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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMMITTEE ON FINANCIAL MARKETS

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OECD ENHANCED ENGAGEMENT COUNTRIES AND THE CURRENT ECONOMIC AND FINANCIAL CRISIS

Discussion note for the OECD Policy Dialogue on Financial Markets with Enhanced Engagement countries

8 October 2009

The meeting will be held from 14:30-18:00 on Thursday, 8 October 2009, and will take place at the OECD Headquarters in Paris, Château de la Muette, in Room CC12 of the Conference Centre, entrance at 2 rue André-Pascal, 75016 Paris. More information about the venue, including a list of hotels in the vicinity, can be found at www.oecd.org/conferencecentre.

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Discussion note for the OECD Policy Dialogue on Financial Markets with Enhanced Engagement countries[1]

8 October 2009

A. Meeting background and overview

This meeting is part of the OECD Enhanced Engagement initiative...

1. The Policy Dialogue on Financial Markets with financial policymakers from Brazil, China, India, Indonesia and South Africa is scheduled as part of the OECD Enhanced Engagement initiative. A central element of this initiative is the promotion of direct and active participation of these five countries in the work of substantive bodies of the Organisation. Already in the past the OECD Committee on Financial Markets (CMF – *Comité des marchés financiers*) has held special sessions with delegations from China (March 2005 and April 2006) and India (October 2007).[2]

...and is held with the OECD Committee on Financial Markets

2. This time, for its October 2009 meeting, the CMF is gathering Delegations from all Enhanced Engagement for a Policy Dialogue. This event takes place in conjunction with the regular session of the CMF and will allow for an off-the-record discussion between Committee members and the representatives of the Enhanced Engagement countries. The CMF comprises officials from OECD finance ministries, central banks, and other financial authorities, and meets biannually to review structural, institutional, regulatory, and market developments.

The discussion will focus on issues related to challenges that Enhanced Engagement (EE5) countries are facing in the current difficult environment

3. This note provides a general overview to guide the discussion at the Policy Dialogue, which will focus on the following issues:

- Current financial market developments with a focus on those related to the current financial and economic crisis;
- Structural issues and selected financial market reforms in Enhanced Engagement (EE5) countries;
- Financial policy issues focusing on elements of the OECD Strategic Response to the crisis, in particular priorities for reform and strategies to phase out emergency measures in the financial sector.

Companion papers to provide more detail

4. Along with this note, a companion paper ["*Structural developments in the financial systems of Enhanced Engagement countries*", DAF/CMF(2009)18], is being distributed which provides more detail on the second discussion item above, *i.e.* structural financial market issues and selected financial market reforms in Enhanced Engagement countries. More detail on the third item is provided in

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[1] The main text of this note was prepared by John K. Thompson.

[2] The background and discussions of these meetings are summarised in "Financial System Reform in China: Discussions with Chinese Authorities", *OECD Journal: Financial Market Trends*, No. 91, vol 2006/2 (November); and "Indian Financial System Reform: Selected Issues", *OECD Journal: Financial Market Trends*, No. 93, vol 2007/2 (November).

the "*Report on the Strategic Response: Finance, Competition and Governance: Priorities for Reform and Strategies to Phase out Emergency Measures*" [C/MIN(2009)9/ANN1], a document prepared for the Meeting of the OECD Council at Ministerial Level, 24-25 June 2009, and being re-distributed as background material to participants of this Policy Dialogue.

Box 1. Issues proposed for discussion

Round 1 *(approx. 45 min)*: **Financial market developments and issues related to the current financial crisis**

- **What are the main vulnerabilities in the international financial architecture that led to the present financial crisis?** To what degree did flaws in the prevailing institutional, competitive and regulatory model for finance as accepted in major OECD countries and major financial centres contribute to the crisis? What were the main reasons that, broadly speaking, the financial systems of EE5 countries weathered the current crisis better than most OECD countries? And why did some EE5 countries perform better than others?
- **What are the main risks to the financial systems of EE5 countries stemming from continued turbulence in financial markets?** What lessons do the EE5 draw about the need to make their own financial systems more flexible and capable of facing the challenges of middle income economies while minimising risk of future crises?

Round 2 *(approx. 1h30)*: **Structural issues and selected financial market reforms**

- **Representatives of EE5 countries are invited to open the discussion by summarising** (for 5-10 minutes each) **broad trends and policies in their own countries**. Some key issues are proposed in the following.
- **Why has lending by banks remained the dominant form of financial intermediation in the EE5 countries?** Why have **bond markets** of the EE5 developed so moderately, lagging behind those of OECD countries, while **equity markets** have progressed so rapidly? Do EE5 representatives expect **institutional investors** to gain in importance and if so how will this impact the financial system?
- **Since the onset of the present crisis, how have the country's policies regarding liberalisation and deregulation evolved**, in particular with regard to *(a)* bank privatisation; *(b)* market access for foreign institutions and investors; *(c)* domestic deregulation, financial innovation and liberalisation of capital movements? Why have most EE5countries decided to retain large-scale public ownership of banks while allowing private and foreign interests to participate as minority investors?
- **Will attitudes of the regulators change** with regard to *(a)* capital requirements and *(b)* acceptance of banks' in-house risk management models? To what degree have countries re-examined institutional arrangements for financial supervision and for the systemic "safety net" as a result of the crisis? What should be the role of central banks in assuring systemic stability?

Round 3 *(approx. 45 min)*: **Exit strategies, further regulatory reforms, and the new financial landscape**

- **What will the international financial system look like after the present crisis?** Do participants see any risk that financial turbulence may recur? Would participants wish to give their ideas about how the general recommendations of the G-20 might be implemented with respect to *(a)* revised norms for the application of Basel II rules, including capital requirements; *(b)* comprehensive coverage to assure that all systemically important institutions are subjected to adequate regulation; and, specifically, *(c)* the regulation of hedge funds, OTC derivatives or rating agencies?
- **What are the observations of representatives of the EE5 countries concerning the OECD "Exit Strategy"?** Which elements of the strategy would they see as most relevant for their countries? Are there key elements not mentioned that should be included? Should we be concerned about maintaining or creating financial institutions that are too big to fail? Would the adoption on a non-operating holding company (NOHC) structure limit the risk of contagion?
- **Will new international financial centres emerge in EE5 countries or other non-traditional regions?** Will financial institutions from non-OECD countries and sovereign wealth funds emerge as "new power brokers"? How will the emergence of new international players influence the process of setting rules for the international financial system?

