General Assembly Second Committee Economic and Financial Committee (GA - ECOFIN)

Topic: Measures to Maintain International Financial Security

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CONTENTS

WELCOME LETTER FROM THE DAIS 4

INTRODUCTION OF THE COMMITTEE 5

1.1 History & Current State 5

1.2 Focus Area 6

1.3 Patterns of Work 6

1.4 Functions & Powers 6

INTRODUCTION TO FINANCIAL REGULATION 8

2.1 Introduction 8

2.2 What is global financial system? 8

2.3 Causes and origins of financial instability 9

2.3.1 Asymmetric and incomplete information 9

2.3.2 Leverage 9

2.3.3 Asset-liability mismatch 9

2.3.4 Inadequate regulatory work 10

2.3.5 Uncertainty and herd behavior 10

2.3.6 Technology 11

2.4 What is Financial Regulation? 11

2.5 Why Regulations? 11

2.6 Why financial regulations are necessary? 12

2.7 What are we regulating? 14

2.8 Four patterns of international financial regulations 15

2.8.1 US Pattern 15

2.8.2 Germany Pattern 16

2.8.3 UK Pattern 16

2.8.4 Japan Pattern...16

2.9 Conclusion 17

CURRENT INTERNATIONAL REGULATION SYSTEM..18

3.1 Banking...18

3.1.1 Global Committee Structure----the Basel Committee 18

3.1.2 Core central banking-International Monetary Fund 18

3.1.3 Predential Regulation of Financial Intermediaries 23

3.1.4 Deposit Insurance...24

3.2 Securities Markets 25

3.2.1 International Organization of Securities Commissions..25

3.2.2 Stock Exchanges 26

3.2.3 Credit Rating Agencies...26

PAST ACTIONS 28

4.1 International Actions on the Economic Growth of Developing Countries....................28

4.2 International Actions on Financial Crisis of 2010 29

CASE STUDY: BANK RECAPITALIZATION CRISIS 2007-2009 30

5.1 Background..30

5.2 Introduction to Banking Crisis...33

5.3 Comparable Perspective in Other Countries..35

REFERENCE 39

WELCOME LETTER FROM THE DAIS

Dear delegates,

Welcome to General Assembly - Economic and Financial Committee of PKUNMUN 2015! The General Assembly provides the unique stage for all nations to come together and achieve efficient communication. The topic of the Second Committee reflects the full breadth of global situation concerning financial world, especially after the global financial crisis 2007-2009. There's no doubt that ECOFIN will be the platform to present your knowledge, innovation and leadership. Before stating your discovery with this guide, you may be willing to know about our dais members:

Delegates, It's my distinct pleasure to welcome you to the Economic and Financial Committee. My name is CHEN Xueyao, Director of our Committee, currently majoring in Economics. After taking the responsibility of academics last year, I've gained experience in both rules and academic topics design. Based on that, I believe that GA-ECOFIN this year will deliver the best academic feast to all of you.

Hi delegates, I'm YUAN Yiyang, the assistant director of GA-ECOFIN, now majoring in finance in School of Economics. This is my second time working as a chair in PKUNMUN and I've accumulated practical experience as a MUNer since high school. The topic you'll be faced with are both complex and challenging, but trust me, you'll enjoy the process of cooperating and brainstorming!

Hello, this is ZHAI Jiayin, the assistant director of GA-ECOFIN. After the whole 6 months' preparation for the 2015 PKUNMUN, I have so many memorable moments to share with PKUNMUN. I believe you must be looking forward to the conference as I do. My dear delegates, enjoy yourself in this year's conference.

The coming year will be the new era of PKUNMUN, as well as the critical point of moderate global economic growth recovering from the past crisis. More agreement has been so far reached on the diagnosis what went wrong during the crisis than on the appropriate regulatory response. Also, there remains no consensus on the balance between international and national regulation. We wait in hope for the change on the global market, and the financial regulation is on the cusp of that change. That's the platform where you can bring your passion and innovation. So just start from now, getting fully prepared for the upcoming challenges as well as opportunities. Look forward to meeting you soon!

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INTRODUCTION OF THE COMMITTEE

The Economic and Financial Committee (ECOFIN) is a committee within the United Nations that solves problems in the area of global finances and economics.

It is one of the six standing committees of the General Assembly, and also referred to as the "Second Committee".

1.1 History & Current State

The General Assembly was established by the UN charter in 1945 that would be comprised of all UN member nations. It is located at United Nations Headquarters in New York.

The first session was convened on 10 January 1946 in the Westminster Central Hall in London and included representatives of 51 nations.

During the 1980s, the Assembly became a forum for the "North-South dialogue": the discussion of issues between industrialized nations and developing countries. These issues came to the fore because of the phenomenal growth and changing makeup of the UN membership. In 1945, the UN had 51 members.

It now has 193, of which more than two-thirds are developing countries. Because of their numbers, developing countries are often able to determine the agenda of the Assembly, the character of its debates, and the nature of its decisions. For many developing countries, the UN is the source of much of their diplomatic influence and the principal outlet for their foreign relations initiatives.

In December 1988, in order to hear Yasser Arafat, the General Assembly organized its 29th session in the Palace of Nations, in Geneva.

Considering the boundless scope of the issues to be discussed, and in order to improve the efficiency of the committee, in 1945, the GA was divided into six separate main committees, one of which is the Economic and Financial Committee.

Currently, the ECOFIN will deal with issues that pertain to economic growth and development, such as international trade, international financial system, globalization, economic development, debt, and sustainable development, and many other topics relating to the global economy. It also pays special attention to Groups of Countries in special situations – such as the least developed countries and landlocked developing countries.

The ECOFIN was recently conducted in Guyana on the October 1st, 2012. This was its 66th session and it aimed to promote the interests of Least Developed Countries and Landlocked developing countries of the world. The macroeconomic policies of nations were also reviewed at this session.

1.2 Focus Area

The ECOFIN will deal with issues relating to economic growth and development such as:

(i) Macroeconomic policy questions (including international trade, international financial system, and external debt sustainability),
(ii) Financing for development,
(iii) Sustainable development,
(iv) Human settlements,
(v) Poverty eradication,
(vi) Globalization and interdependence,
(vii) Operational activities for development,
(viii) Information and communication technologies for development.

The Second Committee will also consider issues relating to Groups of Countries in special situations - such as the Least Developed Countries (LDCs) and Landlocked Developing Countries (LLDCs). It will also consider the item on permanent sovereignty of the Palestinian people in the Occupied Palestinian Territory, including East Jerusalem, and of the Arab population in the occupied Syrian Golan over their natural resources.

1.3 Patterns of Work

The General Assembly was established by the UN charter in 1945 as the body that would be comprised of all UN member nations. According to the charter, it would have the power to discuss the full spectrum of international issues and make suggestions to delegates. The charter would not set so many parameters over member states. Instead, the resolutions passed by the General Assembly have moral forces, since the General Assembly represents the major will of the international community.

Resolutions passed by the ECOFIN that are adopted by the General Assembly carry much weight, since they have the support of the majority of all UN members. The committee's work also influences other international institutions and committees, such as the Organization for Economic Cooperation and Development (OECD), the World Bank(WB), and the International Monetary Fund (IMF). Hence, decisions made by the Economic and Financial Committee tend to be instrumental in accomplishing economic policy objectives for the international community.

1.4 Functions & Powers

According to the Charter of the United Nations, the General Assembly may:

(i) Consider and approve the United Nations budget and establish the financial assessments of Member States;
(ii) Elect the non-permanent members of the Security Council and the members of other United Nations councils and organs and, on the recommendation of the Security Council, appoint the Secretary-General;

(iii) Consider and make recommendations on the general principles of cooperation for maintaining international peace and security, including disarmament;

(iv) Discuss any question relating to international peace and security and, except where a dispute or situation is currently being discussed by the Security Council, make recommendations on it;

(v) Discuss, with the same exception, and make recommendations on any questions within the scope of the Charter or affecting the powers and functions of any organ of the United Nations;

(vi) Initiate studies and make recommendations to promote international political cooperation, the development and codification of international law, the realization of human rights and fundamental freedoms, and international collaboration in the economic, social, humanitarian, cultural, educational and health fields;

(vii) Make recommendations for the peaceful settlement of any situation that might impair friendly relations among nations;

(viii) Consider reports from the Security Council and other United Nations organs.

The Assembly may also take action in cases of a threat to the peace, breach of peace or act of aggression, when the Security Council has failed to act owing to the negative vote of a permanent member. In such instances, according to its “Uniting for Peace” resolution of November 1950 (resolution 377 (V)) , the Assembly may consider the matter immediately and recommend to its Members collective measures to maintain or restore international peace and security (See "Special sessions and emergency special sessions”).

INTRODUCTION TO FINANCIAL REGULATION

2.1 Introduction

The fervid progressing of globalization has contributed to an impressively tighter connection among economies worldwide, while increasing the vulnerability of global financial system in the meantime.

The world economy became increasingly financially integrated throughout the 1980s and 1990s as nations liberalized capital accounts and deregulated financial sectors. With greater exposure to volatile capital flows, a series of financial crises in Europe, Asia, and Latin America had contagious effects on other countries. During 2007 and 2008, the United States experienced a financial crisis characteristic of earlier systemic crises, which quickly propagated throughout other nations. It became known as the global financial crisis and is recognized as the catalyst for the worldwide Great Recession. Revelations of Greece's falsified fiscal data in 2009 caused financial markets to adjust to the realization that Greece was no longer in compliance with its monetary union. The crisis spread to other European nations already experiencing sovereign debt problems and became known as the Eurozone crisis.

In face of the instability in global financial system, a bunch of regulatory measures and legal procedures are carried out to facilitate the global market by national government and international institutions. It is necessary for policymakers to understand the correlation of various economic activities and interaction among countries so as to enhance financial stability.

