Regulatory Reform
in the Financial System

by Angel Gurria, Secretary General of the OECD

The Berlin Conference “Effective Financial Market Regulation after Pittsburgh: Achievements and Challenges” is taking place at a very timely moment. Proposals for reform abound at the national, regional and global levels. The aim of all these efforts is to help ensure that the chances of another global financial crisis like the one we have just endured are greatly reduced. The recent instability in sovereign debt markets reinforces the need to make progress in regulatory reform and better link it to macroeconomic stabilisation.

We must further strengthen the links between micro and macro prudential regulation and surveillance as well as with sound macroeconomic management and fiscal consolidation. The global financial crisis was sparked off in the mortgage market and soon became a generalized event with broad macroeconomic implications. The current sovereign debt crisis in Europe is the result of poor macroeconomic performance and management that, if not addressed, could impact severely the private banking and financial system and spread well beyond the shores of Europe. Since macroeconomic instability can be exacerbated by flaws in the regulatory and surveillance mechanisms, policies at the macro and regulatory levels must proceed in mutually reinforcing ways.

I welcome the recent resolve by Europe’s leaders to deal with the current Euro crisis. They rightly point to the need to strengthen the interaction between macro and micro financial stability. Such interaction will need to be accompanied by decisive steps towards global consistency so as to insure, among other things, that financial arbitrage is not the source of new risks to the economic and financial system.

First, I would like to touch on some of the macro issues in the current situation. Second, I will summarise key aspects of the reform process. The question of whether we have the right overall balance and sequencing in the proposed reforms will be touched on in the third section of this paper. I will finally address issues about the timetable for getting there also taking into account the current economic outlook. This is linked to the very important question of whether all countries must implement the reforms at the same pace, or whether some allowance should be made for the particular circumstances of individual countries with very different starting points, or even for individual financial firms with quite different business models.
Credible fiscal consolidation strategies and sustainable exchange rate policies are needed more than ever

The recent crisis in the Euro Zone is simply another manifestation of the global financial crisis. In very broad terms both crises are about too much leverage: in the private sector first and now in the government sector. The first leg of the crisis saw private debt insolvency dealt with by transferring much of it onto the public balance sheet. With public solvency now being questioned by the markets, the room to keep putting things onto the “pay later” bill has diminished.

Public Deficits are too large in many countries, but the rolling wave of the financial crisis has descended on the European public sector first. There is an institutional aspect as to why this is so. Currency unions work well when there is a single fiscal authority and all regions are flexible and competitive within it. Fiscal regulations like the Stability Pact won’t work if cost structures are allowed to get out of line through lack of regional competitive flexibility. The temptation is to put off painful labour market and pension adjustments and let fiscal responsibility slip; but this very combination makes fiscal adjustment difficult as longer-run growth prospects decline. At this point catalysts for crises become things like credit rating downgrades to a rating below which rules forbid central banks to purchase debt and the market reacts violently -sometimes irrationally - to force policy adjustment.

If things are allowed to get to this point, then the only way to get back in front of the markets is to surprise them with a package of measures that will be judged to be more than actually required. If the policy package proves not to be enough - because initial judgements are wrong or because governments don’t follow through - then the loss of credibility that comes with debt restructuring becomes even more painful. The experience in Latin America teaches that restructuring forced upon a country by a crisis is much worse that the pain of getting the necessary albeit tough policies right from the beginning.

Still another macro aspect of the crisis is the very different situation in Asia. This region did not experience a financial crisis, and yet with its managed exchange rate regime it essentially imports accommodative monetary policy from other parts of the world. This has resulted in loose credit flows and booming asset prices in China, Hong Kong, Singapore, Korea and Taiwan. The risk of some dislocation arising from inflation pressure building up in this region would not be helpful to the adjustment processes in other parts of the world—for at least as far as net exports are concerned, Asia has been one of the really bright spots of global trade.

