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**South Asian Financial Systems at a Crossroad: Promoting Stability and Growth**

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***Panel Discussion: The Future of the International Financial Architecture***

1. Which are the most urgent policy measures to overcome the pre-crisis flaws of the international financial architecture?

The financial crisis has revealed significant aberrations in the global economic as well as in the financial system. At the macroeconomic level, global imbalances and a prolonged period of very low interest rates resulted in a significant mispricing of risks and an unprecedented search for yield. In the financial system, distorted incentives, insufficient risk management, and lack of transparency on the part of financial institutions and serious flaws on the part of rating agencies led to excessive leverage and maturity mismatches. Supervisory and regulatory authorities failed to detect and mitigate these deficiencies at an early stage. Given the increased interconnectedness of financial markets, international cooperation was also insufficient.

The international community has responded to the challenge. Shortly after the outbreak of the crisis the G7 Finance Ministers and Central Bank Governors had mandated the Financial Stability Board (then still the Financial Stability Forum) to analyse the causes of the crisis and to set out recommendations for increasing the resilience of financial markets and institutions. This FSB report and further reports issued in April 2009 were an important input to the recommendations by the G20 at their summits in Washington in November 2008, in London in April 2009 and in Pittsburgh in September 2009. Crucial reform measures comprise:

- A ***strengthening of prudential regulation***: The Basel Committee has already strengthened risk and liquidity management requirements. In particular, in September 2008, the Basel Committee published *Principles for Sound Liquidity Management*; in May 2009 it issued *Principles for Sound Stress Testing*. Crucially, in July 2009 the Basel Committee raised capital requirements for trading book activities, re-securitisations, and liquidity lines to ABCP conduits. Recently (September 2009), the oversight body of the Basel Committee also decided to raise the quality, consistency, and transparency of the Tier 1 capital base, to introduce a leverage ratio and countercyclical capital buffers. The G20 in Pittsburgh endorsed this work program and asked Finance Ministers and Central Bank Governors to develop concrete proposals by end-2010. The Basel Committee oversight body also decided to introduce by end-2009 a minimum global standard for funding liquidity.

- A ***reform of compensation practices***: Important steps have been taken to improve incentives in compensation schemes: In April 2009 the FSB issued *Principles for Sound Compensation Practices*; in September it complemented these Principles by issuing *Guidelines* for their implementation. The Principles and Guidelines stipulate, for example, that a significant portion of variable compensation will be deferred, tied to performance and subject to clawback; they also require that compensation policies and structures are disclosed. These Principles and Guidelines are now being implemented at the national level and implementation will be monitored by the FSB (to report by March 2010).
- A ***broadening of the scope of regulation***: the oversight and regulation of rating agencies and of OTC derivatives markets has been improved. For rating agencies the IOSCO published a strengthened *Code of Conduct* in May 2008, in OTC derivatives markets central counterparties have been established for clearing CDS. Also, for the first time, hedge funds shall now be subjected to appropriate supervisory and regulatory oversight; the IOSCO has published *Principles for Hedge Funds* in June 2009.
- An ***improvement in international cooperation***: the FSB and the IMF have increased their cooperation and will now regularly conduct Early Warning Exercises to detect risks and vulnerabilities in global financial markets and develop recommendations to mitigate these risks (on cooperation see also below, section 2)

Going forward the international community will, in particular, have to ensure that the agreed reforms are seen through and that the implementation at the national and regional level is consistent, not least to ensure a ***level playing field***. This applies foremost to compensation practices, and the supervisory and regulatory regimes for rating agencies and hedge funds. But it will also be a challenge to develop and implement a ***macroprudential approach to supervision***. A crucial area for further reform also concerns the risk from ***financial institutions that are "too big to fail"***. The FSB is developing measures, which could include additional prudential requirements for systemically important institutions and a framework for the resolution of globally active firms. Finally, it is important that international accounting standard setters make progress developing improved and consistent standards.

2. How could international cooperation between supervisory authorities and regulators be improved?

Since the outbreak of the crisis the international community has already taken important steps to strengthen international cooperation between supervisory and regulatory authorities. In particular:

- ***Supervisory colleges have been established for over 30 of the global financial institutions identified by the FSB.*** The colleges will be a crucial venue for strengthening information sharing among home and host supervisors. The FSB will continue to support the working of the colleges, for example by examining whether best practices, including on information sharing, can be incorporated into a protocol.

- ***The framework for cross-border crisis management*** has been improved. In April 2009 the FSB issued *Principles for Cross-border Crisis Management*. An FSB working group is now supporting discussions to develop firm-specific cross-border contingency planning.
- The G20 ***framework for fostering the adherence to international standards*** will also improve international cooperation. The G20 has made clear that they are committed to fight non-cooperative jurisdictions in the areas of tax information exchange, money laundering and terrorist financing and in the prudential area, in order to avoid an unacceptable drain of government resources and regulatory arbitrage. To this end the OECD Global Forum, the FATF and the FSB are all developing robust peer review processes to evaluate the implementation of international standards and to engage jurisdictions of concern. All organisations are committed to assist jurisdictions that lack sufficient implementation due to capacity constraints, in particular through the provision of technical assistance through IMF and World Bank programs.

3. What reform measures are most needed to restore legitimacy and policy scope of the IFIs?

In order to strengthen their governance, many ***international institutions and organisations have already broadened their membership***. In particular,

- the FSB's membership has been broadened to include now all G20 members. Its mandate for ensuring financial stability and its internal structures to fulfil this mandate have been strengthened. Since the outbreak of the financial crisis the FSB has reported regularly to the G20 Finance Ministers and Central Bank Governors; as was the practice before the crisis, the FSB has published all its reports.
- Other bodies have also expanded their membership, including the Basle Committee, the IOSCO Technical Committee, and the Committee on Payment and Settlement Systems - CPSS.
- The IMF has taken important steps to increase the inclusion of financial sector issues into its bilateral and multilateral surveillance, including by reforming the Financial Sector Assessment Program. The Pittsburgh summit has also added an important new aspect to the IMF's surveillance agenda by tasking the IMF within the new Framework for Growth to assist the mutual assessment of national economic policies with regard to their consistency with a sustainable and balanced global growth and to provide regular reports to the G20 and the IMFC. The international community furthermore tripled the funds available to the IMF, and the Fund has proved remarkably flexible in adapting its lending framework to new circumstances, for example by creating the Flexible Credit Line. The international community is also committed to strengthening IMF governance, including by shifting quotas to dynamic emerging and developing countries. Finally the international community is committed to an open, transparent and merit-based selection process for the heads and senior leadership of all IFIs.

It is now important to implement and then evaluate experience with the agreed reforms.