2.2 What is global financial system?

The global financial system is the worldwide framework of legal agreements, institutions, and both formal and informal economic actors that together facilitate international flows of financial capital for purposes of investment and trade financing.

The system has evolved substantially since its emergence in the late 19th century during the first modern wave of economic globalization. The change is marked by the establishment of central banks, multilateral treaties, and intergovernmental organizations aimed at improving the transparency, regulation, and effectiveness of international markets.

Numerous groups and individuals participate in the global financial system. Economic actors such as general consumers and international businesses undertake consumption, production, and investments. Governments and intergovernmental organizations participate as investors and as purveyors of international trade, economic development, and crisis management. Regulatory bodies such as government agencies and multilateral institutions establish financial regulations and legal procedures, while independent self-regulatory associations coordinate standard practices and facilitate industry supervision. Professional associations, policy think tanks, and research institutes collect and analyze data, publish reports and policy recommendations, and facilitate public discourse on global financial affairs.

2.3 Causes and origins of financial instability

2.3.1 Asymmetric and incomplete information

Global capital markets are characterized by asymmetric and incomplete information derived from the fact that all financial assets are promises to pay in an uncertain future. The increasing international exposure of bank balance sheets and equity funds in industrial countries to the financial systems in emerging market economies has not been accompanied by a corresponding depth of information about the true value of the assets and liabilities.

2.3.2 Leverage

Leverage, which means borrowing to finance investments, is frequently cited as a contributor to financial crises. When a financial institution (or an individual) only invests its own money, it can, in the very worst case, lose its own money. But when it borrows in order to invest more, it can potentially earn more from its investment, but it can also lose more than all it has. Therefore leverage magnifies the potential returns from investment, but also creates a risk of bankruptcy. Since bankruptcy means that a firm fails to honor all its promised payments to other firms, it may spread financial troubles from one firm to another.

The average degree of leverage in the economy often rises prior to a financial crisis. For example, borrowing to finance investment in the stock market ("margin buying") became increasingly common prior to the Wall Street Crash of 1929. In addition, some scholars have argued that financial institutions can contribute to fragility by hiding leverage, and thereby contributing to underpricing of risk.

2.3.3 Asset-liability mismatch

Another factor believed to contribute to financial crises is asset-liability mismatch, a situation in which the risks associated with an institution's debts and assets are not appropriately aligned. For example, commercial banks offer deposit accounts which can be withdrawn at any time and they use the proceeds to make long-term loans to businesses and homeowners. The mismatch between the banks' short-term liabilities (its deposits) and its long-term assets (its loans) is seen as one of the reasons bank runs occur (when depositors panic and decide to withdraw their funds more quickly than the bank can get back the proceeds of its loans).

In an international context, many emerging market governments are unable to sell bonds denominated in their own currencies, and therefore sell bonds denominated in US dollars instead. This generates a mismatch between the currency denomination of their liabilities (their bonds) and their assets (their local tax revenues), so that they run a risk of sovereign default due to fluctuations in exchange rates.

2.3.4 Inadequate regulatory work

The **Bretton Woods system** of monetary management established the rules for commercial and financial relations among the world's major industrial states in the mid-20th century. The Bretton Woods system was the first example of a fully negotiated monetary order intended to govern monetary relations among independent nation-states.

It has taken repeated international crises to convince global policymakers that the Bretton Woods Institutions are wholly inadequate to provide the required international security; but the implementation of the required regulatory framework faces the opposition of both the major global economic power and private financial intermediaries; resolution of this impasse may only come about through the geopolitical balance between new currency areas.

Some financial crises have been blamed on insufficient regulation, and have led to changes in regulation in order to avoid a repeat. For example, the former Managing Director of the International Monetary Fund, Dominique Strauss-Kahn, has blamed the financial crisis of 2008 on 'regulatory failure to guard against excessive risk-taking in the financial system, especially in the US'. Likewise, the New York Times singled out the deregulation of credit default swaps as a cause of the crisis.

2.3.5 Uncertainty and herd behavior

Social psychological factors also play important roles in investors' decisions. Many analyses of financial crises emphasize the role of investment mistakes caused by lack of knowledge or the imperfections of human reasoning.

Historians, notably Charles P. Kindleberger, have pointed out that crises often follow soon after major financial or technical innovations that present investors with new types of financial opportunities, which he called "displacements" of investors' expectations. Many financial crises followed changes in the investment environment brought about by financial deregulation, and the crash of the dot com bubble in 2001 arguably began with "irrational exuberance" about Internet technology. Here, an **economic bubble** is "trade in high volumes at prices that are considerably at variance with intrinsic values". It could also be described as a situation in which asset prices appear to be based on implausible or inconsistent views about the future

Unfamiliarity with recent technical and financial innovations may help explain how investors sometimes grossly overestimate asset values. Also, if the first investors in a new class of assets (for example, stock in "dot com" companies) profit from rising asset values as other investors learn about the innovation (in our example, as others learn about the potential of the Internet), then still more others may follow their example, driving the price even higher as they rush to buy in hopes of similar profits. If such "herd behavior" causes prices to spiral up far above the true value of the assets, a crash may become inevitable. If for any reason the price briefly falls, so that investors realize that further gains are not assured, then the spiral may go into reverse, with price decreases causing a rush of sales, reinforcing the decrease in prices, finally leading to a 'bubble burst'.

2.3.6 Technology

The speed and scale of shock transmission between markets has increased enormously due to technological advances in trading and settlement, which forces traders to act without knowledge of wider price movements, exacerbating random fluctuations into serious instability.

The development of technology, on one hand, makes banking more efficient and safer. But on the other hand, some people argue technology also makes new types of financial crimes possible by instant online transactions and privacy invasion. Since Internet creates international linkages, technology might also adds to contagion. Contagion refers to the idea that financial crises may spread from one institution to another, as when a bank run spreads from a few banks to many others, or from one country to another, as when currency crises, sovereign defaults, or stock market crashes spread across countries. When the failure of one particular financial institution threatens the stability of many other institutions, this is called systemic risk.

In conclusion, financial markets are inherently unstable because they deal in expectations; they require strong regulation to underpin contracts and prevent systemic collapse; so that global financial markets require global regulation - not as a means of protecting consumers or small investors, but just so that they can function at all.

2.4 What is Financial Regulation?

The Palgrave Dictionary of Finance defines regulation as action that 'command and control' the individual decisions of firms, in an effort to prevent private decision-making that would take inadequate account of the 'public interest'. Regulation may be self-imposed, or as is usual, by a third party. The Government may intervene in a market or industry in the form of law, administrative rules, taxation or moral suasion. Self-regulation could be imposed through industry associations and codes of conduct.

The regulatory framework will shape market behavior. Therefore, the design and practice of the regulatory framework determines the efficiency and performance of the regulated market.

2.5 Why Regulations?

There are a few theories that attempt to explain the existence and forms of regulation, including:

- The competition for regulation theory suggests that there exists a market for regulation, in which consumers and producers compete. Regulation will serve the interests of those who are willing to offer the most for the regulation. Since regulation can be regarded as a public good, the free-rider problem suggests that the benefit to the individual consumer is likely to be small relative to the producer. Therefore producers will have more incentive to try and obtain favorable regulation through industry associations. A countervailing force is therefore the consumer lobby;

- Capture theory suggests that producers capture regulatory agencies and control them in their own interests. Vested interests reinforce the regulatory framework to support their interests, but the danger is that such behavior would result in non-competitiveness in the international market, leading to long-run social loss.

If we believe the above theories, and assume that regulations impose ultimately a cost on the consumer or taxpayer, it may be in the public interest to remove regulations and allow greater competition. This is the primary driving force behind current market deregulation policies prevalent in OECD markets.

On the other hand, a market without regulation also does not work. Free banking and frontier capitalism results in control by the Mafia with huge losses inflicted on the innocent and unwary. The public interest theory argues that regulation is an attempt to correct for market failures, such as monopoly, externalities and lack of information. For example, the social cost of the failure of a financial institution may be much higher than the private cost to the institution itself. Therefore, financial institutions left to themselves will accept more risk than is optimal from a systemic point of view, thus forming the basic case for government regulation of banking activity and the establishment of capital requirements (Martin Feldstein, quoted in Dale, 1996).

On this basis, we can justify the case for external regulations on private sector behavior on four broad grounds which all relate to market failure:

- First, the moral hazard argument. If a market participant believes that the state will underwrite his losses, then behavior will change. A good example is how deposit insurance encourages depositors and bankers to engage in risky behavior that forces the state to pay in the end, thus undermining market discipline and entailing regulation.
- Second, the widows and orphans argument. These regulations provide protection to poorly (asymmetrically) informed clients, based on the view that small depositors and investors cannot assess properly the riskiness of financial institutions they deal with.
- Third, the public policy argument. In free market economies, public policy arguments call for competition and free trade. An example would be anti-trust laws in some countries to prevent monopolisation of certain markets.
- Fourth, the systemic risk issue, which allows the state to prevent the failure of one participant to destabilize the whole system. This justifies the regulation, for example, of the payment system and the banking sector.

2.6 Why financial regulations are necessary?

The international financial system is vulnerable to emerging market volatility; rather like banking in the US and the UK in the nineteenth century, when huge fluctuations in the real economy were associated with banking booms and busts. There is often a high degree of leverage in short term flows; banks making loans to hedge funds and similar intermediaries based in largely unregulated offshore international banking markets. In other cases they are on-selling risky securities to their clients; or extending short-term loans which are renewed every six months. Banks and other financial intermediaries have financial assets far larger than their own capital, so that the loss of only a small part of their loans threatens their survival. This is why they are restricted in the loans they can make by

regulators. In consequence, when such losses do occur, they must sell other assets in order to `recover the liquidity necessary to maintain their own capital. This exacerbates market fluctuations, leading to collapses more rapid and more deep than the preceding boom, for two reasons.

