# Foreword

By Harald Benink, Jón Daníelsson and Charles Goodhart

On April 6–7, 2006 the Financial Markets Group (FMG) of the London School of Economics (LSE) organized a conference on "The Future of Financial Regulation". This conference, the second in a planned series of (bi-)annual events, brought together a group of prominent academics, bankers and regulators from around the world. The main focus was on the Basel II Accord, adopted by the Basel Committee on Banking Supervision in June 2004. In particular, the conference presentations were centred on the themes of financial regulation and financial stability, the governance of the regulatory decision making process, and financial reforms and emerging markets.

The Basel II Accord introduces a new capital adequacy framework for banks in order to respond to certain deficiencies in the 1988 Capital Accord ("Basel I"). The new Accord is structured around three "pillars". The first pillar focuses on *minimum regulatory capital requirements* and contains new rules for calculating more refined risk weights for different kinds of loans. Moreover, it suggests that capital should be held against operational risk. The second pillar is the *supervisory review process*, which requires supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks. The third pillar aims to bolster *market discipline* through enhanced disclosure by banks. Although the new framework's focus is primarily on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication. Implementation of the Basel II Accord is foreseen for 2007 for the simpler approaches and 2008 for the most advanced approaches embodied in the Accord.

In this special issue of the journal *Financial Markets, Institutions & Instruments* we publish a number of papers which were submitted to us by conference speakers after the conference had taken place. The first paper is by Randall Kroszner, Member of the Board of Governors of the Federal Reserve System. In his paper "The Effect of Removing Geographic Restrictions on Banking in the United States: Lessons for Europe", Governor Kroszner argues that cross-border, intra-European bank mergers are likely to generate benefits similar to those enjoyed in the United States when interstate banking restrictions were removed. These benefits include greater banking efficiency, higher economic and employment growth, more entrepreneurial activity, and reduced economic volatility. The second paper is by Nicholas Le Pan who, at the date of the conference, was Superintendent, Office of the Superintendent of Financial Institutions, Canada & Vice-Chair of the Basel Committee on Banking Supervision & Head of the Basel II Accord Implementation Group. In his remarks Le Pan focuses on some key issues related to Basel II, such as complexity, impact on capital and home-host implementation, and offers ten thoughts on the post Basel II world. The third paper is by John Laker, Chairman of the Australian Prudential Regulation Authority. In his contribution "Basel II – Observations from Down Under" Laker discusses issues related to the implementation of Basel II in Australia. The fourth paper is by Luo Ping, Deputy Director-General of the China Banking Regulatory Commission. Luo provides an overview of the process of China's convergence to International Financial Reporting Standards (IFRS) with particular respect to its banking industry. The fifth paper is by Professor Richard Herring of the Wharton School at the University of Pennsylvania and by Mr Jacopo Carmassi who is a visiting scholar at the Wharton Financial Institutions Center and a PhD candidate in Law and Economics at the University Luiss Guido Carli, Rome. In their paper "The Structure of Cross-Sector Financial Supervision" Herring and Carmassi note that, over the last decade, in many countries the financial supervisory functions that were once performed by central banks have been combined with those performed by other official agencies and/or self-regulatory organizations to form a single financial services regulator. In their paper they consider three questions: (1) why has this change occurred; (2) what role in supervision, if any, should the central bank continue to play; and (3) do these organizational changes in financial supervision pose risks to financial stability. The sixth paper is by Brian Quinn, Former Executive Director, Supervision at the Bank of England & Honorary Professor of Finance and Economics at Glasgow University. In his contribution on the "Governance of the Regulatory Decision Making Process" Quinn looks at how regulatory decisions are taken, and implemented, at national as well as international level, and discusses issues such as independence of regulatory and supervisory authorities, regulatory capture and the rivalry in decision taking between Basel, Brussels and Washington. The seventh paper is by Professor Harald Benink of RSM Erasmus University & FMG/LSE, Dr Jón Daníelsson of the London School of Economics and Dr Ásgeir Jónsson of the University of Iceland. In their contribution entitled "On the Role of Regulatory Banking Capital" Benink, Daníelsson and Jónsson study the role of regulatory banking capital and analyze the incentive effects of the Basel II Accord. They argue that Basel II may become a source of systemic risk due to endogenous risk and the risk sensitivity of the capital requirements. In this context they note that financial instability may enter via the asset side of the banks' balance sheets when banks are forced to sell assets in order to maintain the capital buffer prescribed by Basel II. The eighth paper is by Dr Markus Krall who, at the date of the conference, was a Senior Partner at McKinsey & Company in Frankfurt, Head of the Risk Management Practice in Central Europe as well as a member of the Global Leadership Group of the Risk Management Practice. In his paper entitled "Understanding Basel II Operational and Strategic Implications" Krall foresees a number of interacting developments influencing banks operational and strategic choices as well as the overall level of systemic risk in the global credit markets. The ninth paper is by Dr Silvina Vatnick, who is Lead Financial Economist, Financial Sector Vice-Presidency, World Bank and Board Member, Centre for Financial Stability of Argentina. Vatnick argues that the financial crises that took place in the late 1990s and early 2000s in Asia, Russia and Latin America, have raised doubts about the path and sequence of reforms and highlighted the impact of related risks, including increasing instability in nominal and real variables and other undesired phenomena such as market concentration. Finally, the tenth paper is by Sir Adam Ridley, Chairman of Equitas Trust. His contribution entitled "Regulation of Securities Trading (MiFID) and the Evolution of Exchanges, Clearing & Settlement" reflects on two major families of market development and regulatory change, both of which lie at the heart of our capital markets: the creation of an integrated securities trading market through MiFID; and the swift evolution in exchanges and post-trade institutions which set in around the beginning of the new millennium.