Issues proposed for discussion and procedure

5. Issues proposed for discussion may be found in Box 1. The questions raised are believed to be germane to these topics but are not exhaustive, and participants are encouraged to raise other points they wish to bring to the attention of the other delegates. Participants' interventions should be informal and short (5-10 minutes for lead speakers). The meeting is intended to be an open exchange of views between members of the CMF and Delegates from Enhanced Engagement countries. Committee Members may use the information gleaned from the discussion to inform subsequent debate or as background information for follow-up work or studies, but specific remarks by participants are not for attribution and participants are encouraged to speak openly. EE5 Delegates may, should they wish, provide a limited amount of focused material to be circulated and made available at or before the meeting.

B. Current financial market developments and crisis-related issues

The most severe financial crisis in generations has led policymakers to provide unprecedented fiscal and monetary stimulus

6. The meeting is being held against the background of the most severe financial crisis in generations.[3] A substantial part of the accumulated wealth of OECD countries has been lost as a result of drops in bond and equity prices. Many of the world's largest financial institutions became insolvent and/or required expensive official rescues. The authorities in OECD countries have provided an unprecedented fiscal and monetary stimulus to prevent further contraction of income. Indeed, the shocks of the past two years are so severe that some analysts and policy makers have begun to question many aspects of the model of finance that had gained currency among OECD countries over the past few decades.

A wave of deregulation and liberalisation transformed the financial sector

7. A wave of deregulation and liberalisation has taken place in the past few decades reflecting the assumptions *(i)* that market-based outcomes are preferable to government-mandated outcomes and *(ii)* that private financial institutions had substantially improved their capacity to manage risk. With freedom to experiment and to operate globally, financial institutions engaged in a process of innovation and internationalisation on a scale that transformed finance from a nationally segmented and heavily regulated sector of the economy to one of the most global and market-driven.

The prevailing banking paradigm placed great confidence in the self-regulating properties of the market

8. The prevailing banking paradigm placed great confidence in the self-regulating properties of the market. It was assumed that when a bank is adequately capitalised and observes sound corporate governance practices, management will develop adequate risk management systems to assure that high standards of profitability and financial soundness are maintained. This presumption underlay the Basel II capital adequacy rules which enlarge the scope for banks to utilise their own in-house risk management models. This also led to an increase in banks' off balance-sheet activities, fuelled their "originate-to-distribute" business model and fostered the development of an ever more important "shadow banking" system. Credit rating agencies played their part in underestimating risks of related risk-transfer vehicles (structured products).

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[3] For more background information on and an account of developments leading up to the crisis see the relevant articles in several of the past issues of the OECD Journal *Financial Market Trends*, available at www.oecd.org/daf/fmt.

Supervisory authorities became more inclined to allow banks to devise their own risk strategies

9. Under the new paradigm the bank's internal governance and risk management would be supplemented by disclosure and discipline exercised through the markets. In this environment, the supervisory authorities became much more inclined than in the past to allow banks to devise their own strategies in line with their own risk/reward preferences. Rather than analysing banks' loan portfolios in detail, banks supervisors saw their role as one of engaging in dialogue with the directors and senior management about the risks the bank is taking and whether risk management systems were adequate to deal with those risks.

Risk management systems were considered to be sufficiently robust to withstand any likely shocks

10. The crisis follows a long period in which financial institutions, identifying risk management as one of the central tasks of banking, made large expenditures on systems to quantify and manage risk. However, in the past few years many analysts had called attention to the steady erosion of normal risk premiums in credit and equity markets as well as liquidity premiums. But bank management and boards, rating agencies and supervisors all concluded that risk management systems were generally sufficiently robust to withstand any likely shocks. From the vantage point of the present, however, the system clearly contained more risks than each institution could observe in managing its own position or that supervisors could detect in monitoring each institution.

The extent of risk transfer to the private sector was overestimated

11. The degree to which risk had been successfully transferred to private market participants, especially to the shareholders of financial institutions (and away from the taxpayers) was overestimated. As the crisis unfolded it became plain that risks that had been presumed to be wholly borne by private market participants would have been systemically intolerable. As governments and central banks extended massive support, even banks of modest size were judged to be systemically vital. Furthermore, institutions (notably investment banks) that had been seen as lying outside the official "safety net" were eventually judged too systemically important to fail.

Pressures from the financial system are now exerting strongly negative influence on the real economy

12. Despite efforts to recapitalise banks and remove troubled assets from bank balance sheets, credit has been contracting as banks are seeking to conserve capital and reduce risk with many smaller and marginal borrowers coming under extreme pressure. These pressures from the financial system are now exerting strongly negative influence on the real economy. Thus, despite huge fiscal and monetary stimulus, the OECD Secretariat in June 2009 projected average GDP in Member countries to fall more than 4% on average this year before flattening in 2010.[4] While recent data like the OECD leading indicators suggest a somewhat faster rebound, the pace of activity is expected to remain weak well into next year.[5] Confidence in the system has been shaken as observers are concerned both with the immediate risk of deflation and with the long-term risk that the huge fiscal and monetary stimulus may lead to heightened inflationary pressure in the future.