The first is a process known as 'rolling margin calls' where other assets (many of which are not owned, but rather obligations or options to buy or sell at some future date) have to be quickly sold, depressing their price and forcing other investors to sell further assets and so on. Thus the selling wave moves through the market far more rapidly than the original buying surge. When this results in a reduction of credit to firms in the 'real' economy, firms which have relied on the renewal of bank credit to finance operations are forced into bankruptcy.

The second reason is the effect that losses have upon the reputation of banks and funds, in a process known as 'contagion'. In the absence of reliable information as to the value of the assets held by a particular bank or fund, depositors withdraw their funds rapidly from this and related institutions - thus bringing about the very situation they fear and panic spreads - affecting firms in the same sector or country indiscriminately independently of their solvency. It this situation which usually obliges central banks to intervene by supplying sufficient liquidity for banks to meet their short-term obligations without becoming bankrupt.

Financial markets are thus inherently unstable, which is why at a domestic level they are so closely regulated. At the international level, it is precisely at the interstices between regulatory authorities that the largest short-term profits are to be made and the greatest risks of systemic collapse are to be found. Emerging markets are particularly vulnerable to this instability, not only because they have weak and inexperienced financial regulators. Developing countries have shallow and narrow capital markets, where relatively small flows of foreign capital can have a large effect on prices, particularly those of government bonds and privatization issues which tend to make up the bulk of traded securities. Their firms tend to be highly geared and dependent on borrowed funds, so that credit restrictions have a disproportionate effect upon production. Their populations in turn are vulnerable because much of their population lives near the poverty line, unprotected by modern welfare systems; so that macroeconomic fluctuations - particularly large deteriorations in the exchange rate - can have serious social consequences.

Despite this vulnerability, rapid financial liberalization has been pressed by both international agencies and local modernizing elites in emerging market countries. As a result, large international liabilities have been built up by the private firms and households to finance both investment and consumption. The currency risk was perceived as low by foreign lenders due to the strong growth record and nominal exchange rate stability underpinned by the same capital inflows.

The volatility of short-term capital flows (or 'capital surges') is now recognized as a major problem for macroeconomic management in developing countries; which subsequently translates into investment, growth, employment and welfare. Government expenditure cannot be efficiently allocated to the satisfaction of social priorities when both the borrowing ability and the cost of funds varies so sharply. The impact of short flows on output and investment by firms through the availability of bank credit is also large, reducing private investment. Employment levels and real wage rates are affected by the

influence of capital surges on real exchange rates and domestic demand levels.

On the other hand, it would be helpful if we can bear in mind the two important dimensions of regulations. First, regulation is a cost that is like taxation: someone bears the cost of regulation. The public must always ask whether the benefits outweigh the costs. Second, regulation has a time element - regulations must change with the times. Old regulations may prevent or impede market growth. As markets change, so must regulations. Third, regulation should not prevent the effective working of the market force. For example, we should avoid bank failures, but not prevent all bank failures. Chairman Alan Greenspan of the US Fed (1997), said "our goal as supervisors should not be to prevent all bank failures, but to maintain sufficient prudential standards so that banking problems that do occur do not become widespread."

2.7 What are we regulating?

We can regulate products, functions or institutions or a combination of all three. Problems arise when we have overlapping regulatory terrain, competing regulatory agencies and confused regulatory objectives. There are also arguments for and against the concentration and competition in regulatory agencies. A good example of a one-stop regulatory agency is the Monetary Authority of Singapore, which combines the regulation of the banking system, the securities market and the insurance industry in one institution. At the other end of the spectrum, the US banking sector is regulated by at least four different agencies, the Federal Reserve system, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the state banking commissioners. Since US banks are increasingly engaged in securities areas, their functions are also subject to the Securities and Exchange Commission (SEC) and consumer lobbies.

Regulation may be based on product types such that each regulatory authority specializes in one financial product. Under this framework, a securities regulator will concentrate in the oversight of securities activities, irrespective of the type of financial institutions that are carrying out this business.

Functional regulation is generally conducted by two separate regulatory bodies, an investor protection arm and a systemic stability arm. The investor protection arm deals with retail depositors and small investors to ensure fair conduct, equitable competition and customer protection. The systemic stability agency, on the other hand, looks at the larger players and wholesale activities. It would also be responsible for the safety, structure and functioning of all payment systems and financial markets. Preventive measures include capital adequacy requirement; constraints on connected lending and other rules aimed at preventing insolvency; and an official safety net such as lender of last resort or deposit insurance.

This approach follows the Goodhart (1995) model, which suggests that the difference in focus and function of investor protection and systemic stability is large enough to justify two separate regulatory bodies in each country to share the regulatory responsibilities. According to Goodhart, the formulation of rules for the safety of the system should be the responsibility of the systemic stability arm. On the other hand, the monitoring and operation of the system should be divided between the two arms on the basis of their size, e.g. balance sheet.

Another regulatory framework, which developed historically, takes the form of institutional regulation. It reflects institutional segmentation within each country, with insurance companies, securities houses, mortgage lending companies and banks becoming the concern of differing regulatory bodies. Institutional regulation becomes less practicable as the barriers between operating in differing functional and geographical financial markets have been eroded.

In between, the regulatory system may be organized along mixed functional/institutional lines. As banks, securities houses and insurance companies compete in each other's turf, there is now a less meaningful difference between institutions and functions. One model, colloquially known as "Twin Peaks", consists a Financial Stability Commission, with responsibility for systemic risk, the prudential supervision of all major institutions, and conduct of business regulation of wholesale activities, and a Consumer Protection Commission, which could be in charge of conduct of business regulation in retail markets, as well as detecting market manipulation and insider dealing. It would also carry out prudential supervision of those stock brokers and fund managers who deal with private clients, and of independent intermediaries. This is essentially the model adopted by the Wallis Commission.

2.8 Four patterns of international financial regulations

2.8.1 US Pattern

Under the circumstances of mixed operation of banks, securities houses and insurance companies, the US still apply the pattern of separate regulation, with no united authority or specialized regulation department for mixed operation. Within the framework of financial holding company, institutional regulation is still used in the US. Therefore, subsidiary bank companies are still under regulation and inspection of the main banking regulation institution of the states. In order to supervise the financial holding companies in general, Gramm-Leach-Bliley Act (1999) (Financial Services Modernization Act) points out that the Federal Reserve (FRB) is the umbrella supervisor of these financial holding companies, which will assess and supervise them as a whole and owns the arbitration right on subsidiary companies of banks, securities and insurances if necessary. Meanwhile, the Act makes sure that when specific regulation institutions question the regulation approaches of the FRB, they have the prioritized right to apply their own regime, serving as a competing power. The FRB should not inspect the subsidiary companies directly and should use the results from the other functional regulation departments instead in order to avoid overlapping regulation.

The umbrella supervision has been the basis of American economy. It is characterized by multiple regulators and duplicating rights. The Federal government and the state government both have the supervision rights and multiple departments are responsible for the financial regulation such as FRB, OCC (Office of Comptroller of Currency), OTS (Office of Thrift Supervision), FDIC (Federal Deposit Insurance Corporation), SEC(Securities and Exchange Commission) etc. This kind of system is a symbol of decentralization and constraints but at the same time, more and more leakages are seen in the system. Some people complain that the exceeding number of regulators leads to duplicating regulation and blind spots.

2.8.2 Germany Pattern

The stability of German financial system is widely acknowledged, which partly attributes to its mature regulation system. Universal banking system is widely applied in Germany. A universal bank participates in many kinds of banking activities and is both a commercial bank and an investment bank as well as providing other financial services such as securities, insurance and other derivatives. A universal bank is a kind of Financial intermediation first of all, and it is also a kind of financial conglomerate with investment in businesses and industries. Germany's universal banks can penetrate into all fields of finance, industry and commercial business, playing a leading role in public economy. In order to alleviate and control the risks, the German government has set harsh inspection and restrictions on the universal banks. For example, the total investment can not exceed the total assets of the bank. Despite the universal banking system, separate regulation is carried out in Germany. The Federal Financial Supervisory Authority (BaFin) has three branches special for banks, securities and insurance, running separately in different industries. BaFin is the main institution of financial regulation in Germany. The federal bank of Germany is the central bank. Since the BaFin has no subsidiary bodies, the practical supervision is conducted by the branch organizations of the Federal bank and then the results would be sent back to the BaFin.

2.8.3 UK Pattern

UK' s mixed operation is under the financial holding groups model. The parent companies are usually operational holding companies running commercial banking services while securities and insurance businesses are operated by the subsidiary banks. Meanwhile, strict firewall system is set up in the financial holding groups in order to keep the risks from spreading within the groups. The regulation system has grown from separate to unified regulation. UK integrated all the financial supervision institutions into Financial Service Authority (FSA) in 1998. FSA is in charge of the supervision of all financial institutions. The Financial Services and Markets Act 2000 (FSMA) helped make this transition complete. According to FSMA, FSA has direct supervising responsibility over banking, insurance and securities industries. However, after the Financial Crisis 2008, FSA was divided into two institutions in 2012, one being FCA (Financial Conduct Authority) and the other PRA (Prudential Regulation Authority)

2.8.4 Japan Pattern

Japan's financial regulation was under administrative guidance for World War II. When a modern system of government was introduced after the Meiji Restoration, the Ministry of Finance (大蔵省; Ōkura-shō) was established as a government body in charge of public finance and monetary affairs. Administrative approaches were often used to interfere with the financial activities. The Ministry has long been regarded as the most powerful ministry in the Japanese government. After various financial scandals revealed in the 1990s, however, the Ministry lost its power over banking supervision to a newly established Financial Services Agency. It also lost most of its control over monetary policy to the Bank of Japan when the Diet passed a new Bank of Japan Law in 1998. In addition, it lost its ancient Japanese name in January 2001, to be renamed as Zaimu-shō (財務省), although its English

name remained the same. Therefore, the Financial Services Agency is now the only government organization responsible for overseeing banking, securities and exchange, and insurance in order to ensure the stability of the financial system of Japan.

