of formal or informal arrangements set up in recent decades have injected several elements of cross-border cooperation, making it more interconnected and complex. A web of international groups created over time provide financial market regulators and supervisors as well as central banks with a virtual continuum of opportunities for exchange, debate and consensus-building in all key areas of banking and financial market regulation. Some of these groups have gone further, dictating international standards of good practice that have been successively adopted by participating member countries, and even beyond, on a voluntary basis. The sectoral and geographical coverage of these groups varies widely, as documented by various sources. H. Davies and D. Green have recently provided a useful and comprehensive guide to the present international system of financial regulation¹³. Other rich sources of information are the website of the Bank for International Settlements, www.bis.org, for the global arrangements, and that of the EU, www.europa.eu, for the European ones. Given the complexity of the existing arrangements, a very brief summary is provided here in two separate boxes (one for global arrangements, the other for the EU).

BOX 1: GLOBAL FINANCIAL COOPERATION ARRANGEMENTS

International financial regulatory groups have often been created in times of crisis, as a response to new phenomena or risks requiring enhanced cross-border cooperation. Since all of them have ended up being permanent (the G10 Deputies, discontinued in 2006, being a notable exception) and no comprehensive re-ordering ever attempted, the result is a complex web of superimposed structures, partly redundant and yet in certain respects incomplete. Davies and Green, in the book already quoted, provide a useful representation of these arrangements in the form of flow-chart (see chart 3, page 33 of their guide).

Probably the best known group is the *Basel Committee on Banking Supervision*, in which central bankers and other bank supervisors discuss

issues relating to bank supervision and regulation. Created by the G10¹⁴ in 1974, shortly after the end of the Bretton Woods system, with an initial focus on bank risks deriving from cross-border capital movements under floating exchange rates, the Committee provides a forum for regular cooperation among bank supervisors. In recent years it has evolved into a broad-ranging standard-setter on many aspects of bank regulation and supervision. In 1988 the Basel Committee reached the well known bank capital accord (Basel 1), setting minimum capital standards for banks in the participating countries. After long negotiation the first accord has recently been replaced by a new one (Basel 2, 2004), more responsive to the nature and degree of bank credit and market risks. The Committee does not possess formal supranational authority and hence its conclusions have no legal force in the member countries; nonetheless, peer pressure operates strongly in the group, hence its deliberations carry significant force in its member countries and more broadly. Though its membership is limited to a small number of developed countries, mainly European, its agreements are increasingly applied in the emerging world.

Two additional Basel-based committees focus on related areas. The *Committee on the Global Financial System* analyses global financial markets, with the goal of identifying sources of stress ex ante and promoting improvements in the working of these markets. It fulfils this mandate mainly by regular discussions and publications. Its creation in 1971, by the G10 central banks, was spurred by the birth and rapid growth of 'eurocurrency markets', ancestors of today's global financial markets. The *Committee on Payment and Settlement Systems* instead analyses and monitors the functioning of the payments and settlements infrastructures, domestic as well as cross-border, to ensure that they contribute to overall financial stability. The Committee, which operates with few formal proceedings, has recently promoted important guidelines and principles defining best practice for large payment and settlement systems, in both cash and securities.

Banking and financial market issues are routinely also discussed in periodic meetings of central bankers in the *Bank for International Settlements*, which also hosts a variety of background technical meetings among central bankers.

Other international consultation fora bring together authorities responsible for other segments of the financial system. The *International Organisation of Securities Commissions* (IOSCO) gathers the national authorities responsible for securities markets, while the *International Association of Insurance Supervisors* (IAIS) is the analogue for the insurance sector. The *International Accounting Standards Board* (IASB) aims at developing worldwide, homogeneous and transparent accounting standards. Each of these groupings operates in its own specific area of responsibility, typically by developing objectives, or principles, that national regulators are supposed to follow. If successful, these principles become benchmarks of best practice in the participating countries and elsewhere. These groups work by consensus and their conclusions have no formal binding power. One difficulty of all these structures is the sectoral nature of their mandate, which may be a source of regulatory segmentation and inconsistency. To overcome this, and specifically to deal with the increasing links between banking and insurance, recently [1996] a *Joint Forum* was established on the initiative of the Basel Committee, the IOSCO and the IAIS, to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