Thus far the EE5 countries have weathered the crisis far better than most OECD countries

13. Thus far the EE5 countries have weathered the crisis far better than most OECD countries. Most EE5 countries experienced a slowing of growth, and Brazil and South Africa are expected to see GDP fall in 2009, but the real economy is expected to recover more rapidly than in the OECD as a whole (Figure 1). Equity markets have fallen much less than in OECD countries and indeed several countries have experienced sizable rebounds in 2009 (Figure 2). Moreover, credit

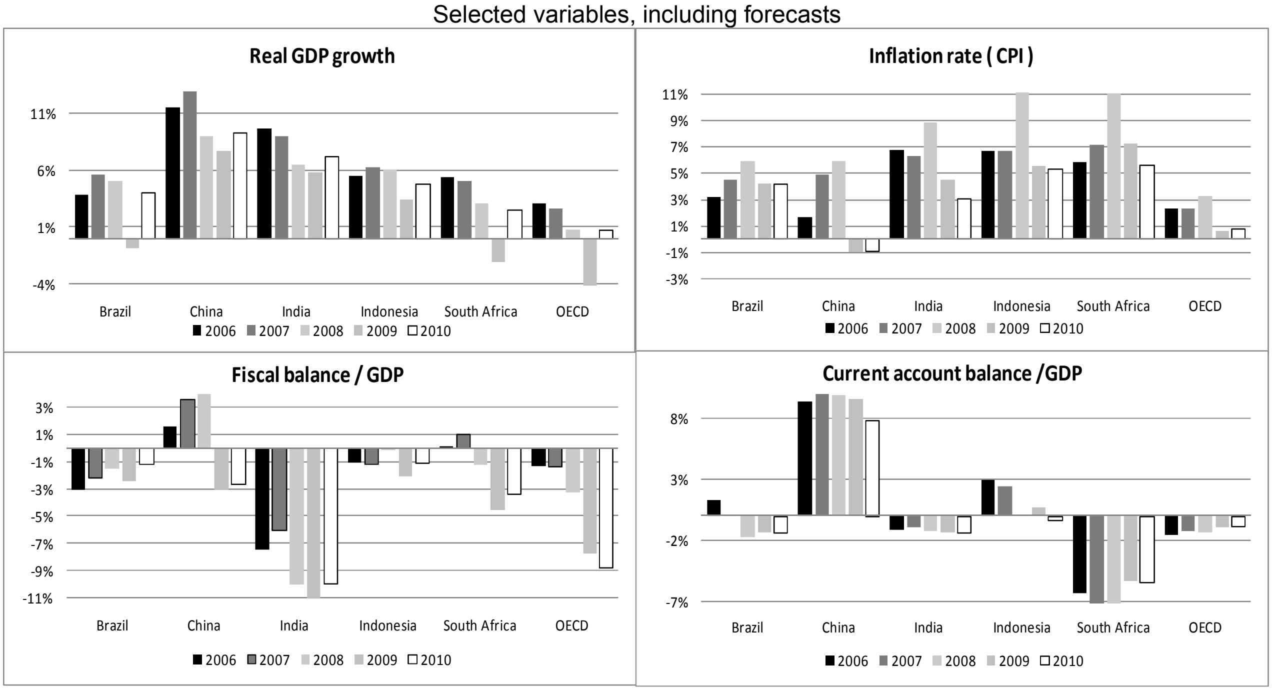
[4] See OECD *Economic Outlook*, vol. 2009/2, no. 85, June 2009.

[5] See the OECD Composite Leading Indicators (CLIs) September 2009 update ,"Composite Leading Indicators point to broad economic recovery", at www.oecd.org/std/cli; and OECD *Interim Outlook*, 3rd September 2009, available at www.oecd.org/eco.

expansion has been maintained much better in EE5 countries than in OECD countries (Figure 3). Narrowing credit spreads underline an increased confidence by investors in these countries (Figure 4).

Figure 1. The macroeconomic stance in EE5 countries and the OECD

Selected variables, including forecasts



Source: OECD *Economic Outlook*, vol. 2009/2, no. 85, June 2009.

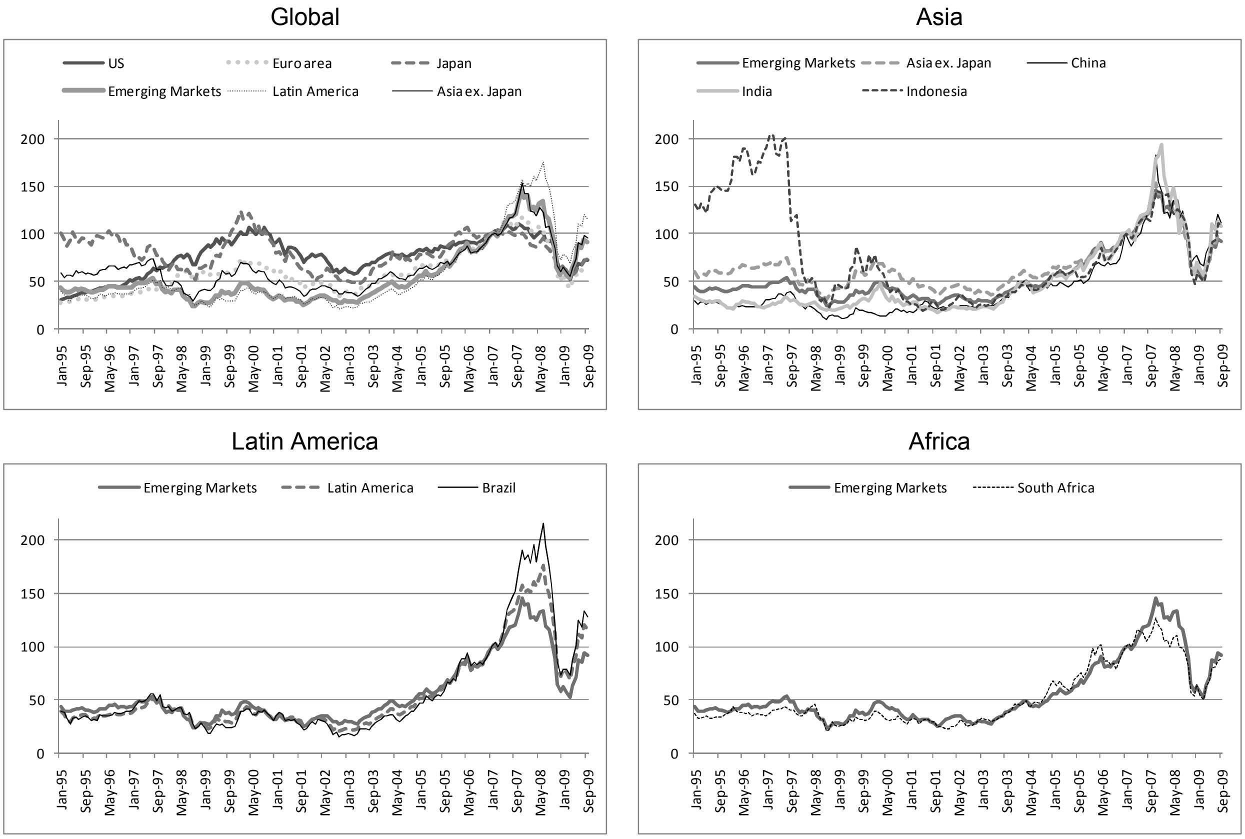
EE5 countries have a relatively lower financial intermediation and have taken a much more guarded approach to financial liberalisation and modernisation