Comparing the four patterns above, we can conclude that the US pattern is a kind of 'double-authority, multiple regulators' model when the central government and state government both have supervision rights over banks and multiple regulation institutions are in duties on each level. This might contribute to the significant power of local state government. Germany and UK patterns are more like 'single-authority, multiple regulators' model, which is beneficial to promote the integration and efficiency of supervision, but it also requires coordination and cooperation among different financial regulation departments. This kind of pattern also requires a mature and sound legal system. Japan pattern, on the other hand, is 'single-authority, single regulator' with every financial institutions under unified regulation of the Financial Services Agency. This pattern is more efficient and responsible but it can also lead to corruption and bureaucracy.

2.9 Conclusion

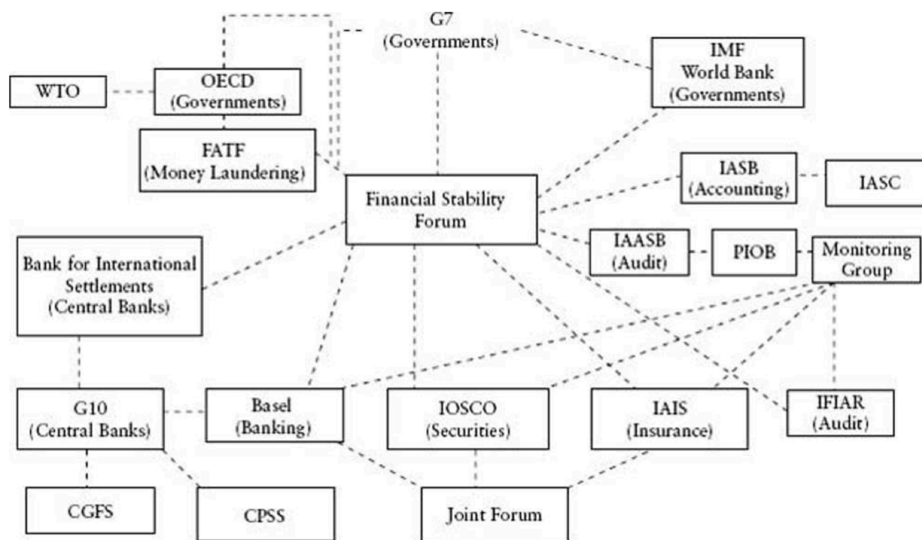
Regulation is an art, not a science. It involves complicated trade-offs between competing interests. As Walter Bagehot said over 120 years ago, money will not manage itself. The regulation of money will be debated in the years to come.

CURRENT INTERNATIONAL REGULATION SYSTEM

3.1 Banking

3.1.1 Global Committee Structure----the Basel Committee

Banking supervisors, in the form of central banks concerned about the creditworthiness, have always had an interest in international affairs. Banks have operated foreign branches since at least the fourteenth century, and cross border risks have always had a major impact on banks' soundness. Central bank governors have discussed the health of their regular meetings in Basel ever since the Bank of International Settlements (BIS) was created between the 2 world wars.



Source: Adapted with permission from Sloan and Fitzpatrick in Chapter 13, The Structure of International Market Regulation, in Financial Market and Exchanges Law, Oxford University Press, March 2007

3.1.2 Core central banking-International Monetary Fund

Most countries have their own central banks, reserve banks or monetary authorities to manage the national currency, which is the same for the global market. International Monetary Fund (IMF), functioning as the core central bank of the global financial market, provides liquidity to the market and serves as a lender of last resort. More importantly, IMF supports sound banks, prevents contagion of insolvency during financial crises and also works with developing nations to help them maintain macroeconomic stability and reduce poverty. In all, IMF aims to achieve global growth and economic stability.

IMF was conceived at United Nations conference convened in Bretton Woods in July 1944, whose

original intention was to build global economic framework to avoid the repetition of the Great Depression of the 1930s. Thus, the responsibility of IMF is to ensure the stability of the international monetary system—the system of exchange rates and international trade. To achieve the original goal, IMF reviews global macroeconomics through surveillance, which is the formal system to assess economic aspects and financial market. For instance, IMF publishes global financial stability reports twice a year, evaluating opportunities and challenges in global financial market. And the most updated edition of April 2014, focuses on the transition from liquidity to growth-driven market, which is particularly in US, Euro and the emerging markets. This is the best way to reveal the most comprehensive analysis to development of global financial markets, and give advice to its members simultaneously.

The core responsibility of IMF is to provide loans to its members experiencing liquidity problems, acting as a lender of last resort. But the environment of lending is changing at the same time. Through the data analysis, it's evident that the fluctuation of the volume of loans is of high correlation with global financial crisis.

[Failure in late 20th century]

IMF was a representative international organization of Bretton Woods, working as a part of International Financial Institutions. As intergovernmental institutions, IMF is essentially the lender of last resort, against which facility it can impose policy conditionality designed to restore long-term solvency in return for the provision of liquidity. Whatever the effectiveness of this approach in the sovereign debt crises of the 1980s, or to the chronic economic problems of the least developed countries, it is not appropriate for the emerging market crises of the 1990s. The Latin American and East Asian crises in late 20th century are essentially related to private sector asset deflation and illiquidity, not state failure.

The root causes of the breakdown were not prevented (and possibly have been exacerbated) by Bretton Woods policies of accelerated financial liberalization, exchange rate anchoring and encouragement of private portfolio investment as a substitute for sovereign borrowing. The IFIs appear to have taken the pre-crisis position that because the external deficits reflect private investment-savings gaps rather than fiscal deficits, they must reflect rational market decisions and thus be respected. However, even had they wished to prevent such inflows, their ex-ante influence over lenders is limited to issuing negative macroeconomic evaluations with the consequent danger of market collapse.

Ex-post, their insistence on large devaluations, high interest rates, credit restrictions and fiscal retrenchment have tended to further undermine both corporations and bank, worsening the crises they attempt to resolve. The failure of recent IMF interventions in East Asia and Mexico essentially derive from the failure to recognize and correct private debt problems. In the commercial world, of course, insolvent companies are placed under new management and the unserviceable debt is written off by the creditors. There is, however no equivalent in international debt crises

[A new Bretton Woods?]

On the summit meeting of world leaders held in Washington, D.C., in November 2008, French President Nicolas Sarkozy and British Prime Minister Gordon Brown called for a "new Bretton Woods" agreement. They were recalling the success of the International Monetary and Financial Conference held in Bretton Woods, New Hampshire, in July 1944.

Through many failures of constructing global financial architecture in the 20th century, Bretton Woods is the major exception. From the lessons below, the successful reform require 3 ingredients:

- Effective and legitimate leadership combined with inclusive participation
- Clearly stated and broadly shared goals
- A realistic road map for reaching those goals

Useful Lessons:

Events	Time and place	Background related to global finance	Results and Influence
Paris Peace Conference	1918-1919 after World War I, Paris	Establish a framework for restoring free trade and the flow of capital	• Concept of Open Trade Wide-spread, but how to achieve unsolved • Ratification of the new global institution, the League of Nations
World Monetary and Economic Conference	1933, London	Re-establish fixed parities for a wider range of currencies	• Signing of Tripartite Agreement by US, UK and France 3 years later, lacking an institutional structure and a sustainable enforcement mechanism
Bretton Woods Conference	1944 during World War II, US	Formation of the IMF and the IBRD, which is today part of the World Bank; Adjustably pegged foreign exchange market rate system: The exchange rates	• US lead in the design of IMF as the principal creditor • Establishment of

		were fixed, with the provision of changing them if necessary; Currencies were required to be convertible for trade related and other current account transactions. The governments, however, had the power to regulate ostentatious capital flows; As it was possible that exchange rates thus established might not be favorable to a country's balance of payments position, the governments had the power to revise them by up to 10%; All member countries were required to subscribe to the IMF's capital.	international trade organization postponed • Resolve of postwar economic order with the agreements on monetary order and open system of trade
The end of fixed exchange rates	1971-1973	Realignment of key-currency exchange rates, including a devaluation of the dollar	• Goal of exchange rate stability abandoned • IMF mandated to exercise "" firm surveillance"[1]
The oil-price shocks	1970s	Organization for Economic Cooperation and Development (OECD) planning to borrow from oil exporters and lend to OECD member countries----Support Fund	• Oil Facility established by IMF right before Support Fund • Vanishing of OECD proposals
Calls for a new Bretton Woods	1980s	The exchange system unstable by the time the Second Amendment took effect in 1978	·G-5(France, Germany, Japan, UK, US) supplanting G-10, trying to stabilize rates around a new equilibrium

[1] "Firm surveillance": over what was supposed to become a stable system through bilateral and multilateral oversight. That mandate was eventually enshrined in the Second Amendment of the IMF Articles of Agreement in 1978.

What we can learn from the lessons:

The international financial architecture over the past century evolved in response to circumstances of the moment. Formal conferences were occasionally an important element of that process. In most cases, however, institutional adaptation to changes in the world economy came from the interplay of internal deliberations and initiatives from groups of industrial countries. When problems were clearly identified and the major countries agreed on the type of solution required, deliberations within a group of those countries usually provided the necessary leadership for reform. In the most successful efforts, leadership came from a small inner group that was willing to include, listen to, and absorb ideas from a wide outer set of participants.