The risk of this region backing away from open markets and imposing capital controls, or taxes that impede cross border flows would be an unhelpful evolution of the institutional architecture. At the OECD we have always been of the view that a key aspect of the adjustment process is how to tap the resources of these high-saving surplus countries to help with the debt - including public debt - and equity needs of the countries trying to deal with the financial crisis. There is also the risk that the use of blunt instruments like reserve requirements and other administrative measures to contain inflationary pressures would not represent the best way to advance institutional structures compatible with sustainable longer-term growth. Indeed, the risk of a
larger than intended negative shock to demand in China would have strong ramifications for the region—and through trade to other parts of the world. The OECD therefore favours policies to deepen capital markets in the Asian region, the fostering of cross-border flows and, of course, working towards more flexible exchange rates. Such an approach would also be consistent with resolving macroeconomic goals and providing more efficient price signals for the allocation of global capital.

**The Regulatory Reform Process**

At the micro/regulatory level there is a need for reforms that do not cut across the goals for low-inflation sustainable growth. The Pittsburgh Summit foreshadowed a long list of reforms:

- More and better quality capital, with a leverage ratio and perhaps countercyclical buffers (the current timetable is for these rules to be decided by the end of 2010 and implemented by the end of 2012).
- Better liquidity and risk measurement.
- Disclosure will be enhanced (e.g. off-balance sheet exposures).
- Oversight of credit rating agencies (CRA's) has increased and accounting standards should be unified between the US and Europe.
- Better regulation of market practices and underwriting standards.
- The use of centralised clearing and exchanges for more over the counter (OTC) derivatives is envisaged.
- Better alignment of compensation with long-term value creation.
- The use of supervisory colleges, legal frameworks and contingency planning for coordination of cross-border issues in a crisis.
- Improved resolution tools and frameworks (the FSB is due to deliver something by October 2010).

The Basel Banking Committee is working on the first two of these reforms - the capital and liquidity rules and has released its proposals for comment - with quantitative impact studies to follow this year. Its proposals aim to improve the quality, consistency & transparency of the capital base; to enhance risk coverage (including off balance sheet) and, very importantly, they suggest 3 new features of the capital rules: a leverage ratio, measures to deal with procyclicality and the introduction of a capital “buffer”. The liquidity measures include new ratios to ensure banks have at least 30 days liquidity cover and that the stability of their funding is improved by rules about the structure of their liabilities and assets.
In addition, in the US the Dodd Bill is working its way through the law making process. The main elements of the US reforms here are:

• A Financial Stability Oversight Council.
• A Consumer Financial Protection Bureau (in the Fed).
• A Resolution Mechanism.
• Regulation of OTC derivatives by SEC & Commodity Futures Trading Commission.
• Restriction on risk taking by banks using depositors’ funds.
• SEC to regulate rating agencies.
• Restructure US bank regulators.
• Creation of an Office of National Insurance in Treasury; to propose regulation of insurance.

Within Europe new directives are being prepared to adapt many of the Basel proposals for Europe, and the issue of how and whether to streamline the vast national supervisory structures and align them with the single market remains alive.

As EU leaders have stated just a few days ago, the sovereign debt crisis is putting further pressure to make progress in financial market regulation and supervision.

Many of the proposed reforms have strong merit. But what interests me at this point in time is whether or not the overall balance and sequencing of the reforms is ‘right’. For if the easier financial reforms are carried out - the low hanging fruit - and the harder but potentially more important things are left to one side there is a risk of partial solutions that lead to second best outcomes. This will also arise if countries go through with their own reforms - influenced by regulatory capture or popular pressure in their own country - without moving in a coordinated way between jurisdictions in a truly global approach. The experience of the past few years suggests we cannot again afford to drift towards a second-best regulatory system for financial markets.
Have We Got the Overall Balance Right?

The recent instability in sovereign markets reinforces the need to make progress in regulatory reform and to link it with macro stabilisation. The financial system should be efficient in allocating capital and risk, without amplifying macroeconomic fluctuations or interfering with the setting and transmission of monetary policy.

In a previous publication the OECD argued that there were 7 priorities for reform:¹

1. Strengthen the regulatory framework by streamlining regulatory institutions, and clarifying responsibilities and business conduct rules.

2. Focus on the integrity and transparency of financial markets.

3. Ensure more capital and less leverage, address the pro-cyclicality issue and avoid regulatory subsidies to the cost of capital.

4. Strengthen our understanding of how tax regimes affect the soundness of financial markets.

5. Ensure better accountability to owners whose capital is at risk through the reform of corporate governance.

6. Ensure the capital of commercial banks is not put at risk by capital market banking, by ensuring a separation of certain activities that put the banks own capital at high risk in periods of financial volatility.

