Rethinking global financial systems

By Kevin Tan

The consensus is loud and clear: in the wake of the worst global financial crisis since the Great Depression, a fundamental rethink of the structure of the global financial markets and greater cooperation of the major regulatory bodies are paramount, said the heads of major financial institutions at the World Knowledge Forum in Seoul.

And ahead of a meeting of the G20 nations in mid-November to discuss financial reforms, leaders from the 45 member nations of the Asia Europe Meeting (ASEM) have pledged to cooperate in overhauling the world's financial systems and called on the International Monetary Fund (IMF) to 'play a critical role' in assisting countries most in need of aid.

At least five countries have reportedly sought the help of the IMF in injecting capital into their economies. The IMF, which has agreed to lend Ukraine $16.5 billion to ease the impact of the financial crisis, is also lending $2 billion to Iceland. Meanwhile, Hungary is reportedly close to securing a 'substantial financial package' from the IMF and the European Union.

Speaking at the World Knowledge Forum, **Douglas Feagin**, head of Goldman Sachs' financial institutions group for Asia, believes that reforms of the financial services sector are crucial in restarting economic growth in the US, Europe and the rest of the world.

Pointing to the bubbles in key asset classes, “unclearly unsustainable” leveraging in the financial systems, and poorly understood and managed derivative securities, Feagin says: “We are going to have to have a change across all these areas – the asset price bubbles, deleveraging and reform of the fundamental securities markets – in order to have a basis to restart economic growth.”

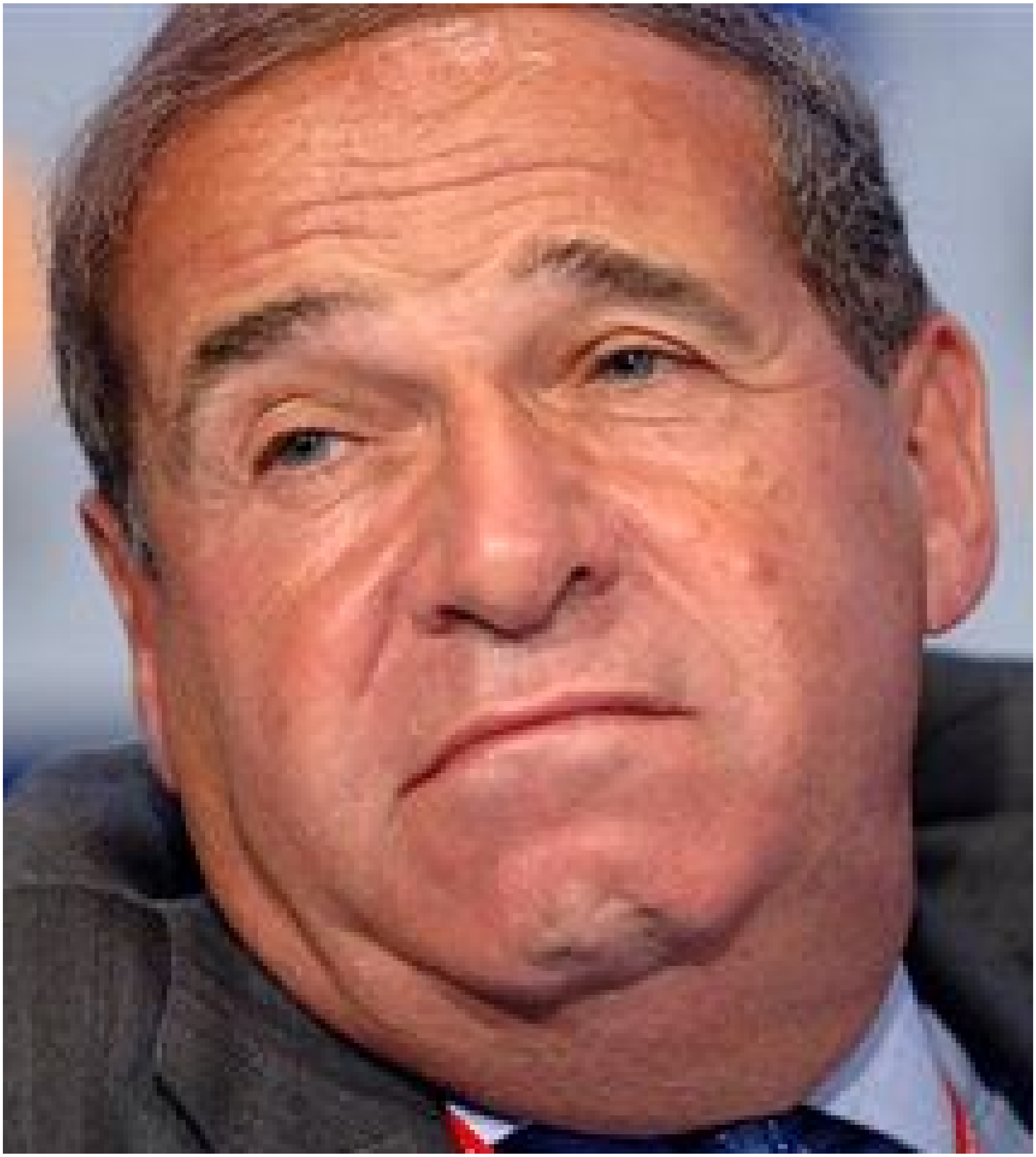
Meanwhile, fears of a global recession continue to weigh heavily on financial markets around the world, even as many individual countries – such as Australia, Japan, South Korea, Singapore, Kuwait and Saudi Arabia – have announced new financial and regulatory measures to shore up their financial systems and currencies, and boost confidence.

