# Blueprint for a new international financial order

By Jean Dermine

**Politicians have acted decisively to restore confidence and liquidity in the banking sector through the injection of capital and guarantees on interbank loans. The UK, continental Jean Dermine - INSEAD KnowledgeEU countries, the US and Switzerland, have injected new capital into their home banks, increasing capital ratios. Political leaders are now calling an international conference for a new international financial order to discuss the creation of a supranational supervisory body, Bretton Woods II.**

Some possible specifics of this new international financial order can be found in past studies – in particular in the context of the European Single Market created in 1992. Two main findings in the literature are as follows:

1. Capital adequacy is not enough.
Raising capital too much can have unintended consequences. Equity capital is costly, leading to the higher cost of bank loans, forcing low-risk borrowers to look for alternative sources of funds. This means banks will end up financing riskier loan portfolios.

The origin of the crisis was not a shortage of capital, but a liquidity crisis (CDOs or other complex illiquid portfolios funded with short-term commercial paper).  In the new international financial order, one needs regulations related to liquidity. Excessively high capital ratios do not address this and may even exacerbate this.

A second source of the crisis was the existence of large and complex financial institutions (LCFI).  Benefiting from implicit public guarantees, these were allowed to grow. A new international financial order needs to regulate increased liquidity and question the existence of LCFIs.

**2. Supranational supervision has limits**

One main benefit of a supranational supervisory body would be to deal with cross-border externalities. It would be able to absorb the costs arising from the default of an international bank. But this ignores the conflicting agendas of domestic supervisors, since taxpayers' money comes from one particular country.

The same would be true for the insurance/bailout function and the supervision of risks. The creation of an international supervisory body would not eliminate the need for the domestic authorities. For example, the UK and the US would not surrender their right to supervise domestic financial institutions when they are in charge of financing a bailout. This reasoning has led New Zealand, with a banking system 90 per cent-controlled by Australian banks, to call for stand-alone, independent subsidiaries that can be controlled by the New Zealand supervisor.

In addition, does one need an additional international structure, when the International Monetary Fund, with its Financial Sector Assessment Programme (FSAP), the Bank for International Settlements (BIS), the European Central Bank (ECB) or the Organisation for Economic Co-operation and Development (OECD), are already using public resources to monitor international financial markets?

If the existence of a supranational supervisor and tougher capital ratios are not the panacea, what can be done to reduce the risk of a crisis? First, existing supervision can be improved, with a better balance between banks, politicians and supervisors. Moreover, civil servants need to be held accountable. How many finance ministers and supervisors have resigned so far?

Based on the frequency of crises (related to hedge funds, the internet bubble and subprime crisis), more public control is insufficient, so we also must increase private incentives to control bank risk. How? Debt holders must face substantial risk. In the current situation, debt holders have benefited from the blanket guarantee or capital injection given by public authorities, unlike the equity holders. The LCFI and ‘too-big-too-complex-to-fail’ doctrines must be abandoned.

For this to happen, we need a special bankruptcy system for financial institutions. Given the Lehman Brothers experience, it must meet three criteria: closure followed by a rapid resolution to maintain liquidity in the market; the legal means to force rapidly a swap of equity for debt claims; and, finally, transparency regarding the exposure faced by counterparties. The last point prevents a domino effect in the markets: the default of one counterparty having limited impact on other institutions.

The acid test for the new international financial order is whether a large financial institution is allowed to go bankrupt. If the answer is yes, debt holders will care about risk, and the pressure will increase on auditing firms and rating agencies to do a proper job. If the answer is no, we will be back to a system of implicit guarantees, letting large institutions grow while the control of risks is left solely to public supervisors.

Cynics will say that politicians are seizing the momentum, surfing on the crisis with their proposal for a series of international conferences on the new international financial order. But the exceptional magnitude of the crisis demands analysis and reforms to prevent any repeat.

However, one should avoid unnecessary costly regulatory burden; or confuse regulation of liquidity with capital regulation. One needs increased accountability in public supervision. Finally, one needs a special bankruptcy system for banks. It is only when the debt of large institutions is at risk that proper private incentives will exist to limit risk-taking. The ‘too-big-to-fail’ doctrine must be abandoned.

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