Andrew Crockett: Issues in global financial supervision

Remarks by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, at the 36th SEACEN Governors' Conference held in Singapore, 1 June 2001.

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The maintenance of financial stability used to be relatively straightforward in the days when banks and other financial institutions earned protected rents and supervisors and managers could focus on simple risk measures. Over the last decades, the world has become far more complicated. Firms are running more complex risks, sectoral distinctions are blurring and markets are integrating globally. This has made the tasks of authorities responsible for financial stability more difficult to define and execute: there are more parameters to be considered, shocks come from many more corners, and the manner in which supervisory actions affect supervised institutions is far more complex.

So how should supervisors and other authorities with responsibility for financial stability adjust? There are substantive and procedural issues to be considered. One substantive issue is how the authorities should respond to a more complex environment. In principle, there may be two options: to adjust to the existing complexity, or to try and shape the environment so that it is compatible with existing regulatory frameworks and prudential approaches. But the latter has costs and brings risks on its own. Moreover, it may not be feasible given the international dimension of financial intermediation.

Another challenge, involving both substantive and procedural issues, and domestic and as well as international dimensions, is to devise rules that are consistent across sectors, leave no gaps, and are implemented effectively and fairly. What supervisory and regulatory approaches are workable in more complex environment? And how, procedurally, should the rules be drawn up and enforced? One response to the latter can be to integrate regulatory and supervisory rule making and enforcement functions in a single body. The other is for the various authorities involved to deepen co-operation. At the international level, a global super-regulator seems neither a realistic nor a desirable option relative to an enhanced co-operative approach seeking consistency with adequate recognition of differences.

To provide some background to these issues, I will begin my remarks by describing some of the characteristics that have resulted from the evolution of the financial sector in recent years and with which the authorities now have to contend. I will then group the remainder of my remarks under two headings: the implications for supervisory and other authorities; and the procedural issues that arise in organizing supervisory oversight.

I. Nature of change in financial systems

The most basic forces affecting the financial sector are: the quickening pace of technological innovation, especially in data processing and communication; and the growing acceptance of market processes as the basic determinant of resource allocation. The impact of technical innovation and deregulation on banking and the rest of the financial sector has been profound. The range of products and services have widened markedly. Intermediation costs have declined enormously. Financial transactions have grown rapidly in relation to GDP. All of this has brought considerable benefits through more efficient origination and allocation of capital, greater availability of capital for investment, greater efficiency in the management of risks, etc.

Let me note **six** characteristics of this transformation that have important implications for supervision and regulation. These characteristics have many common strands and channels of interaction.

First, ***firms are running more complex (and sometimes opaque) risks.*** Advances in the processing of information and in finance theory have permitted the independent pricing of risk factors that were previously bundled together in the same instrument. At the same time, the intensification of financial intermediation has given rise to an explosion in the demand for hedging (and position-taking) instruments. The good news is that the new financial instruments have enormously improved the technology of risk-management. The downside is that these same instruments, if not properly understood and used, increase the potential for loss, whether resulting from inadequate understanding or deliberate leveraged bets.

Second, ***sectoral distinctions are becoming blurred.*** To a degree, this reflects the greater willingness to accept a free market philosophy. But more importantly, the ability to deconstruct and re-combine risks has enabled financial intermediaries to expand and compete effectively in sectors beyond their own. And they can do so under the regulatory umbrella or framework that provides the greatest benefit and flexibility. To be sure, this can helpfully expose regulatory and economic inefficiencies. But where it is motivated principally by regulatory arbitrage, the authorities need to guard against it leading to a system wide reduction in capital adequacy or undue risk concentration.