We would like to thank all conference participants for their active involvement in the discussions. Finally, we are indebted to the FMG/LSE's administrative staff, who provided invaluable assistance in organizing the conference.

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**Harald Benink** has been Full Professor of Finance at RSM Erasmus University in Rotterdam, the Netherlands since 1999. Name of the chair is "Institutional Design of Integrating Markets". Prof. Benink is also a Senior Research Associate to the Financial Markets Group at the London School of Economics. He holds a Master's degree in Economics from Tilburg University, a Master's degree in Financial Economics from TIAS Business School (Tilburg University) and received his Ph.D. degree in Finance and Economics from Maastricht University. The thesis was entitled "Financial Fragility". Prof. Benink's research focuses on banking and finance and on European financial and monetary integration. He has published in various academic journals (including *The Journal of Finance*) and has also published a couple of books (including "Financial Integration in Europe"). He is also frequently cited in international financial newspapers such as *Financial Times* and *The Economist*. Furthermore, he is Founder and Chairman of the *European Shadow Financial Regulatory Committee* (1998) and Founder and Invited Member of the *Latin American Shadow Financial Regulatory Committee* (2000), the *Asian Shadow Financial Regulatory Committee* (2004) and the *Australia-New Zealand Shadow Financial Regulatory Committee* (2006). The Shadow Financial Regulatory Committees consist of prominent professors and other independent experts, issuing policy recommendations in the areas of regulation and supervision of financial institutions and markets.

**Jón Daníelsson** has a Ph.D. in Economics from Duke University, and is currently a Reader in Finance at the London School of Economics. His research areas include financial risk, hedge funds, regulation of financial markets, market volatility, liquidity, models of extreme market movements, and microstructure of foreign exchange markets. He has been a Visiting Professor at universities in the United States, the Netherlands, Germany, Iceland, and Spain, and has published in a range of academic and practitioners' journals.

**Charles Goodhart, CBE, FBA** is a member of the Financial Markets Group at the London School of Economics, having previously, 1987–2005, been its Deputy Director. Until his retirement in 2002, he had been the Norman Sosnow Professor of Banking and Finance since 1985. Before then, he had worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. In 1997 he was appointed one of the outside independent members of the Bank of England's new Monetary Policy Committee until May 2000. Earlier he had taught at Cambridge and LSE. Besides numerous articles, he has written a couple of books on monetary history; a graduate monetary textbook, "Money, Information and Uncertainty" (second edition, 1989); two collections of papers on monetary policy, "Monetary Theory and Practice" (1984) and "The Central Bank and the Financial System" (1995); and a number of books and articles on Financial Stability, on which subject he was Adviser to the Governor of the Bank of England, 2002–2004, and numerous other studies relating to financial markets and to monetary policy and history. In his spare time he is a sheep farmer (loss-making).