14. To some degree, the relatively high resiliency of EE5 countries may reflect the fact that their financial intermediation is relatively lower as compared to the one of OECD countries, and that catch-up effects generate a relatively higher GDP growth. At the same time it appears true that the crisis erupted in the most sophisticated components of the financial system and the EE5 countries have taken a much more guarded approach to financial liberalisation and modernisation than the OECD countries. Banks in EE5 countries have continued to concentrate in traditional deposit taking and lending and became involved in capital markets to a much lesser extent than OECD countries. Domestic institutions in the EE5 had used fewer financial innovations such as structured products, derivatives and securitisation and engaged in less OTC activity. Moreover, the EE5 have had much lower levels of consumer and housing indebtedness than OECD countries.

While financial modernisation has brought considerable benefits, EE5 countries may likely persevere in their more cautious and gradual pattern of modernisation and liberalisation

15. While the crisis has demonstrated the pitfalls of unconditional deregulation, it is also important to keep in mind that financial modernisation has brought considerable benefits, such as increased access by SMEs to financing, increased access by the general public to affordable housing finance and improved possibilities for the general public to invest. The latter will be particularly important as reliance on families, employers and state pensions declines and individuals assume greater responsibility for their own retirement income. The EE5 countries, which had all suffered one or more financial crises in the past few decades, realise that their financial systems must be strengthened as they face the challenges characteristic of middle income economies. However, on balance the EE5 countries may likely persevere in their more cautious and gradual pattern of modernisation and liberalisation.

Figure 2. Selected equity market developments

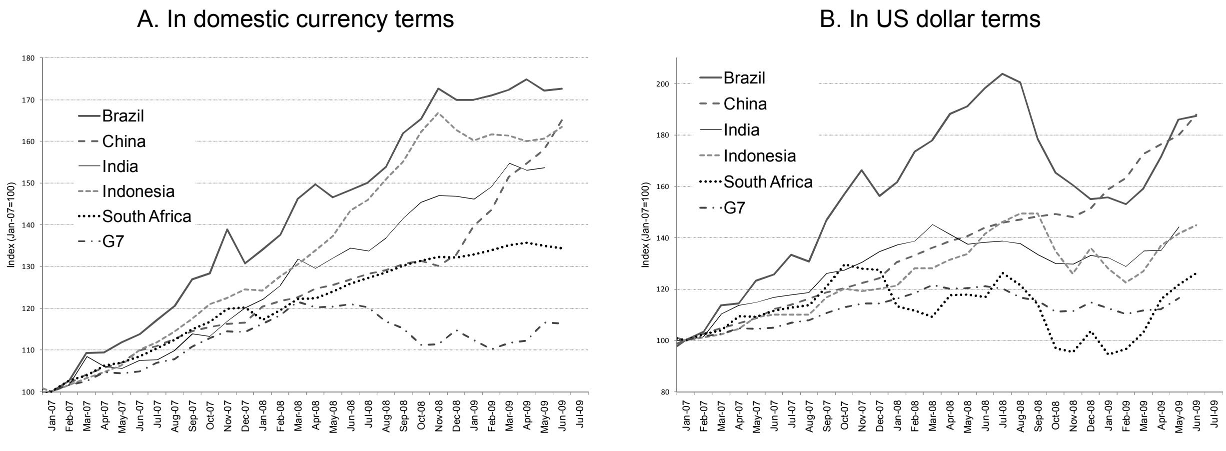


Note: Datastream total market indices (Jan 2007=100), all in US dollar terms,

Source: Thomson Financial Datastream.