A third related characteristic is ***greatly enhanced competition.*** This has been a prime objective of much of the deregulation and privatisation that has taken place in the financial industry. But the competitive climate has been sharpened by other developments, too. A greater focus on shareholder value has induced banks' managements to pay more attention to the rate of return on equity. This is good news in that the financial industry is induced to use its capital more efficiently and financial services have become cheaper to end-users. But it also means that the cushion against bad luck or bad judgement is thinner. Franchise values are much smaller, so that an erosion of capital more quickly leads to the threat of failure (and the temptation to take unwarranted risks to stay in business).

Fourth, ***the source of financial disturbances has become more become more unpredictable.*** One cause is *capital market integration*, which affects a country's financial markets and institutions whether or not the economy is entirely integrated. We have seen that capital flows can be volatile and unpredictable. Contagion means that the problems of neighbouring or more distant economies can rapidly become one's own. Another aspect is the much ***greater diversity of actors*** in the financial markets. In the 1970s and 80s, most financial intermediation was conducted through banks, with insurance companies and investment vehicles having well defined roles. But many different types of institution, including non-financial firms are now involved in both wholesale and retail markets. And financial institutions based outside the major centres have come to play a more important role in international markets.

A fifth characteristic is that ***financial systems appear to have become more pro-cyclical than before,*** capable of amplifying credit growth and leveraging market positions more intensely than before. In essence, the "marginal" risk that financial actors willingly engage is greater than before. To a degree, this is a result of innovations in financial technology, including the process of securitisation, which allow risks to be better distributed and managed. The more widespread use and trading of collateral is also a factor. But it also reflects the intensification of competition, and perhaps a view among firms that they will be able to get out of risky engagements before they sour. Of course, pro-cyclicality works in both directions: once the downturn sets in, the financial system seems more prone to liquidity erosions and reduced credit supply than in previous episodes of stress.

The final characteristic to which I would like to draw attention is the ***greatly increased speed of developments in the financial sector***. The speed of transmission of news in the financial sector has always been high relative to other sectors. Nowadays, market communication and execution can be almost instantaneous. But what is also speeding up is financial sector actors' judgement of strategic opportunities in their environment and their moves to take advantage of them. New and cheaper technology, as well as deregulation, has greatly helped this. Business models get adopted and discarded more quickly. This will test regulators and supervisors, for whom the challenge will be to create rules of the game that are robust to fad, fashions and arbitrage.

There are several consequences of the characteristics I have mentioned and to which will I return. However, one, ***consolidation,*** has itself become a characteristic of the present environment. I believe consolidation has much further to run in many countries. So far, it has mainly taken place within national markets, and within particular sectors. Looking ahead, however, cross-border and cross-functional mergers and alliances seem increasingly likely.

II. Implications for the authorities

As I noted at the outset, a substantive issue raised by the foregoing is how the authorities should respond to the more complex environment that now prevails. In principle, there may be two options: to adjust supervision and regulation to a more challenging environment, or to try and shape the environment so that it is compatible with a more slowly evolving regulatory framework and prudential apparatus.

The latter may be possible, within limits, in economies whose financial markets remain relatively heavily regulated and closed off from other markets. But one cannot ignore the difficulty, the costs and risks of deliberately preventing adjustment when the world outside is changing at an ever more rapid pace. A gap that is created – as against one that is being slowly eroded – is one that may later be much more difficult to close.

In Asia, as elsewhere, countries are following different reform strategies. Given the wide range of initial conditions, there can be no single prescription. All the same, two key lessons of the past crises are by now widely recognised. The first is the need to liberalise financial activities and flows in a manner that is consistent with supervisory and infrastructural capacity. Firms, supervisors and the infrastructure all need time to adapt to a more demanding and complex market environment.

The second lesson is that ***a comprehensive approach is needed.*** The financial sector does not exist in a vacuum. Its efficiency and stability depend, not only on the prudential standards applied to financial institutions, but on the robustness of the financial infrastructure that underpins transactions. Weaknesses in the ***financial infrastructure*** can render useless the most careful supervisory oversight. Weak accounting and auditing practices are a major source of problems. Improved insolvency arrangements are also critical: the absence of fully satisfactory bankruptcy arrangements that permit the orderly restructuring of distressed corporate debt has been an important factor retarding market development, and intensifying financial crises in many South East Asian economies.