Each of the major attempts to revise the international financial architecture came in response to a crisis. When they succeeded, they did so only partially. This observation leads to three broader but interrelated lessons about the context in which financial and other reforms are attempted.

It is inevitable that some important goals have to be set aside, such as the trade organization at Bretton Woods and systemic rules for exchange rates in the 1970s. Even the best "new Bretton Woods" will solve only a few problems. Whatever gets set aside is unlikely to get accomplished for another generation--or at least until the next major crisis.

Financial crises often occur at times when other--and possibly more serious--crises are competing for attention. In the past year, the world economy has suffered a variety of ills, including a financial meltdown and wide fluctuations in the prices of food, fuel, and other basic commodities. Over the longer run, both climate change and the persistence of extreme poverty in much of the developing world are looming crises. If revising the rules of international finance dominates the agenda, the opportunity to find better ways to deal with other issues could be lost, possibly for many years.

Decisions on which countries have a seat at the table have a major effect on what gets done and what gets set aside. Only the major participants in financial markets--industrial and emerging market countries--can devise new rules for finance, but they cannot by themselves devise new rules for trade in commodities. Nor can they cope alone with climate change or extreme poverty. The more inclusive the participation in the next Bretton Woods, the more likely the outcome will have long-run benefits for mankind.

-----James M. Boughton
IMF Historian

3.1.3 Predential Regulation of Financial Intermediaries

The prudential regulation of financial intermediaries aims to prevent not only fraud but also unsafe lending with wider consequences. To some extent, this service is provided by the Bank for International Settlements, but it leaves the greater part of global financial intermediaries still unregulated.

There's also an international financial institution serving for central banks. The Bank for International Settlements is an international organization that fosters international monetary and financial cooperation. The BIS was established on May 17, 1930 by an intergovernmental agreement by Germany, Belgium, France, United Kingdom, Italy, Japan, United States and Switzerland. Its members are the central banks or monetary authorities of:

Algeria, Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Macedonia (FYR), Malaysia, Mexico, the Netherlands, New Zealand, Norway, Peru, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Serbia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Arab Emirates, the United Kingdom and the United States, plus the European Central Bank.

When tracing back to the founding of BIS, we can have a brief sketch as the following:

"The Power of financial capitalism had another far reaching plan, nothing less than to create a world system of financial control in private hands able to dominate the political system of each country and the economy of the world as a whole. This system was to be controlled in a feudalistic fashion by the central banks of the world acting in concert, by secret agreements arrived at in frequent meetings and conferences. ***The apex of the system was to be the Bank for International Settlements in Basle, Switzerland, a private bank owned and controlled by the world's central banks, which were themselves private corporations.*** *Each central bank, in the hands of men like Montagu Norman of the Bank of England, Benjamin Strong of the New York Federal Reserve Bank, Charles Rist of the Bank of France, and Hjalmar Schacht of the Reichsbank, sought to dominate its government by its ability to control treasury loans, to manipulate foreign exchanges, to influence the level of economic activity in the country, and to influence co-operative politicians by subsequent rewards in the business world."*

---- Carroll Quigley, Georgetown Historian

The mission of the Bank for International Settlements (BIS) is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.

In broad outline, the BIS pursues its mission by:

- promoting discussion and facilitating collaboration among central banks;

- supporting dialogue with other authorities that are responsible for promoting financial stability;
- conducting research on policy issues confronting central banks and financial supervisory authorities;
- acting as a prime counterparty for central banks in their financial transactions;
- serving as an agent or trustee in connection with international financial operations.

Even though the BIS is the oldest international banking operation in the world, it is a low profile organization, shunning all publicity and notoriety. As a result, there is very little critical analysis written about this important financial organization. Further, much of what has been written about it is tainted by its own self-effacing literature.

3.1.4 Deposit Insurance

Deposit insurance is a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank's inability to pay its debts when due. Deposit insurance systems are one component of a financial system safety net that promotes financial stability.

The risk that banks will fail and not be rescued has led governments to put in place schemes to reimburse retail depositors for losses. The world of deposit insurance is surprisingly divided. There several separate, albeit overlapping issues on which different countries take markedly different positions.

Whether to operate a deposit protection scheme for small depositors at all is the first question. In the United States, the Federal Deposit Insurance Corporation (FDIC) has been high-profile since the bank failures of the depression years, which was established in 1933 with the foundation “no depositor has lost a single cent of insured funds as a result of failure.” The European Union has a legislated minimum deposit insurance of around £30,000 per individual depositor. But countries such Australia and Singapore long held out against the establishment of deposit insurance schemes on the basis of free market. And in some developing countries, the banking system has been considered to be insufficiently mature to allow the establishment of deposit insurance for small savers.

However, the international trend is increasingly towards the establishment of deposit insurance scheme. There still remain 3 more questions to consider:

- Whether there should be any element of coinsurance built into the scheme, or require the depositor to take some element of risk. In the US, the FDIC fully insures the first $100,000 of all depositors. The UK comes down on the other side, while the first £2,000 of deposits are 100 per cent insured, the remainder up to maximum of £33,000 is only insured as to 90 per cent. In theory, an element of depositor discipline is attractive, but the political tolerance for depositor losses is low.
- Whether deposits should be guaranteed by a fund, or simply by a regular with the power to impose a levy on other banks. This is generally characterized as the difference between pre- and post-funding. The FDIC has a fund with currently totals around 50 billion, which supports more than $3 trillion of deposits in US banks. However, in UK there’s no fund. The UK regulator has the power to impose a levy on other banks to pay for depositors’ losses in the event of a failure. The

range of practice on this point in other countries is diverse ad it's not possible to identify an emerging consensus.

- Even if deposit insurance exists, there's a need for a separate entity to maintain, and to supervise banks specifically for the purposes of protecting the deposit insurance fund. Countries of pre-funding often establish a regulator to protect the fund, while countries with post event funding normally think that there's no need to separate supervision for deposit insurance purposes. Once again, the US and the UK are on different tracks.

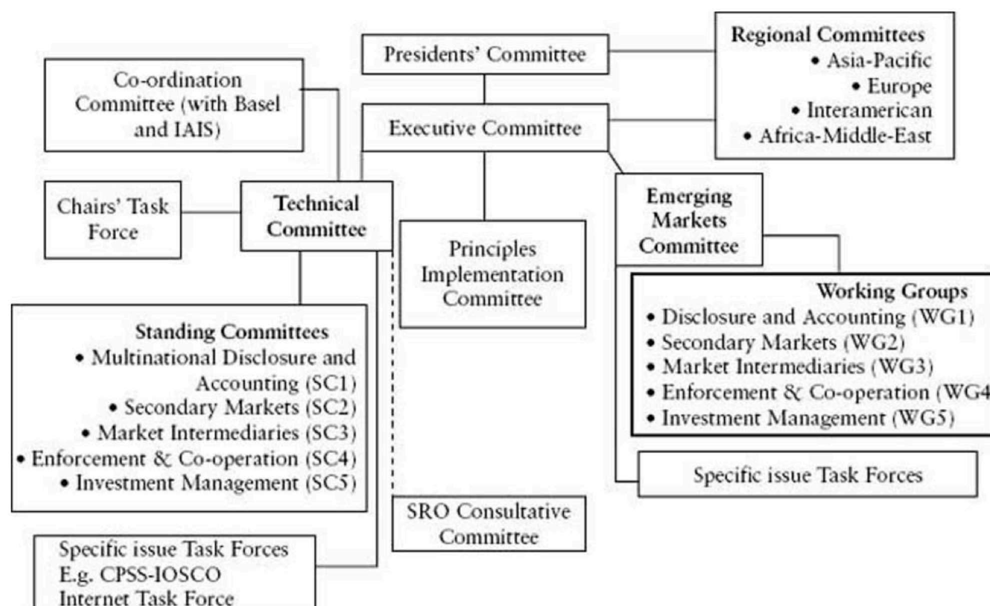
There's no international consensus hitherto. In developed countries with a generally stable banking system, there's little benefit in a pre-fund regime with a separate regulator. However, the balance of argument is different in developing countries where confidence in domestic banks is low.

3.2 Securities Markets

3.2.1 International Organization of Securities Commissions

The parallel organization to the Basel Committee in securities markets is the International Organization of Securities Commissions. IOSCO has members from over 100 different countries, who regulate more than 90 percent of the world's securities markets. The organization's role is to assist its members to promote high standards of regulation and act as a forum for national regulators to cooperate with each other and other international organizations.

However, IOSCO has somewhat lower profile than the Basel Committee, because the cross-border issues faced by securities regulators are less central than those in banking and the business issues are less all-pervasive than the overall risk management and capital allocation rates dictated by Basel.



Source: Adapted with permission from Sloan and Fitzpatrick in Chapter 13, The Structure of International Market Regulation, in Financial Market and Exchanges Law, Oxford University Press,

March 2007

3.2.2 Stock Exchanges

Stock exchanges are affiliate members of IOSCO, while they also join their own association, the World Federation of Exchange. Instead of a regulatory group, WFE is working as a trade association, since the exchange members vary in terms of regulatory responsibilities. Most of them undertake the responsibility of front-line surveillance of trading patterns, while others have their own investigative and disciplinary rules.

"(The work of WFE) enhances the co-operative relationship with supervisory authorities, in orderto advocate the benefits of exchange front-line self-regulation within the total regulatory framework and the process of international mutual recognition."[2]

The WFE now has 58 members, including NASDAQ joining in 2006. Members are required to meet certain minimum standards to qualify as an organized market. However, those standards are generally those which would be required for legal recognition in most developed countries, while WFE is still playing a role raising the operational and regulatory standards in developing countries.