International organisations have also increasingly focused on financial systems analysis and policies in recent years. In particular, the *International Monetary Fund* has focused on financial market analysis and has become a source of financial standards in its own right, as well as comprehensive country-by-country financial sector evaluation (Financial Sector Assessment Programs, or FSAP). Moreover, other regulatory areas have their own international arrangements, such as the *Financial Action Task Force* (FATF) on money laundering and other criminal financial activities, and the *International Forum for Independent Audit Regulators* (IFIAR) for auditing.

The *Financial Stability Forum*, created by the G7 in 1998 in the wake of the Russian default and the LTCM crisis to 'promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country', has a special position. One reason for this is its broad area of competence,

expressed in its aforementioned mandate. A second reason is its broad composition, including political authorities (treasuries) as well as supervisors and central banks, plus all key international fora and institutions (its exact composition is detailed in a footnote). A third reason is its strong political accountability, since the FSF reports directly to the G7. Despite its potential, however, the FSF had initially played a rather minor role, rising to prominence only in recent months, as set out below.

A number of observations can be made. First, the global fora are characterised by marked sectoral segmentation. Though as a whole they cover most relevant sectors and areas (banking, securities, insurance, payments systems, ratings, accounting, etc.), each body in itself tends to be highly specialised. Groups with horizontal mandates (such as the Joint Forum) play a limited role. This can hamper policy effectiveness in a financial landscape increasingly dominated by institutions offering broad menus of financial services and by financial instruments fulfilling multiple roles.

Geographical segmentation is also an issue. Global cooperation arrangements include mainly industrialised countries. This is likely to become an obstacle going forward if, as historical experience suggests, financial integration among emerging markets follows trade integration: the latter has been soaring in recent years. Geographical limitation is increasingly a problem also for the EU fora, whose membership is by definition restricted to EU members. It is difficult today to think of regulatory areas and policies that can meaningfully be considered to concern the European area alone. For example, most challenges for European regulators and supervisors in recent years have come from financial innovation phenomena originating elsewhere.

The fact that all global financial cooperation arrangements operate on consensus limits their effectiveness. Moreover, the various groups differ in their degree of ambition; some have promoted highly influential (and at times controversial) agendas, such as the Basel accords, while others have remained discussion fora. This can be a source of regulatory unevenness. For example, enhancing the role of ratings in the determination of bank capital requirements implies proper oversight of rating providers.

In Europe, unanimity is no longer needed in certain areas; for example, the main directives approved recently under the Financial Services Action Plan (FSAP) require only a qualified majority in the Council. But as we have already noted, this requirement is still quite demanding. Moreover, in practice there remains considerable hesitation in promoting initiatives that are not generally supported.

BOX 2: FINANCIAL POLICY COOPERATION IN THE EU

The EU is unique in the sphere of international financial cooperation in that it has made the development of an integrated continental financial market an explicit policy goal, and has developed legal arrangements to achieve it. There is specific legislation (composed of the treaties and by European laws, or directives) as well as formal procedures for translating this legislation into national jurisdictions. From an operational viewpoint, however, financial regulation and supervision in the EU remain under national control in the sense that the regulatory interface between banks and other financial institutions is national, not European, authorities.

There are broadly three legal bases for EU competence in this area (see the piece by Coeuré and Pisani Ferry, already mentioned, for a more extensive discussion). The first stems from the single market chapter of the treaty, which also covers financial services. The second and the third derive indirectly from the existence of a single currency. The treaty requires that the *European System of Central Banks* (ESCB) contribute to the smooth conduct of national policies related to the prudential supervision of credit institutions and the stability of the financial system. This reflects the close links between the balance sheets of the banking system and that of the central bank (which accepts bank assets as collateral) on the one hand, and with the transmission mechanism of monetary policy on the other. Moreover, the treaty assigns to the ESCB the mandate to safeguard the smooth functioning of payment systems. This area of competence is rather narrow, referring to payment systems only, but the responsibility of the ESCB is exclusive.

