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NAEC: THE FINANCIAL STREAM

KEY FINDINGS

NEW APPROACHES TO
ECONOMIC CHALLENGES

OECD
BETTER POLICIES FOR BETTER LIVES

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The NAEC Financial Stream: Key Findings[1]

I. Introduction

The New Approaches to Economic Challenges (NAEC) initiative is an organisation-wide reflection on the roots of and lessons from the financial crisis. The NAEC Financial Stream brings together work presented to and discussed at the Council and in several of the OECD Committees supported by the Directorate of Enterprise and Financial Affairs over the course of two years. Discussions in Committees allow Members to share their views and provide insights into new work being delivered by the OECD Secretariat. As it happens sometimes with new or exploratory work, some Members might not agree with whole or parts of the final report. As with all OECD reports, the Secretariat makes every effort possible to take into account Members' views. The final report is then published under the authority of the Secretary-General and is not considered as having received the formal support of Members.

The inputs developed for the NAEC Financial Stream cover a broad range of issues including, *interalia*, banking regulation, corporate governance, pensions and ageing, funding long-term investment, international capital markets, state-owned enterprises and global competition policy in the face of mergers. In order to bring these diverse insights together in a way that is conducive to policy thinking in a complex and interrelated global economy, it is useful to organise the discussion according to 3 horizontal themes: (i) strengthening the framework conditions in the global financial system; (ii) designing and building better institutions; and (iii) improving price discovery in markets for a better allocation of resources.

II. Framework Conditions for Strengthening the Global Financial and Competitive Product Market Landscapes

A number of systemic changes have occurred in the financial system, but some of the factors that contributed to the crisis, despite progress, still have not been fully addressed:

International capital markets: The rising weight of emerging markets and increased global financial integration makes it now more important to deal with distortions affecting international capital flows and the persistent boom-bust cycles sometimes associated with them. The systematic undervaluation of exchange rates, supported by capital controls, has generated very large capital flows into developed-country financial markets (e.g. the holding of foreign reserves as Treasury securities). Low interest rates and quantitative easing policies to offset the impact of the stronger dollar on the traded goods sector in advanced economies may also create unwanted pressures in emerging-market countries. Both sets of developments may complicate macroeconomic management and contribute to carry-trade *'risk-on'* and *'risk-off'* cycles in global credit. OECD Secretariat findings suggest that in

[1] This paper is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and the arguments employed herein do not necessarily reflect the official views of OECD member countries. It summarises the key findings of the monograph: "New Approaches to Economic Challenges: The Financial Stream".

the long-run dealing with the resulting global investment-savings imbalances could benefit not only developed countries, but also emerging markets too[2].

The banking system: the epicentre of the global financial crisis was the banking system. This came about due to the under-pricing of risk, with numerous OECD secretariat papers identifying poor micro-prudential regulation, excessive leverage and too-big-to-fail business models as prime reasons for this. Much work has been carried out in the G-20 framework to strengthen the system since 2008 but a considerable agenda remains. The banking systems in many countries remain far too highly leveraged, particularly in large institutions that combine deposit and investment banking[3]. This means that when something goes wrong anywhere, capital can be insufficient, or just feared to be insufficient, to absorb the problems. Maintaining funding can become a problem and creditors and counterparties may become exposed. The huge expansion of the use of derivatives, structured financial products and credit default swaps, has reinforced the financial instability issues associated with too much leverage by increasing the system's interconnectedness. Local problems can more easily become systemic with macro-economic consequences. While there is no consensus on the matter, the OECD Secretariat has long called for minimum leverage rules for banks requiring equity backing of total assets, based on IFRS standards, of at least 5%, well above Basel III standards[4].

Non-bank financial intermediaries: Since deposit banks may not always be well placed to finance important high-risk or long-term projects, a strong framework that is supportive of non-bank financial intermediaries will be an essential part of meeting the challenges that ageing populations will pose over the longer term. These institutions, often referred to as "institutional investors", can also play a key role in ensuring adequate levels of financing for major infrastructure building and maintenance needs. There are several areas where the public policy framework needs to be developed so that these institutions can make a contribution to economic performance across the economy to the maximum possible extent. Among them is management of longevity risk, which is mainly a problem for pension funds. Linking retirement age to life expectancy (as in Sweden), which effectively splits longevity increases between periods of contributing more and periods of taking more benefits, could play a large role here. Beyond that, the state is well placed to assume this risk, but not so in the case of businesses and individuals. Recent OECD Secretariat work suggests that the solution to this is to develop annuity products which would transfer longevity risk from individuals to institutional investors best placed to manage it.

Another issue is that a very large share of the ownership of, and management responsibility for, publicly-owned enterprises and commercial property in advanced market economies is held by investors which are not individuals but institutions[5]. It is obvious that these have important roles to play in allocating

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2 The OECD Codes of Liberalisation are seen as an even-handed tool within which to make progress in this area.

3 As a part of the NAEC effort the OECD Secretariat has worked on building comparable banking statistics for IFRS and GAAP reporting banks, since failure to use comparable accounting frameworks generally overstates the capitalisation of US banks since derivative positions are largely netted from the balance sheet

4 US regulators recently voted for 8 of the largest banks to have a 5% leverage ratio and 6% for a depository institution inside a bank holding company (GAAP basis). This is stronger than Basel III and in the same direction as OECD Secretariat views.

5 OECD estimates that total holdings of institutions amounted to nearly $85 trillion in 2011, most of this in the hands of investment funds, insurance companies and pension funds. Some $28 trillion consisted of

business investment in the economy and monitoring and overseeing corporate management. These roles must be carried out effectively, which raises issues of: (i) arresting the declining role of publicly-traded corporate equity; and (ii) ensuring effective governance at the level of senior corporate management and the Board of Directors.