Figure 3. Domestic Credit: Claims On Private Sector

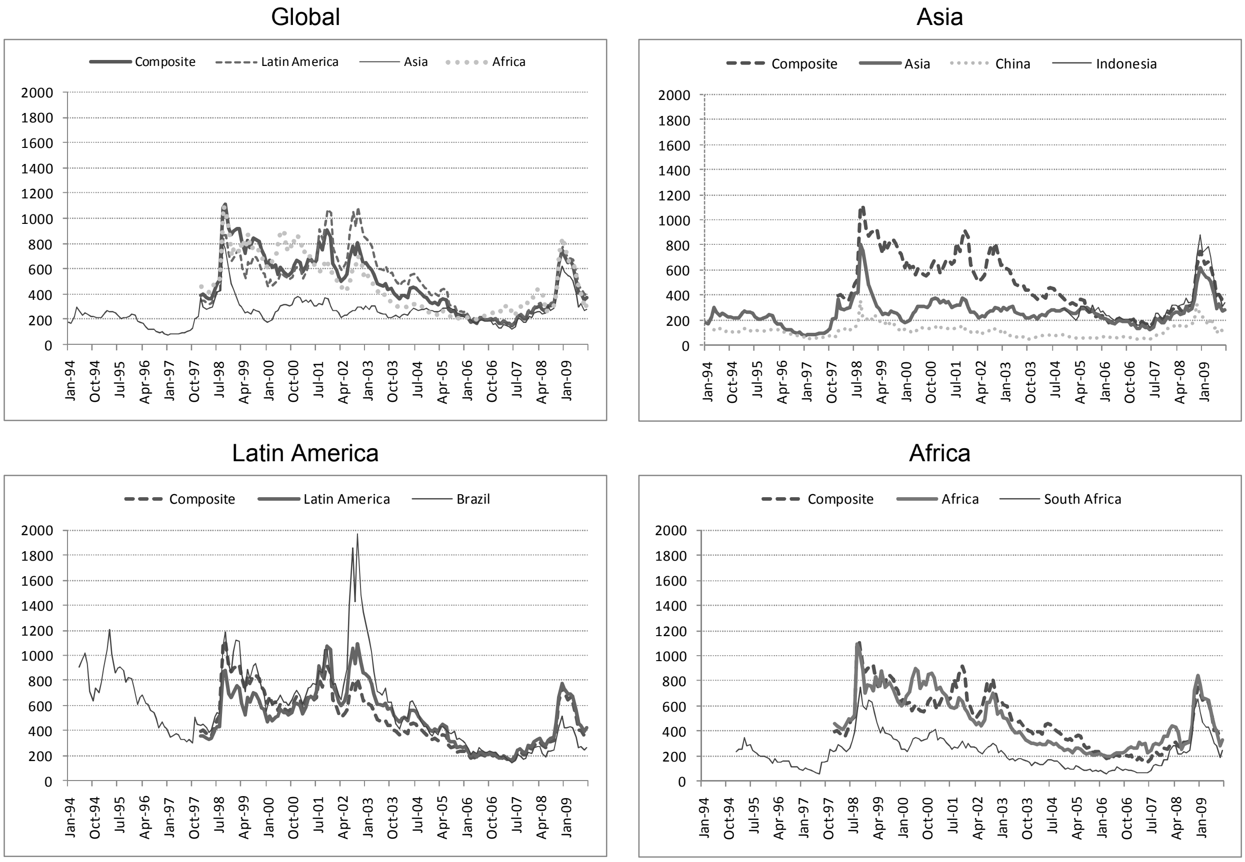
Indices (Jan-07=100), in US dollar terms



Note: G7 includes data from the United States, Japan, Germany, France, Italy, the United Kingdom and Canada, in USD terms.

Source: IMF International Financial Statistics; Thomson Financial Datastream; and OECD.

Figure 4. Selected emerging market bond spreads



Note: JPM EMBI Global - blended spreads.

Source: Thomson Financial Datastream.

C. Structural issues and selected financial market reforms in Enhanced Engagement countries[6]

Large differences in financial structures of EE5 countries against OECD but also within their peer group

16. While large differences in financial structures are found among the EE5 countries, comparison of this group of countries to the OECD countries is nonetheless revealing (Figure 5). Examination of indicators of market depth and intermediation shows that financial systems of the EE5, while less advanced than those of OECD Members, have been developing rapidly, with bank assets and the capital (bond and equity) markets rising steadily as a share of GDP. Although the assets of the banking systems of the EE5 generally account for lower shares of GDP than those of the OECD countries, financial intermediation is still more "bank-dominated" in EE5 than in OECD countries, with bank lending rather than securities issuance the predominant form of financial intermediation.

Financial disintermediation has been less pronounced

17. The phenomenon of "disintermediation" under which major corporate borrowers have been relying on issuance of fixed income securities rather than bank lending has been much less pronounced in EE5 than in OECD countries. In

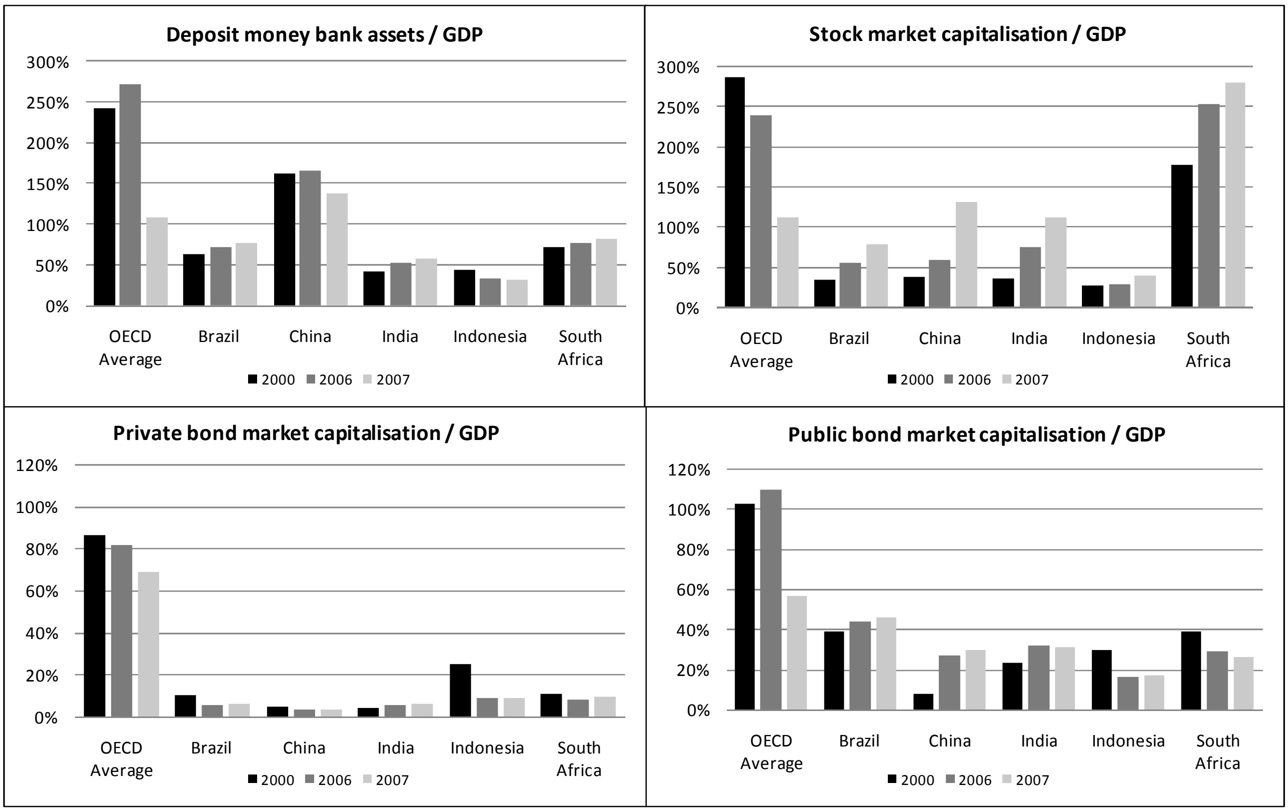
[6] This section highlights and summarises key issues of this note's companion paper ["*Structural developments in the financial systems of Enhanced Engagement countries*", DAF/CMF(2009)18] that contains more detail on structural financial market issues and selected financial market reforms in Enhanced Engagement countries.