Leaving legislation aside (to which the EU Council, the European Parliament

and the Commission contribute), the main EU decision-making forum on financial issues at the political level is the *Economic and Financial Affairs Council*, or Ecofin. Decisions formally require a qualified majority but are often taken by consensus (with occasional dissent). Ecofin agendas pertaining to financial markets are prepared by the *Economic and Financial Committee* (EFC), which in turn avails itself of a number of substructures. In the field of financial services, the EFC meets in a specific formation and background material is prepared by the Commission services (mainly DG EcFin and DG Internal Market).

The distinction between the Ecofin (including the finance ministers of all 27 member states) and the *Eurogroup* (comprising only the 15 countries that have adopted the euro) is important here. As we have seen, EU competence for financial markets depends strongly (though not exclusively) on the existence of the single currency, and research has shown that the euro is a key driver of financial integration. In principle this should imply a distinct role for euro-area ministers on financial regulation. In fact, due to its informal nature the Eurogroup plays only a limited role, and all decision-making functions belong to Ecofin, a more heterogeneous grouping where forging consensus is more complex.

The EU institutional architecture in the financial area has grown significantly since the introduction of the euro. Two directions have been taken. At the central banking level, the ESCB created a *Banking Supervision Committee* (BSC), comprising member countries' central banks and other national banking supervisors. The BSC is a natural forum of discussion and information-exchange on banking and financial stability issues, particularly when they are at the crossroads with central bank competence (such as liquidity policy, central bank collateral policies, payments systems, etc.). At the political and regulatory level, the launch in 1999 of the Financial Services Action Plan (FSAP), a broad programme of legislation covering virtually all parts of the financial sector and, in 2001, the launch of its institutional counterpart, the so-called Lamfalussy framework, led to a dramatic increase in the number of group and committee structures (again, Davies and Green have a useful flow-chart, see chart 5, page 128 of their guide). The relevant 'comitology' was set up in formal terms on four levels; in

essence the first two (basic principles and more detailed legislation and regulation) pertain to EU legislators in cooperation with national political authorities, whereas the second two (so-called 'level 3' and 'level 4'), combining supervisory cooperation, national implementation of EU rules and ensuring a level playing field, rely crucially on the capacity and willingness to cooperate of national supervisors. A key step was the creation of the so-called 'level 3' committees (the *Committee of European Banking Supervisors*, or CEBS, on banking, the *Committee of European Securities Regulators*, or CESR, and the *Committee of European Insurance and Occupational Pensions Supervisors*, or CEIPOS), with the mandate to promote, each in its own sphere of competence, the consistent application of EU legislation across all member states. The role of these committees is discussed further in the main text.

A recent episode serves to illustrate the difficulty encountered by the EU in enacting reforms that, though of key importance from an EU-systemic perspective, face resistance because of diverging national views or interests. The Ecofin's attention recently focused on the effectiveness (or lack thereof) of the Lamfalussy framework, notably in a number of key areas: maintaining an efficient flow of information among authorities; ensuring consistent application of European legislation across borders; simplifying compliance with regulatory and supervisory requirements, particularly for large conglomerates operating in several EU countries; supporting prompt and well-informed action in crisis situations. According to the 'framework', in achieving these goals a major role is supposed to be played by the Level 3 Committees (L3Cs), whose function is to promote consistent implementation of legislation and efficient supervisory action in the Union as a whole.