3.2.3 Credit Rating Agencies

A credit rating agency (CRA) is a company assigns credit ratings, which rates a debtor's ability to pay back debt by making timely interest payments and the likelihood of default, with the analysis of risk associated with debt securities. These securities include government bonds, corporate bonds, certificates of deposit (CDs), municipal bonds, preferred stock, and collateralized securities, such as collateralized debt obligations (CDOs) and mortgage-backed securities. Raters' opinions are usually characterized by a letter grade, the highest and safest being AAA, with lower grades moving to double and then single letters (AA or A) and down the alphabet from there. Credit rating agencies perform a crucial function in international capital markets and potentially provide the first line of defense for investors. Almost all significant borrowers, whether corporate or sovereign, have a rating issued by one or two major agencies.

Credit rating is a highly concentrated industry, with the 2 largest CRAs----Moody's Investors Service and Standard & Poor's controlling 80% of the global market share. In 1975, the SEC began to designate agencies as national organized statistical rating organizations (NRSROs), including 5 agencies in 2009: AM Best (which principally covers the insurance market), Dominion Bond (a Canadian bond rating agency) and Fitch IBCA, together with the 2 majors. But this status as a nationally recognized agency didn't carry out any implication that the SEC approved ratings and methodologies, or carried out any regular oversight of the way the agencies operate. And in other countries there was no comparable registration, though in some cases regulators have used the SEC recognition status as a proxy for deeming rating agencies to be appropriate for the purposes of ratings used in capital requirements.

[2] www.world-exchanges.org

"The more government has power and is meddling with rating agencies, the more the rating agencies will be brow-beaten into giving a generous rating to the sovereign."

---- Sebastian Mallaby, Council on Foreign Relations

Since the credit crisis began in 2007, these agencies have come in for heavy criticism. The US SEC is tightening up on the way they behave. One move would stop individuals on their sales and marketing side from taking part in the actual rating. The EU is not happy either. The potential for a downgrade to destabilize a country was so feared that the European Parliament this year agreed a set of rules designed to rein them in. They state that agencies can issue ratings on countries no more than three times a year, and only after markets have closed.

----Rebecca Marston, Business reporter, BBC News

PAST ACTIONS

4.1 International Actions on the Economic Growth of Developing Countries

Most of the benefits of these decades of economic growth have been concentrated in the hands of a trans-global elite community of about 1.2billion people, mainly in the countries of the Atlantic community and the West Pacific. At the same time, improvements in education, literacy and communications in recent decades have increased the awareness of many marginalized people of this unjust distribution of wealth. When economic crisis break up, many hundreds of millions of people among the poorest communities across the world will suffer most. This is likely to lead to the rise of radical and violent social movements, which will be controlled by force, further increasing the violence. Therefore, measures should be taken to introduce fundamental economic reforms which reverse the wealth-poverty divisions that have got so much worse in the past three decades. Boosting the economic growth of developing countries has long been a priority for the Economic and Financial Committee.

In 1978, the General Assembly adopted resolution A/RES/33/149, entitled "Special measures in favor of the least developed among the developing countries" upon the recommendation of the Economic and Financial Committee. The resolution called for increased aid from developing countries and multilateral financial institutions, and supported measures to give least developed countries extra support in debt repayment and trade.

In 1990, the General Assembly passed A/RES/57/246, "Declaration on the International Economic Co-operation, in particular the Revitalization of Economic Growth and Development of the Developing Countries." This resolution identified the need to diversify developing economies away from their dependence on commodity exports, find strategies to boost development in an environmentally-friendly way, and solve the problem of over bearing debt. It asked developed countries to do their part to assist developing countries, and urged developing countries to control inflation, utilize all available resources, and create favorable environments for investment.

In addition, various conferences resolved to promote better trading policies and to remind developed countries of their responsibility to help developing countries through ODA and other measures. The conferences also recognized the role poverty and hunger play in limiting growth, and set the reduction of those global ailments as a key objective.

Over the years, G8 Summits have contributed to development initiatives as well. In 2002, at the G8 Summit in Kananaskis, NEPAD was introduced, and one year later, the Africa Action Plan was brought forth. Both proposed strategies for economic development in Africa. In 2005, 2007 and other years, G8 Summits have also contributed a lot to the development of Africa.

4.2 International Actions on Financial Crisis of 2010

In light of the financial crisis, the UN has taken many actions to assess its impact and formulate plans for the future.

In June 2009, the UN held a Conference on the World Financial Economic Crisis and its Impact on Development. The report from this conference called for a coordinated and wholehearted effort from the international community "to ensure that the economic and financial crisis does not turn into a humanitarian disaster that would threaten achievement of the Millennium Development Goals."

The World Bank has responded by launching two initiatives: the Infrastructure Assets and Recovery Platform (INFRA) and the Infrastructure Crisis Facility (ICF). INFRA, projected to involve US$45 billion within a few years, helps countries whose infrastructure projects have been jeopardized by the financial crisis find ways to continue progress on them. The ICF is intended to assist countries that have incurred significant losses in financing infrastructure projects because of the crisis by providing loans and equity.

The IMF, bolstered by an increase in funds after the G20 meeting, has already given US$50 billion to help countries get through the financial crisis.

CASE STUDY: BANK RECAPITALIZATION CRISIS 2007-2009

5.1 Background

The US recession began in December 2007, which was the worst financial and economic crisis since the 1929 stock market collapse and the ensuing Great Depression. American households, businesses, state and local governments, pension funds, and other investors have lost trillions of dollars in wealth and savings. Unemployment has risen. The loss of confidence in the Nation's financial institutions has undermined the stability of major banks and the financial system as a whole. Short-term interest rates have been near zero and the credit markets at a standstill. The U.S. crisis has affected the global financial system and damaged economies around the world.

The U.S. government has undertaken extraordinary efforts to support financial institutions and bolster the credit markets. The Department of the Treasury ("Treasury"), Board of Governors of the Federal Reserve System ("Federal Reserve"), and other government agencies have used their legal authority to the fullest in responding to the crisis. Congress has authorized huge expenditures of taxpayer dollars to prop up the financial system and stimulate the economy. Yet, the financial system remains weak and full economic recovery seems months if not years away.

The crisis emerged from a complex interaction of government economic and social policies, evolution of the financial markets, opportunistic business practices, and undue leveraging and risk taking by American consumers, investors, private financial institutions, and GSEs (Government-sponsored Enterprises) alike. These factors gave rise to destabilizing forces that engulfed the entire financial system.

(Figures 1A and 1B display data for the interest rate on commercial paper with a maturity of 90 days for financial and nonfinancial corporations. During the financial crisis, this interest rate has risen for financial institutions and has barely budged for nonfinancial institutions with an AA rating.)

Figure 1A: Commercial Paper 90 Day Rate

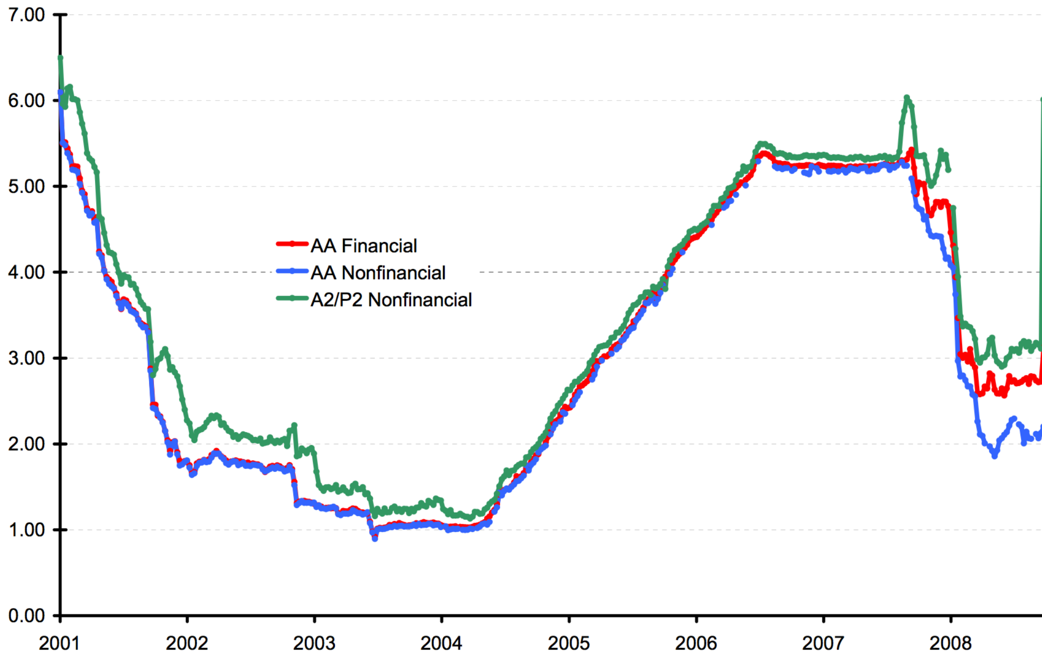
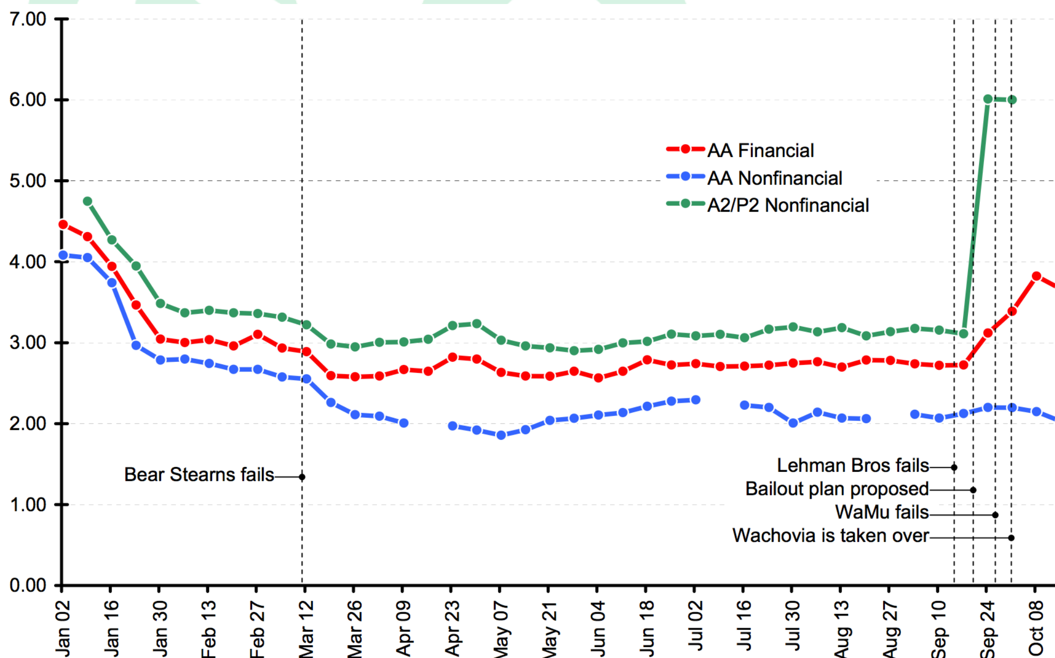