in EE5 countries, with continued dominance of banks

addition to the continued dominance of banks in corporate finance, the lesser development of fixed income markets partly reflects the strong fiscal positions of the EE5 countries. While public bonds outstanding account for rising shares of national income in all EE5 countries except South Africa, public debt-to-GDP ratios are considerably lower than in OECD countries.

Figure 5. Financial intermediation in OECD and EE5 countries

Selected variables, in per cent of GDP



Notes: World bank data, except data for deposit money bank assets/GDP for China which are from the People's Bank of China. "OECD average" indicates GDP-weighted averages of the respective variable over all 30 OECD member countries, except for private bond market capitalisation where averages do not include Luxembourg and the Slovak Republic.

Sources: *Financial Development and Structure Database*, World Bank; People's Bank of China; and OECD.

The size of EE5 equity markets is considerable

18. When measuring the importance of equity markets, a different pattern emerges. The size of the equity market as a share of GDP compares rather favourably with OECD countries. Following the bursting "tech bubble" in 2000-2001 the ratio of equity market capitalisation has declined in OECD countries, but has tended to rise in the EE5. In South Africa, where the equity market has been well developed for decades, it has now advanced to the point where that market is comparatively larger than in any OECD country.[7] Brazil, China and India have all made significant strides in promoting their equity markets. Indonesia has also made visible gains, but still lags behind other EE5 and OECD countries.

[7] In fact, the share of listed equity is higher in Luxembourg than in South Africa, but this is due to the large number of foreign companies listed.

Institutional investors do not play a big role in EE5 countries

19. The composition of public holdings of financial assets differs from those observed in OECD countries. Bank deposits tend to represent a higher share of total asset holdings in the EE5 than in the OECD countries where institutional investors are emerging as the main form of wealth holding. The lower presence of institutional investors in the EE5 has meant that there is a paucity of "natural" buyers for fixed income securities. The relatively slow advance of institutional investment also means that one of the main pressures for financial innovation, i.e. competition among financial intermediaries to develop new products to satisfy the needs of investors, has largely been absent in the EE5 countries. Looking ahead, as EE5 countries progress into higher levels of financial development (and intermediation) they will no doubt diversify into institutional forms of wealth holding as local pension reforms are implemented and the markets for insurance and collective investment schemes (CIS) deepen.

Only about half of the EE5 population has access to formal financial services

20. Another set of key indicators concerns the access of the population to finance. Measuring access to financial services is an important element in the promotion of inclusive development. By one such measure, only about half of the population of the EE5 countries has access to formal financial services, reflecting their earlier stage of development.[8]

While OECD countries engaged in financial deregulation and internationalisation …

21. Over the past three decades the financial systems of OECD countries have been transformed from highly regulated ones under the close control of national authorities to open market-driven systems. The authorities of OECD countries have been progressively removing restraints on the activities of financial intermediaries while removing barriers to capital mobility and accepting financial innovations initiated by private institutions.

…EE5 countries have been more cautious in pursuing such policies

22. The EE5 countries have been more cautious in pursuing deregulation and internationalisation than the OECD countries. The degree of government ownership of financial institutions remains considerably higher in EE5 countries than in OECD countries. Furthermore, in most EE5 countries the state retains a strong hand in setting interest rates, allocating credit and otherwise guiding financial activity. Moreover, financial intermediation is considerably less international in EE5 countries than in the OECD, as can be seen from the relatively low share of foreign-affiliated banks in their domestic banking systems and the low volume of cross border bank lending and bond issues in EE5 countries (Figure 6).