7. Strengthen financial education and consumer protection.

With respect to the reforms foreshadowed at Pittsburgh, I would say that by far the most emphasis has been placed on the second and third of the above priorities - though the Dodd Bill does leave the door open for some more progress on the issue of separation of certain high-risk activities from commercial banking (priority number 6 above).

As far as regulatory reform is concerned, it is important to get the balance right in 4 areas: Capital arbitrage, transparency of financial markets, separation in the banking sector and macro-prudential regulation.

1. Capital Arbitrage: Promises of the Financial System

The financial system in essence is a system of promises. In the traditional credit culture of banking, a bank takes deposits and promises safety and an interest return to its depositors. It keeps a little capital aside in the form of common equity, promising shareholders that they will be paid a regular dividend and capital growth through sound and prudent corporate governance. The bank lends to households and to businesses, which are usually too small to raise money in the capital markets. The borrowers promise to repay loans and to pay interest for being able to bring their spending plans into fruition. Over the years, through financial innovation, this set of promises has become increasingly complex. Banks raise money in wholesale markets, and securitization and the use of complex OTC derivatives has permitted the promises to be shifted around. These innovations and changes in business models have meant that the credit culture of commercial banking has become increasingly mixed up with capital market banking: both within large complex conglomerates, or in the inter-connectedness when dealing with each other in the buying and selling of new products.

Contagion and counterparty risks related to these new products were a key hallmark of the crisis, at least in its first phase - with losses on capital market products destroying capital and leading to systemic problems. The incentives in the system were not appropriate, and when the crisis arose there simply wasn’t enough capital to absorb the losses. The ability of banks to shift promises around - capital arbitrage - played a significant role in the lead up to this outcome. Banks have a great incentive to shift promises around if different capital rules and tax regimes make it beneficial to do so.

We at the OECD believe that one of the most fundamental principles of financial regulation should be that all of the promises in the financial system should be treated in exactly the same way, regardless of where they might sit. If this basic principle is not achieved, then the incentives for capital arbitrage will remain in place. Un-productive financial innovation not focused upon longer-run economic goals will be the inevitable result. Leverage will be expanded in new ways that regulators and supervisors will not be able to anticipate, and unacceptable risk taking - and dare I say “bubbles” - may return.

It is not easy for regulators to deal with this shifting around of the promises of the financial system when there are so many opportunities for arbitrage: different capital rules and the shopping around for the easiest regulatory regime; lack of global coordination of regulations; the different tax treatment of financial products; and the existence of offshore lower-tax jurisdictions.

With respect to the capital rules, the Basel proposal for a leverage ratio is a very good first step for reducing capital arbitrage - the OECD has also championed this proposal and we fully endorse it. A leverage ratio can ensure that banks are sure to have enough capital as the requirement relates to the banks’ whole portfolio, rather than to specific assets with different weights that can be arbitrag ed. Therefore management decisions about allocating capital to risky activities would take account of the full market cost of capital, and the potential risks and rewards of investing in the asset, but would not be influenced by regulatory rules specific to the asset.
The capital required under a leverage ratio needs to be set at a level that ensures enough capital exists to be able to always absorb losses in a crisis.

How well does the leverage ratio proposal sit with the risk-weighted asset approach? This is hard to say - but our feeling is that if the leverage ratio requirement is set too low, with the hope that risk-weighted capital would be higher, then the capital arbitrage process would again come into play, shifting promises around in new ways until excess capital above the minimum required by the leverage ratio was eliminated. In this sense the risk would be that the leverage ratio would become a maximum (rather than a minimum) capital requirement at a too-low level.²

At the OECD we also have a preference for transparent simple rules, rather than an over-reliance on models with subjective inputs - or approaches that rely on too much external rating. While acknowledging the progress made to bring about greater consistency and to use inputs with a less cyclical bias - the pro-cyclical issue - we think the prominent role of the leverage ratio and the use of the Basel Committee’s excellent proposal for a capital “buffer” will in practice be most important for avoiding future crises. This capital buffer idea is very important - and it goes some way towards provisioning in a countercyclical way. An excess capital buffer should be built above the minimum requirement in the good times, in a sufficient amount so that it doesn’t fall below in the minimum in bad times. That banks would build up the buffer by avoiding special dividends, share buy backs and bonuses until the required buffer was met seems very sensible indeed.

