Marion Williams: Governing the global financial system[1]

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The paper is set against a background in which the regulatory world is grappling with the realization that its regulatory regimes have been less than adequate to cope with the fast changing pace of financial innovation, sophisticated securitization and unfettered financial liberalization. It discusses the current global financial architecture, analyzes its strengths and weaknesses, the developments which have led to questions about its adequacy and suggests possible ways in which it can be improved and made more effective.

There is no single international oversight body in the financial world. The earliest institution closest to being described as a global oversight body was the Bank for International Settlements (BIS). It retains however, mostly a developed country focus, principally European.

Within the BIS the most influential group is possibly the Basel Committee on Bank Supervision (BCBS), a Committee which provides a forum for cooperation on banking supervisory matters. It is this Committee which develops guidelines and supervisory standards. Other supervisory groups have developed to cater to geographical needs. The Caribbean Group of Bank Supervisors performs this function for the Caribbean.

The International Monetary Fund was set up after the BIS. An important role for the International Monetary Fund is to provide lender of last resort facilities to many countries both developing and developed. In addition to lender of last resort functions, it also provides an important economic and financial monitoring function through its Article IV consultations and in more recent years, Financial Sector Adjustment Programmes (FSAPs).

The International Organization of Securities Commissions (IOSCO) is an organization of regulators of the securities industry whose objective is to cooperate together to promote high standards of regulation, to exchange information and to provide mutual assistance and generally protect the integrity of the securities markets.

Other International regulatory organizations include the International Financial Reporting Standards (IFRS) body which issues standards adopted by the International Accounting Standards Board (IASB).

The Financial Stability Forum (FSF) is of much more recent vintage. It was convened in 1999 to promote international financial stability. Its first major initiatives related to offshore centres. It does not include developing countries among its members, but makes recommendations and calls for their implementation relating to financial centres in both emerging markets and in developing countries. The FSF comprises 12 countries (G7 plus Hong Kong, Switzerland and Netherlands, Australia and Singapore including related institutions in those countries and 9 international standard setting organizations). The FSF is housed in the BIS.

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[1] Prepared for the Initiative for policy Dialogue (IPD) (housed at Columbia University) which hold its second meeting of it Task Force on Financial Market Regulation On July1-2 (Sponsored by and held at Brooks World Poverty Institute at the University of Manchester). It will analyse a) the transparency and regulatory challenges and discussions emerging from the current crisis, b) the implications of both the crisis and regulatory discussions for developing and developed countries and c0 reforms in the global financial architecture that might make the global financial system more stable and more equitable.

The Financial Action Task Force (FATF) is an intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. They comprise principally European and North American countries with subsequent additions of Japan, Mexico, Singapore and South Africa. Several International Organizations have observer status.

These groups sometimes coordinate with each other both through formal and informal channels. The group with the most representative membership is however the International Monetary Fund which is comprised of 185 members. However up until recently, the IMF had not concentrated its resources on regulation of banks or on monitoring or evaluating the innovations in the financial system and exploring its implications.

The FSF, if it widened its mandate to continual monitoring rather than issue-based approaches could come closest to the kind of entity which has the track record needed to coordinate regulatory and oversight functions of bank regulation, securities, insurance accounting rules and payment system issues and monetary and financial stability issues.

The impact of innovation and the challenge for regulators

It is against the background of this regulatory framework and in the context of a philosophy of financial liberalisation and integration of financial markets that innovative financial technologies took off. Financial technologies however rapidly outpaced the regulatory framework and it is now fairly well acknowledged that regulatory frameworks have not kept pace with financial innovation.

Financial innovation has manifested itself in various ways, the most prominent being the growing importance of new and complex financial instruments, new business models which focus on multiple financial activities facilitated by financial liberalisation, and significant developments in the area of securitisation and disintermediation. To this can be added the rising importance of relatively new, largely unregulated players, such as hedge funds, private equity firms, conduits and structured investment vehicles – SIVs, the constraints to financial innovation seemed limitless and regulators were left behind in the process.