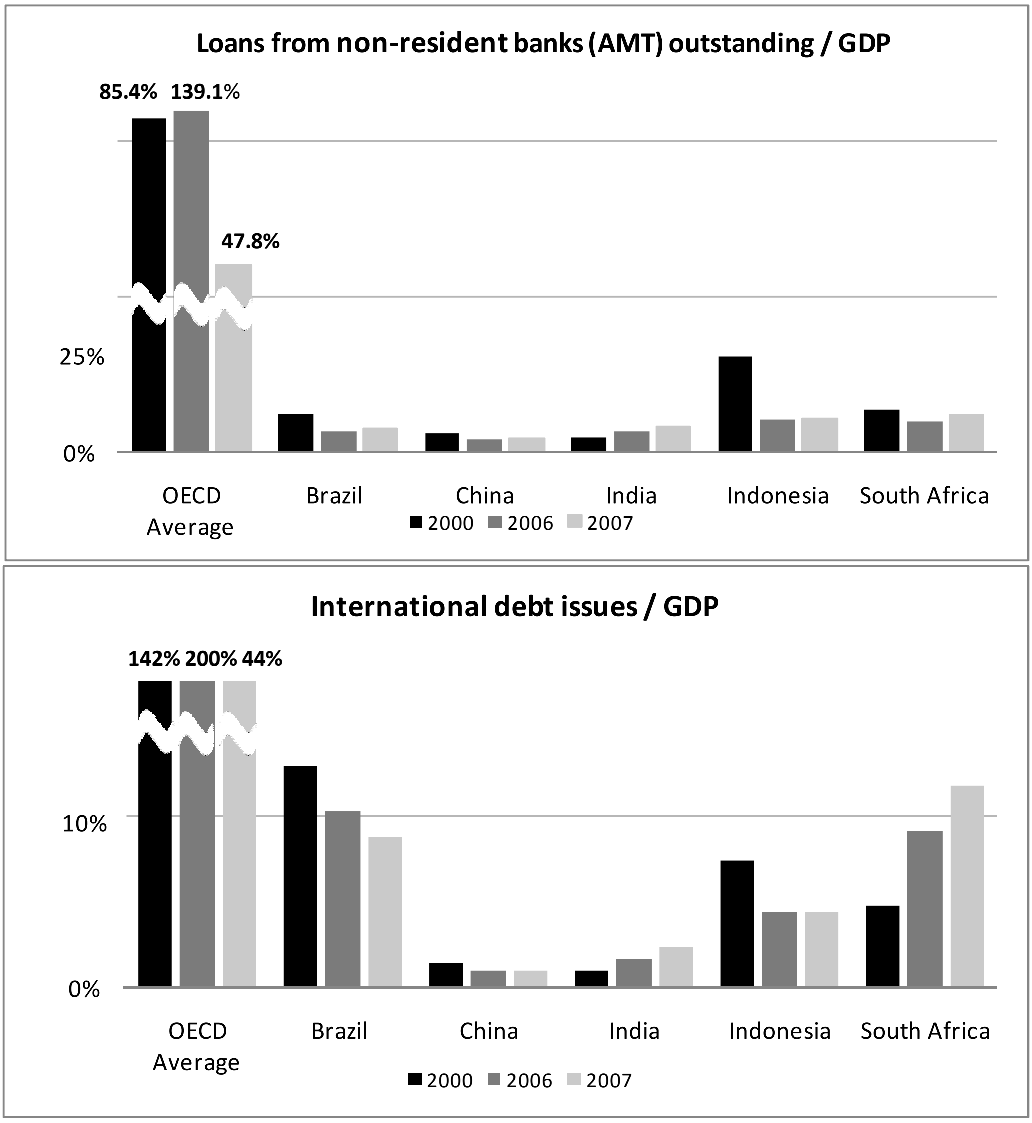
However, EE5 countries have opened their markets to some degree of foreign participation, reflecting rising needs to access global financial markets

23. Although EE5 countries have not embraced the market-based model of finance to the same extent as OECD countries, there has been a clear trend toward greater reliance on markets, and EE5 countries have opened their markets to some degree of foreign participation. In general, EE5 policymakers have concluded that their earlier policies made the economy excessively rigid while making their financial systems fragile. Furthermore, as incomes rise and the burden of providing retirement income shifts from families and governments to individuals, more sophisticated forms of institutional investment and more flexible capital markets will be needed. Simultaneously, EE5 countries will be building institutions and acquiring more advanced skills commensurate with their expanded roles in global

[8] A composite index, developed by the World Bank, measures both the access of small and medium enterprises to formal financial services as well as the access of the general population to a simple range of retail products such as accounts at depositary institutions, automatic teller machines, credit cards and consumer credit. For details, see the companion paper DAF/CMF(2009)18.

financial markets. Therefore, the EE5 countries have been moving cautiously toward deregulation and liberalisation but they have balanced their objective of benefiting from markets against that of safeguarding key national interests and shielding themselves from disruptive forces in international markets.

Figure 6. Internationalisation of EE5 financial markets



Source: World Bank, *Financial Development and Structure Database*; People's Bank of China; and OECD.

EE5 countries have made their financial systems more resilient

24. One area in which EE5 countries have made considerable strides is in making their financial systems more resilient. Efforts have been launched to require banks to observe stricter rules of risk management and to improve balance sheet quality. This is reflected in declining ratios of non-performing loans to total loans and higher capital adequacy ratios.

Despite a trend towards consolidation of supervision inside a single entity, no EE5 country has adopted the unified financial supervisor approach

25. While most OECD countries have still separate supervisors, there has been a discernible trend for some OECD countries to consolidate supervision of financial activity (banking, securities and insurance) into a single entity.[9] Among EE5 countries, no country has adopted the unified financial supervisor approach, each having separate supervisors for banking, securities and insurance. (Indonesia, however, is considering adoption of the unified supervisor.) In all EE5 countries except China, the central bank is responsible for banking supervision. In China, there is a specialised China Banking Regulatory Commission that is separate from the central bank.

D. Exit strategies, further regulatory reforms, and the new financial landscape

Preserving an open and fair environment for trade, investment and finance is of common interest

26. The crisis has highlighted the common interests between OECD and EE5 countries in preserving an open and fair environment for trade, investment and finance. Mechanisms for international co-operation have been tested during the past three years and the results have generally been positive. By agreeing on the need for concerted fiscal and monetary action and by resisting protectionist pressures, major countries have so far averted a retreat from an open trade and financial system that would have aggravated the downward spiral.

G-20 shows consensus on how the financial architecture should be strengthened and on the need to co-ordinate policy responses

27. Major countries have also achieved considerable consensus, at least in broad principles, on how the financial architecture should be strengthened. Recognition has grown of the need to co-ordinate policy responses among a broad group of countries and to engage a wide range of countries in the decision making process. Thus the G-20 that includes key OECD countries, the EE5, as well as other countries,[10] has assumed a leading role in making sure that adequate resources are available for countries experiencing external financing strains and in enunciating broad principles for reform of the financial architecture, at its meeting of March 2009 (Box 2), updated in September.

The OECD has developed an "Exit Strategy" for

28. Alongside the vision of a strengthened financial architecture put forth by the G-20, the OECD has developed an "Exit Strategy" under which governments should gradually withdraw their emergency support and return to a normally

[9] This trend to consolidation reflects two basic considerations: *(i)* private institutions now engage in various financial activities, offering a variety of financial products; and *(ii)* due to financial innovation, many products have been developed that do not fit into the traditional categories of financial activity. Thus, in order to prevent contagion, ensure a level playing field and discourage regulatory arbitrage, several OECD countries have consolidated supervision inside a single entity. Although several OECD countries have chosen this unified supervisor approach, most OECD countries still have separate supervisors for banking, securities and insurance on the grounds that these businesses are fundamentally different and require different supervisors. At the same time, the Netherlands and Australia have settled on a "twin peaks" model where there are two supervisors for all institutions, one with a mandate for prudential issues and the other for "conduct of business" oversight. The role of the central bank in financial supervision as well as in safeguarding financial stability is also an issue upon which there is considerable variation of views.

