

## Network of Global Agenda Councils

### Discussion highlights on Financial Market Development

at the Summit on the Global Agenda, Dubai, United Arab Emirates 7-9 November 2008

*This reflects work that is still in progress. It will continue to be updated and revised.*

*The views expressed here emerged from the Council meeting and do not necessarily reflect the views of the World Economic Forum or those of all the Council Members.*

#### 1) What is the state of the world on this issue and how is the economic crisis impacting it?

The Council on Financial Market Development focused on key policy issues related to the development of financial systems in emerging markets. These are oriented to two broad areas: post-crisis models for financial system development in emerging markets and the integration of these financial systems into the international regulatory architecture.

Empirical findings illustrate the beneficial impact of financial market development on overall economic growth and improved economic opportunity for individuals. However, in light of the financial crisis, the world has begun to reassess the relationship between governments and financial markets.

Research supports the generally positive roles of privately-owned financial institutions and market competition in promoting growth and opportunity. Nevertheless, pervasive market failures and the global reverberations of the current crisis highlight the value of domestic and global regulatory systems that provide sound incentives for private market participants and that limit systemic risk. Government intervention to save an unprecedented range of financial institutions has affirmed and expanded social expectations of the role of government in finance.

Recent developments warrant a sober review of financial policies along multiple dimensions.

1. **Legitimacy and accountability.** The crisis has shaken the overall legitimacy of national and international financial policies and institutions. The recent crisis has exposed sizable gaps in the risks and activities addressed by regulatory organizations.

***Response:** At the global level, the representation of emerging market economies in international regulatory bodies as commensurate with their economic importance will enhance the legitimacy of these bodies. The relevance of international bodies will be improved if there are mechanisms and incentives for domestic regulatory agencies to act on their recommendations. Greater accountability and participation of the full range of relevant domestic regulatory agencies, along with the cultivation of political support for this participation, will enhance their effectiveness.*

2. **Global regulatory architecture.** Financial markets are global, suggesting the value of a regulatory architecture that looks beyond national borders. One of the persistent problems in international organizations is to balance legitimacy, which requires wide membership, with agreement, which typically becomes more difficult as a group expands. Within finance, a second problem is that regulatory authority is, and is likely to remain, national due to deeply ingrained differences in legal systems.

***Response:** Given the global nature of finance, close coordination and cooperation among financial regulatory bodies is imperative for effective regulation. There is the potential to fortify an existing international regulatory body or regulatory bodies (such as the Financial Stability Forum) or create a new, more robust organization which would still allow for heterogeneity across domestic regulatory regimes. Features of this organization might include:*

- *Staffing depth to monitor development in global financial systems and coordinate responses*

- The development of a set of core principles of effective regulation which could be promoted and implemented in a consultative capacity to domestic regulatory bodies
- The discouraging of unhealthy and potentially destabilizing “regulatory competition” between countries as the steward of enhanced “Memoranda of Understanding” between countries
- The comprehensive monitoring of the full range of financial market activities (e.g., lending, securities underwriting, insurance, derivatives, etc.) perhaps working with existing specialized international bodies (e.g. IOSCO, IAIS, IASB, etc.).

3. **Multidisciplinary nature of financial policy.** The crisis advertises inadequate communication and coordination among policy-makers focusing on particular issues, including monetary policy, macro-prudential regulations and the particular activities of financial institutions, including lending, underwriting, insurance, derivatives trading, etc. For example, the burgeoning credit default swap market produced systemic risks that were not adequately addressed by the insurance regulators overseeing the writing of these contracts, or by bank supervisors charged with limiting bank risk-taking.

**Response:** *There are different institutional forms for reducing the balkanization of financial regulation and enhancing the national and international assessment of financial risks. Regardless of the precise institutional form, the current crisis reminds us of the importance of developing greater capacity to assess risk across a wide range of financial market activities. This includes the systematic monitoring and assessment of macroeconomic indicators as indicators of systemic risk.*

4. **Regulatory system adaptability.** Regulation must adapt to financial innovation to maintain sound incentives. For example, credit rating agencies worked well for much of the last century. However, the boom in structured products and the hiring of credit rating agencies to both create and rate those products produced powerful conflicts of interest. Credit rating agency profits and employment boomed. Regulators did not adapt.

**Response:** *Regulation should not thwart financial innovation, which is a crucial input into technological innovation and entrepreneurship – it should move in tandem. The international community has an important role to play in advising and supporting countries in developing mechanisms for adapting regulations to changing conditions. This includes helping countries overcome the political challenges of creating financial regulators powerful enough to adapt to financial innovation, yet not so strong as to abuse those powers and distort the effectiveness of the financial system.*

5. **Capacity of regulators.** As financial markets and institutions become more complex and more global, the burden on financial policy-makers has grown dramatically. Those involved in financial policy-making must assess the incentives of individual actors, as well as systemic risk. Financial policy analysts must examine national economic conditions, international developments, and also write very detailed laws and regulations regarding contracts, markets and transactions. Thus, financial policy involves the involvement of macroeconomists, financial economists, lawyers, regulators, political scientists and private market participants. There is a growing concern, in developed and emerging economies alike, about the capacity of financial policy-makers to obtain and marshal these skills effectively, quickly and on an ongoing basis.

**Response:** *Effective financial policy involves the coordinated deployment of an integrated range of skills. Proficiency in related disciplines such as macroeconomics, law and corporate governance are essential to the systematic, cross-disciplinary communication and integration necessary for effective policy-making. This capacity is needed at both the domestic and international levels and can assist emerging market countries in learning from the current crisis, assessing systemic risks and limiting excessive risk-taking within a competitive, market-oriented system.*

6. **Governance of financial institutions.** Recent visibility of “non-correlated” executive bonuses are symptoms of the larger failures of shareholder governance over financial institutions. The inability of owners to deter individuals or divisions from undertaking decisions which are contrary to the long-run profitability of firms highlights the need for better private governance mechanisms.

**Response:** *As emerging market financial institutions become more widely-held, rather than having large, controlling owners, recent events advertise the urgent need to strengthen shareholder protection laws and empower shareholder governance over financial institutions. Furthermore, to the extent the corporate compensation structures create a systemic risk problem, this provides a legitimate reason for regulatory concern.*