Governments around the world have so far reportedly pledged about $4 trillion to bolster banks and restart money markets. China, South Korea, Japan and ten Southeast Asian countries have also pledged to create an $80 billion fund to combat currency speculation.

“I think we are going to see for the first time a private-public sector partnership and a globally coordinated attack on some of the underlying weaknesses in our global economy,” says **Steve Ellis**, worldwide managing director of consultancy Bain & Company.

"If we continue to act as the really globalised economy we are today, and if we maintain that tight linkage between public and private sector in ways that can reinforce the flow of capital, that can hopefully reinforce economic growth and address some of the very pressing issues facing our planet, I think we could look back on this as a real catalyst."

While there appeared to be consensus among the speakers at the Forum that comprehensive reforms of the global financial systems are needed, opinion was split between some calling for a universal financial regulatory body and those supporting closer and greater cooperation between the major regulatory bodies around the world.



Sir Leon Brittan, vice chairman of UBS Investment Bank, expressed scepticism about former Irish prime minister Bertie Ahern’s suggestion about the creation of such a universal regulatory body. Brittan, a former vice president of the European Commission, says he doubts this would be a “correct solution” given the presence of the IMF and the World Bank, as well as the protracted length of time needed and the significant challenges in creating such a regulatory body.

Brittan says a ‘more promising avenue’ would be a “college of regulators – and not a new super regulator – which would work closely together, with detailed regulations being applied in each individual country.”

“Cooperation between international regulators on a greater scale – even though it is already taking place and one shouldn’t underestimate the extent to which it is already happening – is something that is going to be important.”

Agreeing with Brittan, **Jeffrey Shafer**, vice chairman of global banking at Citigroup, criticised calls for “a universal global body with no direct democratic accountability” as an “ivory tower fantasy” and “a diversion of energy”.

Shafer, a former Under Secretary of the US Treasury, favours a focus in the US on regulatory functions rather than just on individual institutions. Regulatory bodies, he says, are needed to look into systemic risks and the activities of individual financial institutions.

“You need to give that systemic institution the power to intervene and actually make individual institutions do things when they see large imbalances emerging in the world, and that will be a tough thing to get into the regulation at the end of the day,” says Shafer.

To be sure, overhauling the financial regulatory frameworks around the world is a dicey proposition because while bad regulations can create crises, it’s not certain that good regulations can prevent them, cautions **Paul Tregidgo** , a vice chairman of the investment banking division of Credit Suisse.

The fundamental issue “right at the centre of the (financial) storm” lies in how risks are created, assessed, distributed and regulated, which are regulatory questions that must be addressed, says Tregidgo.

“Do we actually know when we create risk what we are creating? … When we assess risk, are we actually assessing risk in a world of global connectivity? Do we understand the cost and price of risk as it should relate to other instruments?”

“Do we understand that when it is subject to stresses which we have not experienced before, and lastly when we distribute risk, are we really distributing it?”

Tregidgo adds there is a need for closer regulatory oversight of how major financial intermediaries approach, assess and price risks.

“It’s time for a new regulatory contract but that regulatory contract, broadly speaking, must balance the complexity and connectivity of which I spoke earlier,”

“I would suggest minimal regulation but forceful in letter and spirit because innovation … is not going to go away and must be encouraged to flourish. But innovation cannot be allowed to game the system.“

Certainly, there are mixed views about how best to balance regulatory oversight and allowing room for financial innovation to spur economic growth. But for the next few years, ‘de-structuring’ or structural changes to banks and financial institutions will be a theme, says **Michael Gordon**, global head of institutional investments at fund manager Fidelity

International.
“Regulation is going to have a goal of trying to get us to a more simple financial world,” says Gordon. “We may look forward to a world where banks are more like banks as we used to know them, brokers more like brokers, corporate finance returns as a function of itself, asset managers being pure asset managers and the like,”

“I think we will see a trend back to simplicity away from complexity. I think financial modelling will be less trusted.”

For now, the concerted efforts of central banks and major financial institutions around the world to inject liquidity to resolve the global credit seizure are working, says Goldman Sach’s Feagin.

“We are now seeing people starting to be comfortable opening up the markets again,”

“I think we have seen some pretty dramatic steps and some pretty positive steps but a huge uncertainty remains, and this is going to take many years to get fully resolved.”

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