One area in which change is needed almost everywhere is ***corporate governance practices***. Where demands for reform and infrastructural improvements are made by professionally operating boards and management in anticipation of expanded business opportunities, the authorities should have few qualms about embracing them.

While a sound infrastructure and strong corporate governance, including effective bank management, are crucial elements in an overall adjustment strategy, equally important are adjustments in regulation and supervision. Let me review the major changes that have taken place in this area.

An important trend has been to ***strengthen the risk sensitivity of the prudential framework.*** Banking supervisors have focused intensively in recent years on detailed aspects of sound risk management practices in financial institutions: first, the accurate measurement and monitoring of risk; second, controlling and pricing exposures; and third, the holding of adequate capital and reserves to meet unexpected losses. This work is very apparent in the proposed revision of the Basel Capital Accord. In the revised standardised approach, risk-weights will be more reflective of actual risk. And in the internal ratings based approach, subject to safeguards, banks will be able to use their own credit assessments. This is intended both to strengthen internal firm discipline and to reduce the "gaming" that became rampant under the old Accord. But, as supervisors know well, the parameters of increased risk sensitivity must be calibrated and implemented carefully so as to avoid increasing the potential for discontinuities in adverse market circumstances.

A complementary trend has been, and continues to be, the ***strengthening of supervisory oversight***. This has implied a move away from direct control-type regulation on types of activities and financial flows, and towards supervision – a move, in other words, away from compliance with portfolio constraints, and toward an assessment of whether the overall management of a financial firm's business is being prudently conducted. There are several reasons for this shift (which is reflected in pillar two of the revised Basel Accord). First, the rapid development of new instruments and methods of risk management make mechanical application of balance sheet ratios inappropriate. Second, regulation inevitably creates incentives for financial engineers to find a way around the rules. More generally, regulation is too blunt an instrument to capture the technicalities and the sophistication required to control risk in a complex financial organisation.

To be effective, increased reliance on supervisory oversight requires an ***upgrading of supervisory capacity,*** both in terms of staffing and skills. An effective supervisor must understand all aspects of a financial firm's business, and can foresee the multiple sources of risk it is likely to confront. This means that supervision is becoming a more demanding profession, and the skills required of supervisors are becoming greater and more diverse. Accounting and legal training, while important, are no longer enough. Supervisory authorities are going have to seek also staff with backgrounds in economics and business management. Supervisors are becoming more like consultants, whose task is to understand the bank's business and draw management's attention to underappreciated sources of risk.

A third trend has been ***increased reliance on market discipline.*** Disclosure and transparency are an important part of a more robust financial architecture, as the third pillar of the new Accord recognises. There is still much to do, in Asia and elsewhere, to raise disclosure standards and to allow the market to provide the necessary discipline. Asia's crises were a stark lesson that sweeping problems under the carpet did not solve them. At the same time, supervisors need to take a balanced view of the utility of market forces as an aid to stabilising behaviour. Market participants may be subject to collective misperceptions of risk, such as reflected in the underpricing of risk in upswings. And even if risk is correctly perceived, private responses may not be appropriate from the viewpoint of systemic stability. Private behaviour can be affected by expectations of official action (moral hazard); by short term horizons induced by the nature of contracts; by differing interests as between principals and agents; and more generally by the combined effect of forces that make for what we commonly term "herd behaviour".