Figure 1B: Commercial Paper 90 Day Rate in 2008



The following narrative explains that immediate causes and occurrences of the crisis: (which are not the key points in this background, but can help you analyze the macroeconomic situation)

- **Too Many Loans With Flawed Credit Standards**
- **Subprime and Unconventional Mortgages**
- **Unregulated Mortgage Originators**
- **Originate-to-Distribute Model3**
- **Securitization of Mortgages**
- **Government Policies Encouraging Borrowing**
- **Mortgage Fraud and Abuse**
- **Global Credit Imbalance and Low Interest Rates**
- **Excessive Consumer Debt**
- **Fannie Mae and Freddie Mac4**
- **Demand for Mortgage-Backed Securities**
- **Complex Products that Obscured Risk**
- **Flawed Credit Ratings**
- **Investor Complacency**
- **Excessive Leveraging**
- **Risk-Rewarding Compensation Practices**
- **Bursting of the Housing Bubble**
- **Devaluation of Mortgage-Related Assets**
- **Mark-to-Market Accounting**
- **Bank Failures**
- **Uncertainty and Panic**
- **Moral Hazard**
- **Lehman Brothers Failure**
- **Run on Money Market Funds**
- **Pressure on the Commercial Paper Market**
- **Liquidity Crisis at AIG—Credit Default Swaps**
- **Implosion of Wall Street Firms**
- **Mixed Message from Congress**
- **Freezing of Credit Markets**
- **Government Rescue and Relief**

[3] Originate-to-Distribute Model: Many mortgage brokers originated loans solely for the purpose of selling them. This model allowed them to earn loan origination fees without bearing the ultimate credit risk.

[4] Known as "GSEs", which are the largest purchasers of mortgages.

5.2 Introduction to Banking Crisis

Banking crises can occur either independently or concurrently with a currency crisis (a so-called twin crisis) or with a sovereign debt crisis, or both. In a systemic banking crisis, a country's financial and banking industry experiences a significant number of defaults while financial entities face vast problems fulfilling financial contracts on time. As a consequence, a country experiences a large increase in nonperforming loans, and a large part of the capital in the banking system is reduced. Sometimes, these events follow a fall in asset prices (for example, in the real estate market) and sometimes overlap with runs on banks, but in order to be defined as "systemic," such crises must involve a large number of institutions or cover a large portion of the banking system.

There're two factors during banking crisis. The first one is a currency crisis, which is defined as the situation in which a country experiences a nominal depreciation of its currency of at least 30 percent. At the same time, the rate of depreciation increases by at least 10 percent compared with one year earlier. For instance, the collapse of the Thai baht during the Asian Crisis of 1997-98 is a prime example of a large currency crisis: The currency had depreciated by more than 30 percent less than two months after the fixed exchange rate was abandoned in the summer of 1997.

The other factor is a sovereign debt crisis, in which a government fails to pay its own debt, either in part or in full. For example, in 1998 Russia defaulted on its Soviet-era debt and began restructuring the components of its sovereign debt. Notice that at least partial default is required to meet the definition of "sovereign debt crisis" used by the IMF. That means the current difficulties experienced by some European countries would not qualify as a "sovereign debt crisis." During the recent financial crisis, no twin or triple crisis (as just defined) has occurred so far. Some European countries have experienced difficulties in managing and refinancing their debt, but so far none has defaulted.[5]

The recent global financial crisis witnessed many countries experiencing banking crises. After 2007, there were 13 cases of systemic banking crises in which all countries experienced extensive liquidity support, increases in guarantees on liabilities and significant nationalizations. In some cases, the countries also experienced significant asset purchases (as in the United Kingdom and United States) and sizable restructuring costs. During the same period, a smaller group of 10 countries experienced serious problems in its banking sectors that entailed extensive liquidity support and increases in guarantees on liabilities; in these 10 countries, there was only one case of asset purchases (Switzerland) and there were no cases of significant nationalization.

Situation in US

To recapitalize the banking system in the US, the government has taken a schizophrenic policy approach to the ongoing credit crisis. And the Trouble Assets Relief Program (TARP) became the central part of the economic stabilization act, as well as the best measure to recapitalize the banking system.

[5] In the time of April 2011, by Silvio Contessi and Hoda S.El-Ghazaly, "Banking Crisis around the World: Different Governments, Different Responses", Federal Reserve Bank of St. Louis

The TARP program originally authorized expenditures of $700 billion. The Dodd–Frank Wall Street Reform and Consumer Protection Act reduced the amount authorized to $475 billion. By October 11, 2012, the Congressional Budget Office (CBO) stated that total disbursements would be $431 billion and estimated the total cost, including grants for mortgage programs that have not yet been made, would be $24 billion.

Timeline:

On October 14, 2008, Secretary of the Treasury Henry Paulson and President Bush separately announced revisions to the TARP program.

- On November 12, 2008, Secretary of the Treasury Henry Paulson indicated that reviving the securitization market for consumer credit would be a new priority in the second allotment.
- On December 31, 2008, the Treasury issued a report reviewing Section 102, the Troubled Assets Insurance Financing Fund, also known as the "Asset Guarantee Program." The report indicated that the program would likely not be made "widely available.
- On January 15, 2009, the Treasury issued interim final rules for reporting and record keeping requirements under the executive compensation standards of the Capital Purchase Program (CPP).
- On February 5, 2009, the Senate approved changes to the TARP that prohibited firms receiving TARP funds from paying bonuses to their 25 highest-paid employees. The measure was proposed by Christopher Dodd of Connecticut as an amendment to the $900 billion economic stimulus act then waiting to be passed.
- On February 10, 2009, the newly confirmed Secretary of the Treasury Timothy Geithner outlined his plan to use the remaining $300 billion or so in TARP funds. He intended to direct $50 billion towards foreclosure mitigation and use the rest to help fund private investors to buy toxic assets from banks. Nevertheless, this highly anticipated speech coincided with a nearly 5 percent drop in the S&P 500 and was criticized for lacking details.
- On March 23, 2009, Geithner announced a Public-Private Investment Program (P-PIP) to buy toxic assets from banks' balance sheets.
- On April 19, 2009, the Obama administration outlined the conversion of Banks Bailouts to Equity Share.

But why is it a schizophrenic policy approach? As the crisis faded, the government officials publicly expressed their disappointments about this program: “There’ll be no more taxpayer funded bailouts period”. They indicated their intentions to never again deploy a TARP-like program.

There’re certainly many problems within the whole program. The overseers have identified various problems, such as the failure to improve small business’ access to credit, the lack of transparency in implementation, more importantly, the creation of moral hazard. The central reason for this failure to plan for a scenario where the government is once again forced to bail out financial institutions is regulators’ burgeoning faith in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) and its newly-created tools to address the fundamental failures in the financial system.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into federal law by President Barack Obama, which brought the most significant change to financial regulation in the United States since the Great Depression. Dodd-Frank gives the Federal Deposit Insurance Corporation ("FDIC") the authority to resolve and break apart certain large financial firms whose imminent failure would threaten the stability of the financial system. The FDIC and other financial regulators have promised that this new tool will reduce the chance that future taxpayer bailouts will be necessary. However, the success of Dodd-Frank is far from certain. The future or taxpayer bailouts hinges on the ability and willingness of FDIC to use its new authority, coordinating with other federal regulators, and to insist on organizational changes well before the trigger point of a crisis. There's a pertinent comment from Professor Joseph E. Stiglitz, the Nobel laureate, " (Dodd-Frank resolution authority) has made little difference, because few believe that the government will ever use the authority at its disposal with too-big-to-fail banks."

Regarding TARP as a capital injection program, of which the cornerstone is the Capital Purchase Program, we have to focus on the improvement of recapitalization scheme. Here're some facts and data (see Figure 2) of state interventions from which we could draw some inspiration.

5.3 Comparable Perspective in Other Countries

The recapitalization measures (See Table 1) taken by other countries also reflect the weaknesses of Dodd-Frank system. Particularly, when it comes to non-price conditions, the CPP contains relatively lenient non-price conditions (See Table 2) such as few limits on execution compensation for participating banks. To achieve effectiveness in achieving recapitalization goal, there's much more to learn from European and Japanese experiences.