While the prominence of a leverage ratio is a key tool for reducing regulatory arbitrage, its ability to do so will be compromised if it is not adopted consistently in the global financial system across all jurisdictions - that is to say its introduction will need to be coordinated in a consistent way. There seems to be some agreement about this, and we will see what happens in practice.

A closely related issue concerns the number and structure of regulators and supervisory agencies. Here there appears to have been much less progress with the idea that regulatory regimes should be streamlined. If promises can be passed out of the banking system into the insurance sector, for example, or into the shadow banking system more generally, then the enforcement of capital rules for banks will be less effective. Regulatory regime shopping would then remain a feature of the system working against the ultimate aim of reducing arbitrage, leverage and ensuring that there is enough capital to absorb losses in future crises. Worse still, it will stimulate new innovations to avoid holding capital - hardly a productive activity for a financial system that is supposed to be improving the allocation of resources to attain long-term growth.

² As an illustration of the problems that arise with the weights applied to specific assets—right now Greek sovereign debt is zero risk weighted. It is very difficult to specify what is risky and what is not in the capital weighting approach.
I don’t have the answers as to how to bring about a more unified structure of regulation - and perhaps it is asking too much of our political systems to deliver it - but at least improved coordination among regulators should be sought.

2. Integrity and Transparency of Financial Markets

I will now come back to the issue or the complexity of capital market products - for even if we have good regulatory rules - these will mean very little if we do not have transparency and integrity in financial markets. In particular I want to touch on some issues with respect to the credit default swap (CDS) that have been so prominent in the shifting of promises in recent years.

Prior to the CDS innovation and its widespread use in financial markets, the market for “credit” was incomplete - for example, unlike other many other assets, it was not possible to go short bank loans. Regulators did not have to think as much about the shifting of promises: but this all changed with the CDS innovation. It has played a key role in securitization and the shifting of promises between banks, insurance companies and investors - with the line between the banking and the shadow banking systems also moving backwards and forwards depending on how regulations and innovations interact with each other in terms of the incentives they create for short-term profits. There is at least some doubt as to whether this type of activity is very productive in terms of long-run economic goals.

The saga unfolding at Goldman Sachs is one very good example of derivatives being used in this way. The use of Repo 105 in Lehman Brothers to disguise leverage is another. But these are only recent things in the news. Phase 1 of the global crisis was arguably driven by this sort of structuring of products simply to make short-term gains. Politicians and policy makers sometimes ask me whether this means that CDS and related structured products should simply be banned outright in banking. There is no clear cut answer. This is because the CDS can play a productive role in genuinely meeting investor demands and diversification with longer-run benefits for the economy although we are aware of the downside risks.

We feel that the Basel proposals to build incentives into the capital rules that encourage more trading of CDS and related products on centralized exchanges is a very useful step in the right direction - it adds transparency and allows for exchanges to play a greater role in guaranteeing the delivery of promises. Of course many genuine demands between banks and their customers for tailored products with specific requirements will not lend themselves to generalized trading on exchanges - liquidity will always be a problem - and it will have to be dealt with in contracts between banks and (hopefully sophisticated) investors.

Progress can also be made on harmonizing standards and practices, and establishing central counterparty clearing arrangements to reduce the gross size of outstanding contracts by netting

3 An accounting manoeuvre involving a temporary sale of asset, the cash from which pays off liabilities in the lead up to an accounting period (leverage ratio falls temporarily), after which the assets are contractually bought back again.
mechanisms. With respect to the inputs for valuing OTC capital market products there has also been progress with audit oversight and rating agency reform.

While progress has been made in improving the transparency or markets and products, the issue of how they are reported through accounting standards deserves to be touched upon. Loans with reasonably predictable cash flows lend themselves to amortised cost accounting, whereas capital market products should in principle be marked to market, and fair value through profit or loss accounting principles should apply. While this may seem harsh for supervisors trying to deal with a crisis situation - where the pressure is for forbearance and less disclosure of the true divestment value of assets on balance sheets, longer-run reform should make no exceptions to the need for integrity and transparency.