The role institutional investors can play in financing large global infrastructure needs over the longer term will be enhanced by measures to provide reasonable prospects that such investments will generate returns that these institutions can capture. These include, *inter alia:* public-private partnerships; simplification of planning procedures; reduced regulatory uncertainty; better infrastructure planning and project design with separated political and technical responsibilities; and more transparent budgetary processes.

Product markets and competition: Two issues extending beyond financial markets are also covered in the NAEC Financial Stream paper. *One* is the need to ensure competitive neutrality as state-owned or controlled enterprises (SOE's), notably large banks and emerging-market-based oil and gas producers, participate more actively in the global economy. Developing internationally accepted best practices for SOE's would help to maintain a *level playing* field between public and private companies. The *second* is the need to ensure policy coherence across jurisdictions and co-operation among competition authorities, as globalisation of business activity increases, notably leading to more M&A activity, and the number of independent competition authorities rises. Multiple approvals can be costly and large jurisdictions can effectively veto mergers with harmful externalities to one another's economies.

III. Designing and Building Institutions

The banking system: Much of the NAEC policy agenda relates to institution building. As regards the banking system, work for NAEC has shown that there is no reasonable ex-ante capital rule that would be enough for all contingencies. In addition, restraints are needed on high-risk activities that expose banks' capital to losses that can threaten their funding base of deposits which benefit from government-backed insurance or guarantees. The idea of safer bank business models to avoid these situations has led to a number of proposals to separate high-risk activities from traditional banking[6], but they have generated great debates about specifics and have proved difficult to agree and implement. Empirical analysis of a data base including 108 individual G20 banks for NAEC sheds some light on the issue. For the OECD Secretariat, the clear implication of this work is that the size of the derivatives portfolio, measured in terms of its gross market value, should be the focal point for the design of separation rules.[7]

Central clearing counterparties (CCP's): The high risks associated with large-scale derivative trading calls attention to specific proposals to create CCP institutions. It is important to understand that the proposal for a CCP for derivatives shifts settlement risk to a new systemically-important institution, it does not remove that risk, and therefore adequate capital and processes are equally important as they are for banks.

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publicly-traded equities and smaller amounts were allocated to other funding of enterprises such as private equity and venture capital.

6 This includes OECD itself, *The Financial Crisis: Reform and Exit Strategies*, 2009, and those associated with Paul Volcker, John Vickers and Michel Barnier.

7 While there is certainly no consensus, the EU proposal "*Structural Measures Improving the Resilience of the EU Credit Institutions*" would separate underwriting and market making in derivatives and securitisation from the depository institution, which is consistent with OECD Secretariat views.

Stock market infrastructure: Another area where attention to strengthening institutions is needed is the stock market. This could help to reverse the trend away from equities. Work for NAEC has focused primarily on the United States but the analysis has been extended to cover the top 26 IPO producing economies worldwide. The core issue, notably in the United States, is that measures to ease regulations and reduce costs with a view to making it easier for new businesses to go public have not done much to support the exchanges themselves and the broker-dealers that make them work[8]. The result has been a reduction of capital markets' support infrastructure, especially around small caps, as the research, sales and trading that allow small companies to thrive as traded entities can no longer be provided profitably.

IV. Improving Price Discovery in Financial Markets

If financial markets are to mobilise savings and allocate credit efficiently across the economy accurate price signals will be essential. Work for NAEC has focused on two issues in particular: pricing longevity risk and price discovery in equity markets.

Products for hedging longevity risk: If annuity products are to play an important role in providing individuals with reliable income streams protected against longevity risks the institutional investors who provide them will need suitable instruments which allow them to manage this risk themselves effectively. While product design and pricing to hedge longevity risk are the responsibility of the financial institutions themselves, governments should encourage standardisation, liquidity and transparency, and regulating these where necessary.

Stock markets and trust: The price discovery process in secondary stock markets plays a central role in the allocation of equity capital. Efficient and fair price formation is critical, not only for allocative reasons but also for investors' confidence and trust in the integrity of the markets. Some fundamental changes in the structure of equity markets, driven by both technological advancements and regulatory initiatives, during the last decade pose some challenges:

- They have led to *fragmentation of markets*, leading to the emergence of 'dark pools', i.e. anonymous trading volume away from the exchanges and not openly available to the general public. Since these do not publicly display orders they generate unequal access to market data and this may ultimately affect the quality of price discovery.

- *Algorithmic trading* and so-called *high-frequency-trading*, involving execution of orders by computer-based systems according to a pre-designed set of rules and procedures, has emerged as a dominant trading practice during the past decade. This has raised some policy concerns relating to both corporate governance and fairness.

- *New equity-based instruments* have become widespread. Most obviously, index tracking has become an important "strategy" for a broad spectrum of investors and has encouraged the development of exchange-traded funds. These are tax-efficient and offer reduced fees for investors but have raised some concerns about their impact on prices. This may be a contributing factor to the decline in IPOs which is part of the wider decline in the use of tradable equity noted earlier.

Better and internationally-coordinated market conduct rules and regulations, where appropriate, are needed to improve price discovery and fairness in both trading and hedging markets.

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8 Reduced fees and the restriction on tick sizes undermine the revenues needed to support these services.

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OECD INITIATIVE ON NEW APPROACHES TO ECONOMIC CHALLENGES

The OECD initiative on "New Approaches to Economic Challenges" (NAEC) is an organisation-wide reflection process on the causes of the crisis and the lessons for policy. It was launched at the 2012 OECD Ministerial Council Meeting (MCM) with the objective to catalyse a process of continuous improvement of the organisation's analytical frameworks and advice.

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