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EXECUTIVE SUMMARY

Three years after the onset of the global financial crisis, much has been done to reform the global financial system, but there is much left to accomplish. The regulatory reform agenda agreed by G-20 leaders in 2009 has elevated the discussions to the highest policy level and kept international attention focused on establishing a globally consistent set of rules. Comprehensive reform, once agreed and implemented in full, will have far-reaching implications for the global financial system and the performance of the world economy. In designing the reforms, it is imperative that policymakers keep their focus on the overarching objective of creating a financial system that provides a solid foundation for strong and sustainable economic growth.

This paper argues that the current reforms are moving in the right direction, but many policy choices lie ahead—nationally and internationally—which are both urgent and challenging. Policies need to address not only the risks posed by individual banks but also, importantly, those posed by nonbanks and the system as a whole. The recent proposals of the Basel Committee on Banking Supervision (BCBS) represent a substantial improvement in the quality and quantity of bank capital, but these apply only to a subset of the financial system.

Real progress is thus needed in several key areas where much has been said, but less accomplished. Prompt progress by the international community is essential to reduce the likelihood and impact of another crisis and to alleviate regulatory uncertainty.

According to IMF staff analysis, policymakers need to focus their attention on the following five key goals for financial sector reforms:

- **Ensure a level playing field in regulation**. Global coordination is needed to reap the benefits of global finance; foster competition; and minimize the scope for cross-sector and cross-border regulatory arbitrage, which could be damaging to global financial stability.

- **Improve the effectiveness of supervision**. Strengthened supervision is a necessary condition if a new cycle of leveraging and excessive risk taking is to be prevented. As a result, supervision needs to be more intensive and intrusive, as well as more focused on cross-border exposures.

- **Develop coherent resolution mechanisms at both national level and for cross-border financial institutions**. At the national level, it is critical to have effective policies and procedures for resolving financial institutions in a prompt and orderly manner. The IMF has proposed a "*financial stability contribution*" linked to an effective resolution regime to pay for the fiscal cost of any future government support to the financial sector. Given the global reach of financial institutions, the IMF has also proposed an enhanced cross-border coordination framework for resolution to eliminate moral hazard while preserving financial stability. The first step is to focus now on making this approach operational

among a small set of countries that are home to most cross-border financial institutions. Such an agreement is critical to address the problem of "too important to fail." Because of the complexity of the issues involved, moving this work forward will require political commitment at the highest levels.

- **Establish a comprehensive macroprudential framework**. Success in achieving financial stability will depend critically on complementing microprudential regulations, which aim to improve the resilience of individual institutions, with effective macroprudential regulations that strengthen the resilience of the financial system as a whole. This will require identifying, monitoring, and addressing systemic risks generated by the individual and collective behavior of firms.

- **Cast a wide net**. Reforms must address emerging exposures and risks in the entire financial system, not just the banks. Absent a broader perspective, there is a danger that riskier activities and products will migrate to the less (or un-) regulated segments of the system, as occurred with off balance-sheet investment vehicles during the recent crisis.

While the focus of this paper is on the authorities' responses to the crisis, private sector ownership of the financial reforms will be key to the successful implementation of the new rules. Business models and practices will need to be aligned with the new financial structure laid out by public policy, risk measurement and management will need to be improved, and boards of directors will need to be equipped with powers to rein in excessive risk taking and be held accountable for it. To the extent that financial reforms succeed in restoring market discipline, by correcting misaligned incentives and enhancing transparency and disclosures, they will have found a powerful ally toward maintaining financial stability.