For example, many commentators highlight the fact that not all banks erred in their approach to risk management and governance, while others were very poor performers in this respect. This argues for strengthening the governance of financial firms ensuring their full accountability to the owners whose capital is at risk. Shareholders must exert more discipline on management to pursue strategies with appropriate longer term-risk and reward payoffs. But this sort of discipline is impossible if shareholders and their agents do not know what is truly happening on bank income and balance sheet statements. It is very important that US GAAP and IFRS convergence occurs as quickly possible - in line with all the other regulatory reforms - and that it does so in a manner that does not compromise on transparency issues.

3. Separation

Contagion and counterparty risk played a big role in the crisis. The OECD believes that separating from commercial banking some of the capital market activities that were associated with large losses during the crisis remains one of the most important areas to address if we are serious about reducing the chances of a repeat crisis in the future, with all of the negative impacts on the real economy. Yet to date we have seen very little progress in this area. Commercial banks play a key role in lending to consumers and businesses - and small and medium-sized businesses (SME’s) are particularly dependent on banks to fund their activities and provide jobs. Quite often these banks have large retail funding of their activities and benefit from guarantees that their unsophisticated investors’ money will be safe.

It seems to us that commercial banking should be separated from capital market banking in some way. Why do we insist so much on this? The answer comes from asking why banks are asked to hold any capital at all. Banks hold capital so that it will be there to absorb losses when they occur in a crisis. The capital has to be there to do this. If it is not, banks will be forced into deleveraging or, worse, into bankruptcy. If you allow banks with retail and commercial banking functions to bet their capital in proprietary operations, then it is precisely going to be the case that such capital will not be there in a crisis. Prices of capital market products can fall sharply in crisis periods, resulting in the contagion and counterparty risks that I have referred to as the main hallmarks of the crisis.
Some policy makers recommend that prop trading desks and bank-sponsored hedge funds and private equity affiliates should be separated.\(^4\) We agree that these functions should certainly be separated from commercial banking. But at the OECD we are a little more extreme. Other investment banking activities are capable of losing more money than these few functions. OTC derivatives are a very clear example of an activity that needs to be separate from commercial banking and carried out in a securities firm with separate capitalization and not subject to regulatory subsidy and implicit or explicit guarantees. But if this is so what about origination? It was at the very heart of the crisis. Bank capital is at risk because it involves warehousing loans and securities before they are sold to clients. But if we include origination, then why not market making? Big capital market banks that have hedge funds as clients need inventory for rapid execution, and this too means that bank capital is at risk.

In very broad terms, the issue here is that higher risk investment banking should not be mixed up with commercial banking. If it is, the cost of capital for the investment bank will tend to be subsidized with the stamp of approval provided by explicit or implicit guarantees, and from the commercial banks point of view their capital may be at risk in ways that are hard to anticipate. If the capital is not there when loan losses mount, commercial banks move into a de-leveraging phase with negative impacts on the economy. The separation issue is concerned with reducing this risk.

There are many ways to go about separation in practice. At the OECD we favour a non-operating holding company structure where the capital of each affiliate is strongly silo’d. That is to say, counterparties of the securities/derivatives businesses have no call on the capital of the group as a whole—only on the entity with which they trade—and certainly not that of the commercial bank. For these separated activities margin requirements and the cost of capital will be higher, and there can be no implicit subsidy from deposit insurance in the retail banking affiliate to the cost of funding in the capital markets activities of the group.

4. **Macro prudential regulation**

The Basel Banking Committee has also called for better macro prudential management, whereby policy makers can take into account asset price and credit cycles in order to deal with pro-cyclicality at a broader level. At the OECD we see this macro prudential recommendation as an admirable objective. However, the difficulties of undertaking it should not be underestimated. The reason for this is leads and lags in modeling credit, and the problem of structural change caused by financial innovation—often in response to the very sort of regulatory changes proposed by the Basel Committee. Credit lags the cycle, and the identification of a ‘bubble’, leading to provisioning to offset it, could easily occur at a time when the economy is beginning to turn down—exacerbating the cycle. Similarly, just as securitization dampened balance sheet credit growth in the past—leading to a false signal that there was no leverage problem—so too might future developments in the shadow banking system lead to similar distortions that would be difficult for supervisors and other policy makers to identify.

\(^4\) For example the Volcker plan and some of the earlier comments by Mervyn King.
The current outlook and the timetable for reform

In the response to the sovereign debt turmoil European leaders have called for “the need to make rapid progress on financial markets regulation and supervision; increasing transparency and supervision in derivatives markets and dealing with the role of rating agencies”. They also called for an “intensification of the work on crisis management and resolution in the financial sector and on a fair and substantial contribution of the financial sector to the costs of crises”.