Finally, central bankers and supervisors are increasingly aware that generalised financial instability usually has its roots in macroeconomic factors. Banks do not often get into serious difficulties all by themselves. And if they do, we usually have remedies at hand. Crises typically occur because banks are jointly exposed to a common macroeconomic shock. This realisation has spurred a search for techniques that will ***make banking systems more resilient to the financial version of the economic cycle***. Banks need to be encouraged to build up capital cushions in good times so that they are available to protect their lending when the cycle turns down. By the same token, they would also lessen the risk that the credit cycle would unnecessarily exacerbate the economic cycle and hence the risk of financial distress. Among such techniques are stress-testing, pre-provisioning, cyclically variable loan to value ratios, and so on. The strengthening of the supervisory review process (Pillar 2) envisaged in the new Accord could provide a sounder basis for promoting these practices.

Monetary authorities, too, are beginning to ***recognise the complex two-way relationship between monetary and financial stability.*** The seeds of future financial instability are usually sown by excessive credit expansion. This facilitates the build up of leverage in the financial system and exposes institutions to losses when the credit cycle turns. Monetary policy will have to be more conscious in future of the risk of accommodating excessive credit expansion and the unsustainable rise in asset prices that often accompanies it.

III. The organisation of supervisory functions

As I noted at the outset, there are also procedural issues to be considered in adjusting to a more complex environment. The blurring of distinction between institutions makes it increasingly important to have consistency in the supervisory rules and enforcement methods that apply across different sectors. In its absence, there would be the twin dangers of regulatory arbitrage or competition in laxity. This is an issue for an individual economy as much as for an increasingly integrated global financial system. Hence, there is a national and an international dimension to the question of how the supervisory function should best be organised.

At the national level, two quite different approaches are being pursued: to bring all regulatory, supervisory, and oversight functions together in a single entity, as the Scandinavians first did in the late 1980s and others (e.g. Japan, the UK) have copied since; or, to keep the entities separate, but create mechanisms that ensure appropriate co-ordination among the relevant authorities. Each has advantages and disadvantages.

At one level, the single entity solution seems attractive. It would certainly seem preferable if the preponderance of domestic institutions were themselves integrated financial conglomerates. (But even then – as in Netherlands – the authorities can come to different conclusions). And integration might be an attractive option where a history of supervisory or regulatory failure calls for adjustments that are unlikely to obtain within an existing diversified structure.

But even if these conditions are met, it is not immediately clear which are the regulatory activities that it makes sense to bring together and which to keep on a stand-alone basis. Should for example the prudential supervision of banks and other financial institutions be integrated, but market regulation, including customer and investor protection, be kept separate? Experience with how well integrated regulators handle potentially conflicting objectives during episodes of significant turmoil might tell.

A single all embracing financial authority naturally prompts the question of where that authority should reside. This is now the subject of intense debate in quite a number of countries. And where such entities have been created, they mostly exist outside the central bank. This can be seen to have a number of advantages: Given the blurring of distinctions between different types of financial institutions, the retention of supervisory responsibilities within the central bank may give rise to perceptions that the lender of last resort function is being extended, with consequent risks of moral hazard. There could also be a conflict of interest with monetary policy, if central banks were induced to be excessively expansionary in order to head off weaknesses at individual financial institutions. There is also the issue of reputational risk. Finally, the central bank may be perceived as too powerful if it is both independent and endowed with a broad range of functions.

There are, however, arguments for retaining at least some supervisory functions within the central bank. The central bank will have easier access to market information in the case of a crisis, and it will be easier to co-ordinate monetary and prudential policy actions. It will be easier to assess and respond to the build-up of systemic risk if the supervisory authority also has responsibilities, and hence specific know-how, in other areas of the financial system (e.g. market functioning and the operation of clearing and settlement systems), as do central banks. And, access to supervisory information can help the central bank better calibrate monetary policy (e.g. the case of the "headwinds" that confronted the US economy during the recovery of the early 1990s).

In these terms, there is no obviously "right" answer to this debate. Individual observers may have their own preferences, but at the end of the day, the answer probably depends on country-specific circumstances. For example, how independent from political and industry pressure can a separate supervisor be? How scarce are the relevant skills? And how blurred have the distinctions between different types of financial intermediary become? Some, such as Charles Goodhart[*], have argued that these considerations lead to the conclusion that the case for combining supervisory and monetary policy responsibilities in the central bank will generally be stronger in emerging markets.