By the first half of 2007, financial market activity had expanded at a tremendous pace. However, dependence on capital markets and on sustained market liquidity also increased, as banks and other intermediaries placed greater reliance on their ability to “originate and distribute” loans and other financial products. They also depended on the market to manage their risk positions dynamically. The coincidence of greater levels of deregulation and integration of capital markets implied that if a major problem arose it was more likely to spread quickly across borders. This environment encouraged an increase in risk-taking as many players “hunted for yield. Interestingly, the composition of investors also changed.

Measuring risk where credit can be sliced and diced

The widespread use of structured credits effectively lowered the compensation for bearing credit risk and market risk to historically low levels. It is during this time that a market for bearing risk through complex structures of credit derivatives flourished. There were a few warning signals particularly about hedge funds, but not many warnings about securitisation. Regulators were caught napping and the rating agencies did not spot the weaknesses.

There are two aspects to this problem, one is the absence of oversight bodies which were monitoring and more importantly, which had authority to forestall this problem and the other was the absence of rules or processes which would help to prevent its occurrence. There was also clearly a need for internal corporate ground rules at the operational level. However, securitization is here to stay as it is a critical factor in achieving financial flexibility in a world of global flows. However, it is important that credit originators bear greater responsibility for the credit worthiness of the credits they originate. Because of the difficulty of tracking risks in securitised loans which have been leveraged several times, loan originators need to be required to take more responsibility and to suffer some penalty for failure of the loans they originate. A solution to this problem will require greater study by derivative experts, but it is important that is addressed.

Concentration and risk management

Developing guidelines for risk management and requiring compliance to them are a core remedy for this situation and adequate internal risk management measures and processes at the level of the firm are very important. Portfolio concentration seems also to be an important area which calls for attention. Sectoral concentration and instrument concentration are both risk areas for which guidelines need to be developed.

Regulatory slips

In addition to national oversight level, something went wrong also with global regulatory and oversight systems. The IMF did not see itself as having specific responsibility for these developments and the BIS, while it did see itself as an entity with some responsibility for the stability of the financial system, was a European dominated organisation, and most of its clients were not experiencing these problems at home to the same degree as they were occurring in the US. They did draw attention to the development, largely in the area of hedge funds but did not appear to display alarm and were perhaps too hesitant in requesting remedial measures from US regulators, in which jurisdiction the problem was escalating most.

The initiatives which had been taken in the late nineties as offshore centres flourished, and which gave rise to the Financial Stability Forum and the FATF did not replicate themselves with the same aggression and with concerted action as in the case of the offshore centres issue, nor did these entities evaluate the nature of the problem sufficiently quickly.

As cracks in the financial architecture surfaced and new vulnerabilities were exposed, it became increasingly important that both market participants and policy markers improved their understanding and assessment of threats to financial stability, and take steps, where appropriate, to contain and reduce them.

The Financial Stability Forum (FSF); the International Monetary Fund (IMF) with their emphasis on macro prudential indicators and early warning systems have recently been active in the development of models to identify and assess potential sources of major vulnerability to the financial system. This involves great degrees of dialogue by regulators with practitioners, to understand better current approaches to measuring risks and to encourage improvements and the sharing of best practices in stress testing techniques. The former group lacks the network for so doing and the authority. The latter has that network but presently lacks the track record of analysing financial markets, instruments, structures and flows with a view to improving quickly on risk management techniques.

Size, market share and mega-financial institutions

The extent to which mega-financial institutions are at risk has not been highlighted a great deal but may be a sleeping giant problem. Indeed, in the UK and in US the financial institutions which failed were small financial institutions and not mega institutions. However, when we look at the write-downs of debt the largest debt write-downs in North America have been by the largest banks. If these have been larger relative to their size, then we would have a greater problem. Indeed, preliminary indications are that there is a need to focus more on size, governability, adequacy of internal controls and internal information flow as increasingly important aspects of financial governance by oversight bodies of mega-banks.

Indeed many large banks have been increasing their capital by going to market, some tapping into liquidity outside of their jurisdictions, even when regulators have not demanded it. There may be some issues here of too light a regulatory hand and over confidence in the role of the market. Responsibility rests with the CEOs as was evident in the firing of three CEOs of three large financial institutions in the US recently. It emphasises that Information flow, internal oversight systems, distributed decision making and incentive systems which support good governance need to be an integral part of review by regulators, particularly so in mega-financial institutions where distance from the operation can be a problem.