The current economic outlook in Europe, but with obvious ramifications in global financial markets, introduces new elements in shaping the implementation and timing of the phasing in of new capital rules. This is also a very difficult issue because all countries are not in the same position, and there are substantial differences between individual firms. On the one hand, there is a very good argument for allowing some flexibility in the timetable. Some European banks have less capital and more leverage than their US counterparts for example, and the crisis in Europe seems to have lagged behind that in the US (in both the writing off of losses and in the speed of raising more capital).

**US Banks**

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<th>Assets</th>
<th>Equity less Goodwill</th>
<th>Leverage</th>
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<tbody>
<tr>
<td>Q4 2009, USD billions</td>
<td>Q4 2009, USD billions</td>
<td>Q4 2009, USD billions</td>
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<tr>
<td>BANK OF AMERICA</td>
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<td>JPMORGAN CHASE</td>
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<td>MORGAN STANLEY</td>
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**European Banks**

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<th>Assets</th>
<th>Equity less Goodwill</th>
<th>Leverage</th>
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<td>Q4 2009, USD billions</td>
<td>Q4 2009, USD billions</td>
<td>Q4 2009, USD billions</td>
</tr>
<tr>
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Right now the economic outlook in Europe reflected in our latest projections is weaker than in the United States, and a sovereign debt crisis has caused new dislocations that have to be dealt with. From this perspective it could seem very poor timing to impose new capital raising burdens on European banks struggling to adjust their balance sheets not only for loan losses related to the crisis and the slowdown in activity currently under way, but also because of new pressures
related to their exposures to sovereign debt. Countries that need to adjust their fiscal policy more strongly than others risk a prolonged period of weak economic activity. Very clearly, it would be helpful if the economies of other EU countries did not weaken excessively at the same time. This might have the effect of making the adjustment process more difficult. Indeed, the weaker is economic growth the more difficult becomes the task of fiscal adjustment—weaker growth leads to weaker revenues, and the adjustment process ends up “chasing deficits down”. This might prevent credit from supporting the recovery to an even greater extent thereby making the adjustment process all the more difficult.

However, it has also to be born in mind that right now credit demand is in any case very weak, as private sector deleveraging continues - supply constraints related to capital are not binding right now.

Making undue allowance for particular regions because of the current set of macroeconomic difficulties does not make for sound financial reform and a level playing field in global financial markets. If capital rules were more lenient in some regions for a number of years, then capital arbitrage would continue, as the incentive to take advantage of jurisdictions where the regulatory burden is less would be compelling. Banks that performed well and are very well capitalised would find themselves competing with banks carrying a lower capital, essentially rewarding poorer performers at the expense of strong performers. This would weaken rather than strengthen overall financial stability. It is very important that the sequencing of the reform process should see all jurisdictions moving together and respecting the principles of a competitive level playing field and with new opportunities for regulatory arbitrage kept at a minimum. The OECD therefore supports the idea that capital rules should be announced at the end of the year - consistent with the timetable set at Pittsburgh. Supervisors should cajole the banks under their jurisdiction to raise common equity capital as quickly as possible.

**Conclusions**

I draw three lessons from the above considerations:

First, financial sector reform and macro stability go together and therefore require coordination between the different policy domains and agencies. This is also true from the point of view of the timing of actual phasing in of reforms which has to take into account the need to move quickly towards fiscal sustainability and therefore avoid pro-cyclical effects.

Second, global consistency is the key principle that should be respected in the financial reform process - speed is less important than balanced progress towards first best longer-run reform. The new capital rules suitable for the long run should be announced at the end of this year, and implementation should be encouraged by supervisors from now until prospective completion of requirements by the end of 2012. This should also help to speed other convergence issues that need to be settled - accounting standards, derivative rules, and the separation issue for example. If these and other reforms are carried out in a piecemeal way there will be inevitable overlaps with possibly unforeseen and negative consequences for the financial sector and the economy more generally.
Third, while international coordination is essential it will not produce results if individual countries do not put in place the right policies to achieve fiscal sustainability and to phase in new regulatory measures once they are agreed so as to avoid opportunistic behaviour.