In late 2007 and early 2008 the Ecofin examined several proposals, eventually discussed in the April 2008 informal Ecofin meeting in Slovenia. There was initial consensus that a key issue would be to grant L3Cs sufficient room for manoeuvre to ensure a level playing field in regulatory and supervisory terms. Views diverged on how to do this, and particularly on how binding their decisions should be. The most radical position was taken by Hungary, which suggested the creation of a new Europe-wide financial supervisory authority, modelled on the European Central Bank. This

proposal was difficult to implement because it required a change in the current treaties. The UK proposed to set up, by legislation, new cross-border groups – supervisory colleges and stability groups – to deal both with cooperation and information exchange in normal times and to ensure an appropriate response to crises. This proposal, innovative and consistent with the approach followed at the same time in the FSF (see below), was somewhat outside the existing Lamfalussy framework. Italy's proposal¹⁵ focused on two goals: the establishment of a common set of rules ('single rulebook') to be applied by national supervisors, so that similar cases would be treated equally in all countries, and the establishment of integrated supervision of cross-border groups. All this was to be achieved either by transforming the L3Cs into permanent agencies, or by giving them sufficiently binding force through new EU legislation. The Commission summarised the debate in four options, in increasing order of ambition: 1) clarifying the existing Commission decisions concerning the role and tasks of the committees; 2) as above, but also strengthening their mandate on supervisory cooperation and convergence; 3) including existing and new tasks of L3Cs in EU legislation and relevant directives; 4) transforming L3Cs into permanent EU agencies.

In essence the qualitative divide was between not using (proposals 1 and 2) or using (3 and 4) EU 'hard law' to strengthen the role of the committees. The Ecofin discussion confirmed the reluctance to move beyond a 'soft' approach based on Commission decisions (option 2) to the more powerful legislative instrument. Ministers adopted a conservative, gradualist stance: try a modest approach first, simply clarifying and strengthening the committees' mandates, and then perhaps review it later. Such a position may also have been influenced by concerns that strengthening the L3Cs would erode the position of certain national banking groups, or the influence of national administrations, or both.

But this conservative position ignored two decisive facts: first, the committees' existing charters, if interpreted literally, already contained the main elements necessary to make progress in the four priority areas above¹⁶. If this has not happened so far, it is hard to believe that simply adapting the mandates without more legal force can make a difference. Moreover, gradualism is not a promising option when financial stability is at risk. Although

the discussion took place in the months immediately following the eruption of the mortgage crisis, and amid major concern for the stability of some large banks exposed to the crisis, little or no support was garnered for proposals which could have strengthened the EU regulatory and supervisory environment in a decisive way.

In sum, two things seem to be lacking in the present configuration of international regulatory arrangements (both at global but also at EU level). The first is binding force; decisions often tend to converge on the 'minimum common ground', and therefore lack ambition and vision. The second is sectoral and geographical breadth. These are areas where the recent experience of the FSF, to which we now turn, is of interest and from which some useful lessons can be learned.

THE NEW ROLE OF THE FINANCIAL STABILITY FORUM (FSF)

We have already mentioned that the FSF possesses one key element which boosts its effectiveness: broad participation, both sectoral and geographical. Virtually all authorities, national and international, having the information and influence necessary to deal with any specific problem are represented in the FSF¹⁷. However, this is not sufficient; the comprehensive nature of a group's attendance list does not necessarily imply effectiveness, and may even create confusion. Other complementary elements are a strong mandate, clear focus and good management and leadership.

In October 2008, two months after the onset of the crisis, the G7 ministers and governors meeting in Washington for the IMF/World bank annual meetings asked the FSF to 'undertake an analysis of the causes and weaknesses that have produced the turmoil and to set out recommendations for increasing the resilience of markets and institutions going forward', and to report back to the G7 at the spring meetings (April 2008). This mandate per se is remarkable, first because of its authority (coming from the highest political level), second for its clear and pragmatic/operational content. The reference to 'analysis' and 'recommendations' left no doubt that the FSF was in a short time to come up with proposals that, given the gravity and urgency of the situation, would quickly become

action in all countries involved. As such, the G7 mandate was a significant act of global financial governance, unprecedented in nature and content though fully consistent with the original FSF mandate.