Innovation, financial market development and monetary policy

The role for central banks in influencing macroeconomic outcomes has also changed as a result of the inter-connectedness of capital markets and the internationalisation of financial flows. The development of deeper, more complete and more competitive financial markets have strengthened the pass-through effect of central bank interest rates to market interest rates and has led to a closer relationship between market and bank interest rates. Consequently, the deepening of financial markets has served to amplify the effects of monetary policy on bank interest rates, and ceteris paribus other variables such as inflation.

However a countervailing truth has also been evident. The major monetary policy transmission channel through bank lending has become less important, yet new regulations are still focusing on the quality of bank credit.

Widespread use of credit derivatives has meant that banks could respond more flexibly to changes in financial market conditions, and may therefore not pass through each and every change in the central bank's official short-term interest rate. Moreover, financial development has not only broadened banks' options in terms of responding to interest rate changes; they have also broadened borrowers' financing opportunities, reducing their dependency on bank loans.

These developments have meant that there is a more urgent need for adequate amounts of data which would provide policymakers with sufficient ammunition to try to maintain financial stability. Indeed, in some jurisdictions investment banks, the key institutions in this securitization boom fell outside the prudential purview of key financial regulators

Measuring stability

Initiatives to build robust financial stability indices have thus far not been good enough or easily understandable by the market. Moreover interpreting them with sufficient precision in order to home in on remedial areas in need, has been a fuzzy exercise.

The concept of financial stability involves various financial intermediaries, financial market segments and infrastructure, for which a whole host of different quantitative and qualitative indicators can be used. As a consequence, determining the degree of financial stability remains a highly integrated complex task. It therefore means that the governance system which has responsibility for ensuring financial stability must be able to monitor information and analyse developments in several financial sectors and not just in commercial banks.

Recognition of the multi-faceted nature of ensuring financial stability contributed to the concept of a single regulator as evidenced in the establishment of Financial Services authorities in some jurisdictions and was intended to help to deal with the problem of the widening scope of financial transactions and interconnectedness. It is beginning to appear that it is becoming increasingly difficult for a single regulatory authority to fully grasp all the intricacies of securities regulation, insurance, banking and derivatives use and all other financial institutional arrangements simultaneously. It seems therefore that what is required is not only greater depth of understanding by regulators in each specific financial area but also greater collaboration among regulators in these areas with a view to collaborating to ensure greater stability in the systems as a whole.

The role of calculating the feedback effects between financial system behaviour and the real economy has traditionally been conducted by central banks on a national scale and by the IMF on a global scale, and the latter still remains a very important role. The IMF may be well positioned to evaluate these effects, but it is not clear that it is best positioned to set regulatory criteria.

There therefore seemed to be a role for an oversight monitoring body with multiple oversight responsibilities, but with the ability to access a wide range of inputs from various single regulatory bodies with single regulatory responsibilities. The bodies which come closest to this are the BIS and FSF, despite the drawback that they are not truly global institutions. It is useful to note here that the BIS is the engine room of the FSF.

Given that feedback effects play a crucial role in assessing a financial system's vulnerability to contagion and systemic-wide stress this is an area that some international oversight body needs to concentrate on more intensively. Since this requires continuous monitoring and interactive dialogue and risk management skills, a joint FSF/IMF collaboration may be necessary.

Data availability and relevant data identification

With the exception of market prices and regulatory information, only a limited set of data is available in a timely and manner and in a manner that facilitates international comparison. For instance, financial intermediaries' financial reporting contains little information on risk transfer mechanisms, and the use of off-balance sheet financial derivatives.

Methods have to be found also for handling the shifting demand for data in an environment in which financial markets are constantly undergoing change. This is the regulators challenge. At present, stability forecasting is often scattered with respect to risk categories, financial market segments and structural or regulatory issues. While every national regulator should be involved in this process, global recognition of this problem may be needed at the global level. This must not be confused with any doubts about the skills and knowledge of such special geographic groupings.

Central bank as regulator or financial services authority?

Having set guidelines, the issue of compliance is important. Over the years there has been a simultaneous shift from a direct and administered system to market-determined and marked-based systems of determining interest rates, exchange rates and other key financial variables. However, the regulator or policymaker must still remain vigilant at all times to ensure that private owners and management of financial intermediaries operate within defined risk parameters, observe the standards, guidelines and codes diligently, comply with prudential regulations and norms, and follow the best corporate governance practices. The regulator who has responsibility for compliance may not necessarily be the regulatory which sets the guidelines as guidelines can span regulatory authorities. The need for coordination is therefore essential.