[10] The G-20 was created as a response both to the financial crises of the late 1990s and to a growing recognition that key emerging-market countries were not adequately included in the core of global economic discussion and governance. The Group has regained importance in response to the current financial and economic crisis. The G-20 is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States of America. See www.G-20.org.

withdrawing official emergency support...

functioning market.[11] The OECD strategy emphasises that it is more important to be sure that incentives are properly structured than to exit as quickly as possible.

...proposing a set of preconditions to rehabilitate banking systems and a return to market-based intermediation

29. In its strategy the OECD proposes a set of preconditions for successful exit and a sequence of policy actions that will lead to the rehabilitation of banking systems and an eventual return to market-based intermediation: *(i)* The toxic assets of impaired institutions should be identified and resolved, either through sale to an external asset management company (AMC) or through adequate provisioning; *(ii)* the viability of banks must be assessed after resolution of toxic assets. Arrangements must be made to liquidate banks that are not viable and to arrange for mergers and acquisitions of remaining parts of failed institutions by stronger institutions. *(iii)* Once a group of viable institutions has been tentatively identified, recapitalisation can take place. *(iv)* The authorities should begin gradually to remove their support. In this phase it will be important to phase out rapidly direct central bank support to non-bank institutions and to replace central bank direct support for individual banks by counter-cyclical open market and liquidity support operations. *(v)* Beneficiaries should face progressively tighter terms on continued official support. *(vi)* Guarantees should be unwound. *(vii)* When institutions can obtain funding in the market, the authorities should begin to reduce their ownership in banks through sale to private investors.

Box 2. Selected key reforms recommended by the G-20

1. Partly to bridge the gap between the prudential supervision of individual institutions and monitoring systemic stability, the **creation of a Financial Stability Board** (FSB) was proposed in place of the existing Financial Stability Forum. The FSB will *(a)* assess vulnerabilities in the financial system; *(b)* promote co-ordination and information exchange among authorities responsible for financial stability; *(c)* monitor progress in meeting regulatory standards; *(d)* support contingency planning for cross-border crisis management, particularly for systemically important firms; and *(e)* collaborate with the IMF in Early Warning Exercises.

2. Recognising that gaps and inconsistencies in the coverage of regulations may have aggravated the fragility of the system, the G-20 recommended that **all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight**. Members agreed to amend regulatory systems to ensure authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadow banks, and private pools of capital to limit the build-up of systemic risk. It was noted that large and complex financial institutions require particularly careful surveillance. Hedge funds or their managers will be required to register and to disclose appropriate information on an on-going basis to supervisors or regulators. The G-20 also agreed to promote the adequate regulation of credit derivatives markets, in particular through the establishment of central clearing counterparties.

3. In order not to aggravate credit contractions present capital adequacy ratios (CARs) should be maintained, but once recovery is assured, **prudential standards should be tightened**. Buffers above regulatory minima should be increased and the quality of capital should be enhanced, with guidelines for a harmonised new definition of capital ready by end-2009. To correct present procyclicality, CARs should encourage banks to build buffers in good times for use in time of stress.

Source: G-20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency,* Final Report, 25 March 2009, available at http://www.G-20.org/Documents/G-20_wg1_010409.pdf; and G-20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG2), *Final Report*, 27 March 2009, available at http://www.G-20.org/Documents/G-20_wg2_010409.pdf.

[11] For more detail see the "*Report on the Strategic Response: Finance, Competition and Governance: Priorities for Reform and Strategies to Phase out Emergency Measures*" [C/MIN(2009)9/ANN1].

It is important to minimise the creation of institutions that are "too big to fail"

30. The OECD cautions against the pitfalls of promoting mergers among financial institutions. The need to maintain adequate competition is important, since the crisis has already caused the exit of many financial institutions and hence remaining institutions are larger with more market power than before the crisis. Moreover, it is important to minimise the excessive creation of institutions that are "too big to fail."

There are advantages in a non-operating holding company (NOHC) structure

31. Observing that contagion was one of the factors that contributed to the spiral of destabilisation since 2007, the OECD stressed the advantages of the non-operating holding company (NOHC) structure. The OECD argued that NOHC structures enhance transparency and provide a simple way of protecting a commercial bank's balance sheet from affiliates (including securities firms), thereby reducing contagion risk and facilitating the job of regulators.

EE5 countries are gaining importance in world financial markets

32. As already visible in the leading role of the G-20, the events of the past three years will in all probability enhance the role of EE5 countries in the global allocation of capital and in global decision-making. Non-traditional financial players, with the EE5 countries in the lead, were already gaining importance in world financial markets as a result of their high rates of growth and their rising shares of world trade and investment. Meanwhile, global payments imbalances have been leading to the accumulation of investible assets in certain non-OECD countries. The events of the past three years should accelerate this trend.

Financial powers are shifting to new "power brokers"

33. Some recent analyses have predicted the emergence of "new power brokers" consisting of central banks and sovereign wealth funds from Asian countries and oil exporters as well as hedge funds and private equity funds.[12] Since the report was published in 2007, the 2009 update shows the prospects for the latter two categories of investors have dimmed on balance but the position of sovereign wealth funds and central banks from non-OECD countries has become larger. In addition, the relative weight of financial institutions has shifted dramatically among geographic regions in the last three years. At this time the three largest banks in the world measured by capitalisation are domiciled in the Peoples' Republic of China. More generally, institutions outside OECD countries are likely to become bigger players in financial markets. The emergence of large asset holdings, rising shares of world equity and bond markets and the emergence of powerful financial institutions in new regions of the world are likely to influence the contours of the world financial system in years to come.

[12] McKinsey Global Institute (2007), *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Shaping Global Capital Markets*, October 2007; and McKinsey Global Institute (2009), *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Faring in the Financial Crisis*, July 2009.