The organisational style was also important (see the website <http://www.fsforum.org/>). After an initial overview and prioritisation of the issues the mandate was broken down into specific tasks, assigned to individual national authorities or international groups present in the FSF, depending on competence and expertise. A restricted working group, composed mainly of supervisors and central bankers, was set up to discuss technical aspects in detail and to come up with recommendations. This ensured that the FSF members possessing the necessary technical expertise would be in the driving seat from the beginning, and would thus come up with policy proposals which were sound.

The report presented in April 2008 at the Washington meetings (available on the aforementioned website) was comprehensive and ambitious in several ways. The bottom line is a sequence of some 65 detailed policy actions, to be undertaken by national authorities, international bodies, the private sector and the FSF itself, by a tight deadline. They are divided into five areas:

1. Strengthening prudential instruments (capital provision, liquidity management, risk controls);
2. Enhancing market information (transparency and valuation procedures);
3. Reforming credit rating (both their provision and use);
4. Enhancing the authorities' response to risks;
5. New arrangements to respond to stress situations.

Since the document is rather long, a summary of the list of recommended policy actions is provided in Box 3, overleaf.

BOX 3: SUMMARY OF THE RECOMMENDATIONS OF THE FSF TO THE G7

The first chapter calls upon the BCBS, IOSCO and national supervisors gradually to raise capital requirements for several instruments, including complex structured products, liquidity facilities for conduits and credit risks in banks' trading books; to review the capital adequacy of monoline insurers; to issue guidance on the management of liquidity risks; to strengthen bank risk management practices using the supervisory powers implied by Pillar 2 of the Basle II accord. It also calls upon market participants to review internal compensation practices and remove incentives to excessive risk-taking, and to review the soundness of the existing operational, legal and settlement infrastructures for over-the-counter derivatives.

The second chapter calls upon market participants and supervisors to review their risk disclosure practices, giving detailed indications about information to be provided. The new guidelines are to be used to make robust risk disclosure on the occasion of the 2008 mid-year reports. It calls upon the BCBS and the IASB to promote, through Pillar 3 of Basle II and better accounting standards, a more effective and internationally consistent disclosure of off balance-sheet exposures. It calls upon the BCBS, IASB and market participants to improve internal valuation practices in a variety of ways. Securities market regulators and private agents are invited to join forces to improve the transparency of securitisation practices.

In the third chapter, a number of recommendations are set out to improve the production of credit ratings, inter alia by avoiding conflicts of interests within the rating agencies; IOSCO is asked to issue a new code of conduct by mid-2008. Specific recommendations are directed at improving the quality of ratings for structured products. Finally, market participants and supervisors are asked to limit their reliance on credit ratings.

In the fourth chapter, several policy actions are designed to improve the authorities' ability to evaluate risk. Supervisory authorities are to enhance their collaboration and information exchange, specifically through the establishment by the end of 2008 of colleges of supervisors for the largest financial institutions. The FSF itself is to strengthen its risk monitoring

work, *inter alia* through better collaboration with other international bodies and regular contacts with financial market participants.

Finally, in the fifth chapter, the recommendations focus on the authorities' ability to deal with stress situations. In particular, central banks are asked to ensure that their liquidity management frameworks are flexible enough to accommodate market needs in difficult circumstances. Authorities are also to strengthen their cooperation in crisis management across borders, and strengthen deposit insurance schemes.

These recommendations add up to a programme for reform of a large part of the global financial system. Most recommendations have an immediate operational impact in areas that fall under the direct competence of national regulators and supervisors. The document clearly signals that the FSF, in which most of them are represented, is to coordinate their action and embodies their regulatory and supervisory power. The document also contains a broad range of initiatives to be undertaken by international organisations, specialised supervisory groups (such as BCBS and IOSCO), standard-setters as well as the private sector. In terms of breadth of coverage, the ability to bring together input and authority from different sources and the relevance of its likely impact, the FSF report to the G7 constitutes an unprecedented act of global governance.