But whatever is the answer to the question "Who should supervise?", it is necessary to define tasks clearly and in such a way that the tools are available to discharge them. One risk in the present trend to remove supervision from the tasks of central banks is that central banks could be left with a responsibility for overall financial stability that is neither clearly defined nor supported with the necessary powers or access to information to discharge it. So where separate supervisory authorities are being established, it is important to set up a structure that promotes the necessary exchange of information and permits the central bank to influence the design of prudential rules. Much attention is being given to this subject in the countries where new supervisory structures are being put in place. Equally, however, where supervisory responsibility remains with the central bank, it is important that it too develops close co-ordination with other relevant authorities.

A global super-regulator?

Of course, the issues to which the single regulator is a possible response at the national level exist at the global level as well. How to ensure a level playing field internationally, both in terms of regulatory/prudential policy and enforcement? An approach sometimes discussed has been to set up a world financial authority, with powers to set and enforce regulations world-wide. I do not believe such an approach would be either feasible or desirable. It is not feasible, since there is very little chance of sovereign legislatures ceding powers in the regulatory area to a supranational body. And it would not necessarily be desirable. A single regulator could well be too monolithic, disinclined to experiment with new regulatory approaches. The rules it would create might not take adequate account of the particularities of the financial sector in different jurisdictions. And insofar as all countries had to agree on regulatory initiatives, there would be a risk of converging on the lowest common denominator.

In my view, the most promising approach is that adopted by the Basel Committee and followed by most other standard-setting bodies. It is to draw up a set of standards that can be agreed by supervisors in the most advanced jurisdictions, whose broader adoption is encouraged by peer pressure and market forces. It is remarkable to note that, while the Basel rules are backed by no formal legislation, nor has the Basel Committee any law-making mandate, its recommendations have greater acceptance and force than many treaty-based agreements.

Of course many issues remain. One is to ensure that rules made by a restricted group are adequately responsive to the circumstances of countries that are not members of the standard-setting group. This can be achieved by a process of consultation and review, in which a much wider range of countries is involved. Another issue is implementation. How can countries be encouraged to adopt the measures that will strengthen their financial systems? Here part of the answer seems to be to seek greater

[*] CAE Goodhart "The Organisational Structure of Financial Supervision" FSI Occasional Paper No 1, BIS, Basel, 2000.

support from the market. If markets reward high standards by easier access to funds at lower costs, there is little doubt that strong internal pressures would be created to improve standards.

Perhaps it is appropriate here to say a word about the Financial Stability Forum. The Forum was created in 1999, and includes senior representatives of ministries of finance, central banks and regulatory authorities in the major financial markets, as well as representatives of the main international organisations and standard setting bodies. A key reason for setting up the Forum was the realisation that there are many bodies whose activities contribute to financial stability and who have a stake in its preservation.

The Forum, in other words, is a tangible recognition of the fact that financial stability requires vigilance in a number of dimensions. Individual financial institutions have to be run on prudent lines, markets have to be open and transparent, and the financial infrastructure has to be robust. All of these objectives have to be pursued at a global level, since the financial industry is global and capital markets are increasingly integrated. Yet there is no global authority that can act in all the areas that are required. The Forum helps to fill this gap, by facilitating the co-ordination of efforts by the numerous separate authorities having responsibilities in the field of financial stability.

IV. Conclusion

In summary, prudential regulation is becoming more complex and demanding, as well as more important and fascinating. It is demanding a more comprehensive approach than hitherto. It is bringing together multiple disciplines in an attempt to harness the forces of the market to improve the market's stability. It stresses greater risk sensitivity, flexible supervision, and more reliance on market discipline. This is, of course, no more than a further important step along the road to a more efficient and resilient financial system. But it is an important step. And it will work to the benefit of us all.