Figure 2. Timeline of Select State Interventions (2008–09)

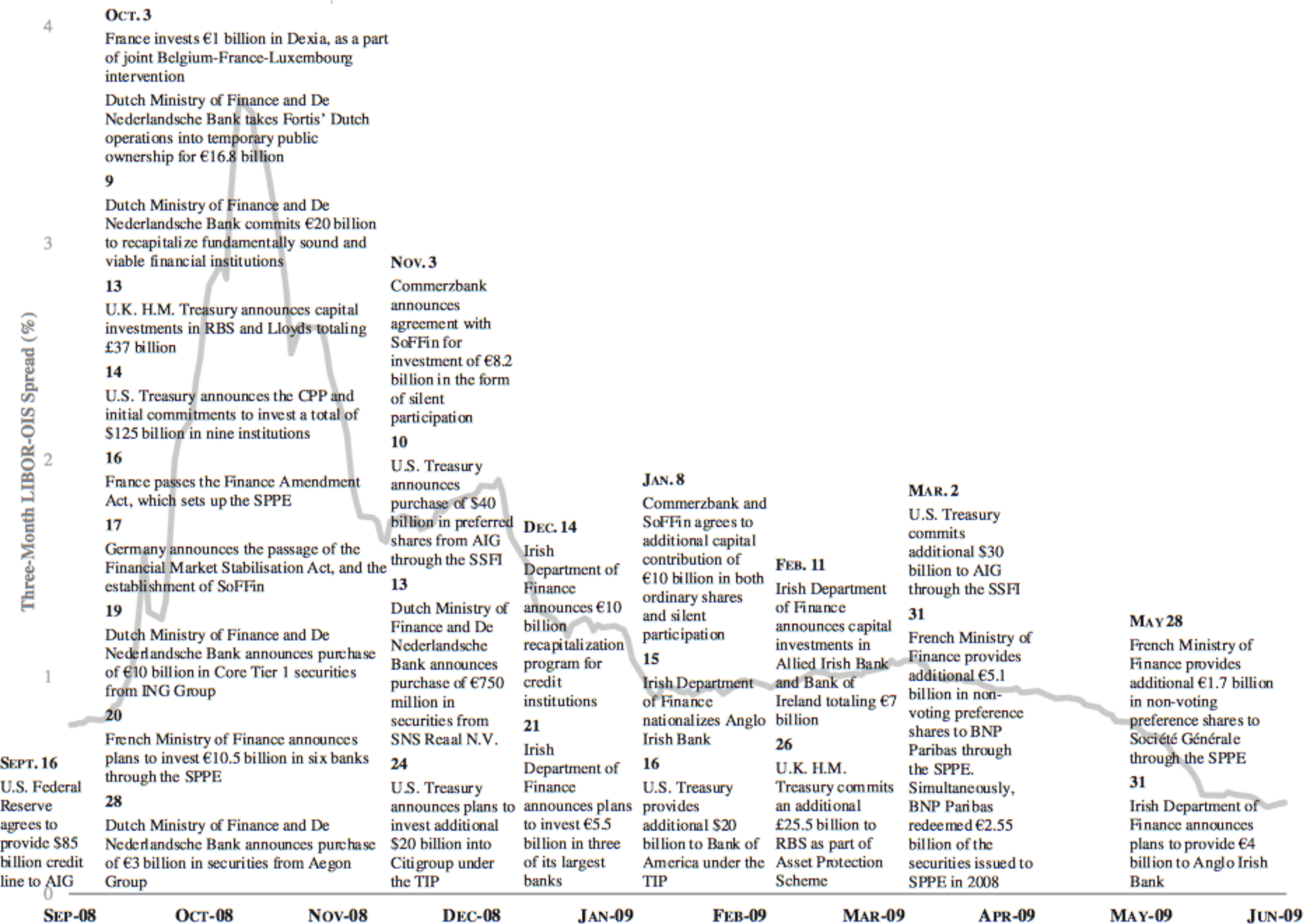


Table 1: Summary of Recapitalization Programs (2008–09)

Program	Amount Committed[1]		Outlay ($ bn)[1]	Recipients		Instrument	Dividend/ Interest rate	Covenants and Restrictions				
	Total ($ bn)	% GDP (2008)		#	% Asset[2]			Exec Comp	Ordinary Dividend Ban[3]	Board of Directors Appointment	Required Lending	Required Restructuring
U.S. (TARP)												
CPP	$250	1.7	$204.9 (*10.56*)	707 (*210*)	69.2	NCP & Warrants	Initial: 5%, 5 yrs: 9%	✓		✓[4]		
TIP	--	--	$40 (*0*)	2 (*0*)	--	NCP & Warrants	8%,	✓	✓	✓[4]		
SSFI	$69.8	0.05	$67.8 (*13.5*)	1 (*0*)	--	NCP & Warrants	10%	✓	✓	✓[4]		
U.K. (GRS)	$64.7	2.9	$103.4 (*103.4*)	2 (*2*)	27.4	NCP, Common	Initial: 12%, 5 yrs: LIBOR +7%	✓	✓	✓	✓	✓
Germany (SoFFin)	$109.3	3.8	$39.7 (*23.7*)	(4) (*4*)	17.4	Silent participation, Common	Average 9–10% based on risk profile	✓	✓		✓	✓
France (SPPE)[5]	$53.7	2.6	$26.4 (*0*)	6 (*0*)	91.9	NCP, TSS securities	Initial: average 8% 5 yrs: CDS-linked rate	✓			✓	
Ireland	$7.7	4.0	$14.7 (*14.7*)	3 (*3*)	26.6	NCP & Warrants	8%	✓		✓	✓	✓
Netherlands[6]	$27.3	4.1	$18.0 (*3.95*)	3 (*2*)	65.5	Convertible securities	Dividend-linked, floor of 8.5%	✓		✓		✓
Japan												
1998 Financial Functions Stabilization Act	$102.6	3.5	$14.5 (*2*)	21 (*2*)	--	Mostly subordinated debt.	Varied. Average LIBOR+1.43% (SD) for first 5 years.					
1999 Early Strengthening Act	$214.7	7.3	$71.84 (*7.43*)	32 (*7*)	--	Varied[7]	Varied. Average 1.07% (CP) or LIBOR+1.28% (SD) before step-up.				✓	✓

Source: Data used in compiling the information in this table is derived from a variety of sources. For further information, a separate listing of the sources used is available online at the Journal on Legislation website at http://www.harvardjol.com/wp-content/uploads/2013/04/sourcesPDF.pdf.

1. Converted using date-of-announcement exchange rates. For outstanding balance, converted using Feb. 7, 2013 exchange rates. The % GDP for Japanese programs were converted using 1998 and 1999 GDP.
2. Percent of total banking assets in program, calculated using 2008 data.
3. Includes "effective" ban on dividends. For example, the TIP limited dividends to $0.01, and the SSFI prevented AIG from increasing its dividends from $0 for five years. However, restrictions on dividends that are only effected through companion aid programs are excluded.
4. Only effective after nonpayment of dividends for six quarterly periods (whether or not consecutive) for the CPP and TIP; effective after nonpayment of dividends for four quarterly periods for SSFI.
5. Dexia not included in calculations because its recapitalization arose in different isolated event, and was also recapitalized using SPPE funding in coordination with Belgium and Luxembourg.
6. ABN/AMRO/Fortis not included in calculations because its recapitalization arose in different isolated event, and was nationalized in coordination with the Benelux states.
7. Includes convertible preferred shares, nonconvertible preferred share, and subordinated debt. Loan amount, coupon rate, and step-up date varied across institutions.

Table 2. Summary of Non-Price Conditions for Comparative Programs

U.K. (GRS)

- Prohibits all common stock dividends without regulator consent for as long as the preferred shares were outstanding.
- Prohibits bonuses for 2008 and requires "any severance package for a dismissed director be reasonable and perceived as fair."
- Requirement to restore and maintain mortgage lending to SMEs at the 2007 level and to provide reports on their lending activity.

Germany (SoFFin)

- Limitations on common stock dividends (temporary ban on dividends for first tranche in Commerzbank).
- Caps compensation to senior executives at €500,000 a year without bonus.
- Requirement to increase in loans available to SMEs (€2.5 billion for Commerzbank).

France (SPPE)

- Prohibits bonuses and severance payments where there are "large-scale lay-offs"
- Prohibits stock options and free shares to senior executives, and limits authorization of bonuses to one year.
- Requirement to maintain a three to four percent annual growth rate in overall lending level and to provided monthly reports.

Ireland

- Requires a 25%–33% reduction in compensation for senior executives, 25% for non-executive directors, and bans both bonuses and salary increases in 2008 and 2009.
- Requires increase lending to SMEs and first time buyers by 10% and 30% respectively.
- Commitment not to commence foreclosure proceedings for principle private residences for twelve months after arrears appearing.
- Requirement to establish a €100 million environment and clean energy innovation fund.
- Requirement to provide €15 million to new seed capital fund with Enterprise Ireland.

Netherlands

- Prohibits bonuses for 2008, and limits severance payments to one year's fixed salary.

Japan (1999 Early Strengthening Act)

- Requirement to increase lending to SMEs (unspecified goal which varied by individual restructuring plans).

U.S. (TIP)

- Prohibits all common stock dividends in excess of $0.01 per share per without the consent for as long as the preferred shares were outstanding.
- Prohibits severance payments and bonuses to executive, and requires a portion of 2008 bonuses be payable as deferred stock or cash awards and a portion be subject to performance based vesting.
- Requirement to provide quarterly reports on use of purchase price.

U.S. (SSFI)

- Prohibits increase in common stock dividends for five years (AIG had eliminated ordinary dividends at the time of the transaction).
- Prohibits severance payments to Senior Partners (approximately top seventy officials), and limits annual bonus pools of Senior Partners to 2006 and 2007 levels.
- Prohibits use of purchase price for executive compensation.

Source: Data used in compiling the information in this table is derived from a variety of sources. For further information, a separate listing of the sources used is available online at the Journal on Legislation website at http://www.harvardjol.com/wp-content/uploads/2013/04/sourcesPDF.pdf

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