The follow-up after April suggests that the momentum is not being lost; the reform programme is being implemented, though it is still too early to say whether it will eventually be successful. Several steps taken in recent months give us a clue. In an unusually long and detailed press release after its April meeting¹⁸, the G7 endorsed the programme and set tight deadlines for its implementation – 100 days for the most urgent disclosure, accounting and liquidity and risk management changes, end 2008 for the remaining actions in the list. Importantly, the G7 has also given a mandate to the FSF to monitor the process and to ensure its timely execution. After an intermediate report in June at the G7 meeting in Osaka, the FSF was asked to report back more extensively at the October 2008 G7 meeting in Washington, a year after the original mandate was given.

Several factors together contributed to this remarkable exercise in collective policymaking. One, already mentioned, was the presence around the table of all relevant authorities, at national and international level. Another was undoubtedly the urgency and seriousness of the situation. National and international authorities normally inclined to defend their own area of competence and responsibility would hardly have agreed to share information and influence so quickly and to such an extent had they not felt genuine concern about potentially serious consequences for financial stability, but also for their own reputation. From the outset the strong backing provided by the US has been particularly important. The second factor was the clarity and decisiveness of the political mandate given by the G7. Each representative at the FSF table acted with full political backing from home. In addition, the pragmatic and informal working arrangements adopted by the FSF may also have played a role. Different areas of work were identified and assigned to members on the basis of expertise and competence. The set of recommendations was assembled by a working group composed mainly of central bankers and supervisors, before being submitted to the FSF plenary. Effective leadership and internal organisation contributed to generating a pragmatic, results-oriented spirit which helped in reaching agreement very rapidly.

CONCLUSION

While financial interdependence and the cross-border impact of domestic policies have increased in recent decades, financial market regulation and supervision remain predominantly in the national domain, with only a modest quantum of international coordination. This creates inefficiencies and risks, but the more recent crisis experience may help create a consensus for this to change.

There are signs that this may already be happening. The role of the Financial Stability Forum in coordinating the regulatory response to the crisis offers an interesting new model of international cooperation. Circumstances have contrived to give the FSF the opportunity to fulfil its original mandate in a way it has not done before. One trigger has been the widely shared awareness of the risks involved and of the need to act

quickly and cooperatively to avert them, but this alone would not have been sufficient. The 'FSF model' – composed of a mix of a strong political mandate, broad sectoral and geographical representation of competent authorities and effective internal management – is proving effective and indicates what future cooperation among financial policymakers at the global level may look like.

While these seem promising developments, there is no guarantee that lasting progress will be made. The informal arrangements that have applied during the crisis will need to be transformed into more stable structures, where coordination among regulators on crisis prevention can become the rule in normal times. This not only requires cohesion and political will but directly calls into question the role of the IMF. The Washington-based institution has an established structure and its role as the guardian of stable and efficient financial markets has increased recently. Its surveillance tools and conditional lending ability will be valuable, particularly as financial integration extends to emerging economies. On the other hand, the FSF's clear focus and direct link with the leading financial authorities will continue to be essential. The IMF and the FSF provide complementary elements of *supranational* and *international* governance, and hence will need to cooperate, no matter how difficult this may be in practice.

In order to derive benefit from this painful experience, it is vital that protectionist instincts and the temptation to exercise indiscriminate controls be resisted. Neither the regulatory deficiencies nor the errors by market participants which are at the root of this crisis fundamentally call into question the benefits of properly functioning, open and competitive financial markets. If anything, the arguments advanced here suggest the opposite, namely that the system may have suffered from insufficient globalisation (by regulatory and supervisory authorities), not from excessive globalisation (of financial markets). Understandably, a public opinion confused by events and angry at the prospect of unfair burden-sharing in resolving the current crisis may not be receptive to such a conclusion; politicians will have a responsibility to help the public gain an accurate perception of events and policies. The specific solutions chosen to resolve the crisis will also be important in this respect.

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NOTES

- 1 This essay elaborates on a presentation made at the third Bruegel annual meeting conference on 'The new world economic landscape', held in Brussels on 12 June 2008. Most of it was written between July and August 2008, before I joined the ECB as adviser to the Executive Board. I thank Jean Pisani-Ferry for stimulus and advice. Jérémie Cohen-Setton, Giovanni Sabatini and Nicolas Véron offered very helpful comments. The views expressed here are exclusively personal and I alone am responsible for any errors or misjudgements.
- 2 During 2005-2008, the author was Director General for International Financial Affairs in the Italian Ministry of Finance. As such he participated regularly in meetings of the Financial Stability Forum and Ecofin.
- 3 See Lane and Milesi-Ferretti, (2008). Financial integration in the euro area has accelerated strongly since EMU, see Lane (2008).
- 4 A similar argument is made by Véron (2007).
- 5 See Alesina, Angeloni and Etro (2005).
- 6 See Alesina, Angeloni and Schuhknecht, (2005).
- 7 See Pisani-Ferry and Sapir (2007).
- 8 See Lane and Milesi-Ferretti (2007).
- 9 Again on this point, Lane and Milesi-Ferretti (2008) note that 'the substantial decline in home bias in advanced economies, together with their more advanced stage of financial development, has implied a spectacular increase in the amount of cross-border capital, and hence the potential for significant effects on individual countries of even modest shifts in cross-border portfolio allocation'.
- 10 For remarks along these lines see White (2008).
- 11 See Reinhart and Rogoff (2008)
- 12 Passing single market directives requires qualified majority in the Council, which under the current Nice Treaty means meeting three cumulative criteria: simple majority of member states, 74 percent of the Council votes and 62 percent of the EU population. According to Baldwin et al (2001) these criteria are difficult to meet and imply a decline in the Council's decision-making efficiency relative to earlier treaties.
- 13 See Davies and Green (2008).
- 14 Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States.
- 15 The document circulated at the meeting is available in the website of the Italian finance ministry, see Ministero dell'Economia e delle Finanze (2008).
- 16 A partial exception is CESR, whose original mandate only mentions a role of advisor to the Commission, not that of fostering and monitoring a consistent application of EU laws in the member states.
- 17 FSF membership includes the following: senior representatives from the treasury, the authority supervising financial markets and the central bank of each G7 country; the central bank governors of Australia, Hong Kong, Singapore,

Switzerland, the general manager of the BIS, the Vice President of the ECB, the Deputy managing Director of the IMF, senior officials of the World bank and OECD, plus the chairpersons or top representatives of the Basel Committee on Bank Supervision, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, the International Accounting Standards Board, the International Organisation of Securities Commissions and the Joint Forum. Representatives of other organisations may also be invited on an occasional basis.

18 Available at: <http://www.ustreas.gov/press/releases/hp919.htm>.

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TESTING TIMES FOR GLOBAL FINANCIAL GOVERNANCE

by
Ignazio Angeloni

In the last ten years, cross-border holdings of financial assets as a percentage of GDP have tripled within Europe and doubled between Europe and North America. Yet the assignment of responsibilities for financial regulation and supervision has hardly altered. In spite of the higher degree of integration within Europe and for all the institutional and legislative apparatus in place in the European Union, cooperation at the global level within the framework of the Financial Stability Forum (FSF) is proving significantly more effective.

As the world moves towards an overhaul of global finance rules – probably resulting in significant regulatory tightening – Ignazio Angeloni asks whether the combination of political mandate, informality and national enforcement will suffice, or if there is a need for a more formal international authority.

IGNAZIO ANGELONI, former Director for International Financial Relations at the Italian Ministry of Economy and Finance, joined Bruegel in June 2008 as a visiting scholar. He was also Deputy Director General for Research at the European Central Bank.

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