Even the role of governments in the process of underwriting balance sheets has been an issue. In the UK it was Government which gave verbal undertakings to depositors about the safety of their funds. In the US, the question also arose around the issue of central banks bailing out financial institutions (which were not banks) and whether the use of funds which would otherwise be available to the treasury, was appropriate. This issue of bailing out financial institutions which central banks do not regulate also has implications for reporting obligations and raises the spectre of the wisdom and practicality of a single regulatory authority and the moral hazard of an institution which regulates but does not provide financial support, and the information and regulatory needs of the authority which does. It is noted that Northern Rock was regulated by the FSA and bailed out by the Bank of England.

Importance of real time information

The use of technology to produce an updated management information system on real-time basis and the re-engineering of business processes and systems are the tools which can help regulators to remain on the top of the potential problems. Also, in many instances, the ability to regulate effectively is also dependent on the robustness of governing legislation, rules and regulations, as well as the ability of legislators to act quickly in changing such laws and regulations.

Very often financial regulators and legislators take years to enact laws and regulations while financial activity is changing rapidly. In this situation, the regulatory system can be irrelevant in the face of fast paced financial developments.

In this context, the content, characteristics, embedded risks and the accounting of the ever growing array of financial instruments particularly derivatives, hedge products and other similar products have to be fully understood so that guidelines governing them may need to be revised and made relevant, and quickly. However, while some of these rules may be set by securities regulators, it is banks which use securities, and the absence of appropriate rules by securities regulators is affecting the stability of banks and near-banks who answer to different regulators and who may need in extremity to be bailed out by a third regulator – the central bank.

Common standards and disclosure requirements

Regulators have also to insist that there are common standards for valuation of assets and liabilities and there are common yardsticks for measurement. It is not clear that these standards should necessarily be accounting standards. Transparency and disclosure standards have to be kept under constant watch and suitably upgraded so that the innovators are obligated to provide the full range of information required to evaluate risks. While the regulators should not stifle financial innovation, they should have the capacity to understand the risks involved and disseminate them to the market participants.

The traditional approach of regulation, that is, mainly compliance-oriented with emphasis on review of portfolios rather than evaluation of processes has diminished effectiveness in the present dynamic landscape. The imperatives of market innovation demand a departure from the current predominant approach towards a more proactive approach that forces banks to recognise issues when they occur or, preferably, even ensure that the probability of their occurrence is contained. This approach puts more emphasis on examining the bank's risk measurement and management processes instead of simply reviewing its assets portfolio. It demands that a bank's risk management processes should be scaled up to reflect risk appetite and the complexity of operations. Specifically, the bank which engages in more complex nature of businesses should be expected to have in place credible internal risk measurement models and should assess and maintain economic capital, adequate to cover the underlying business risks.

Capital adequacy

The emphasis on adequate capital has helped a great deal in the past but cannot in itself ensure solvency and stability of the financial system in all situations. However, there are some inherent rigidities which fail to cover many of the risks that banks assume in their business operations. That's why capital adequacy concepts have been becoming less rigid though it has been undermined through the use of regulatory capital arbitrage. The current sub-prime crisis in the US is testimony to the effects of regulatory arbitrage and the impact of regulatory loopholes, which can occur in even the most developed financial system.

While the BIS has been the most pro-active in trying to stay on top of these aspects of risk measurement in the industry, it too has fallen behind. This could principally be because the BIS has been concentrating principally on commercial banks, whereas the weaknesses in the financial systems had moved to the securities markets.

Measuring fair value

Accounting guidelines and bank regulation guidelines do not always coincide. Recent accounting mark-to-market rules of the IFRS are a case in point. Indeed, the role that mark-to-market accounting may have played in the evaluation of assets of financial institutions in recent months and in hampering the ability of creditor financial institutions to organize workouts of debt with their customers has been a matter of some discussion. Accounting rules tend to make the decision to reschedule or reorganize debt workouts a matter for greater provisioning by the financial institution, thus discouraging workouts and the long term prospect of recovery.

In the recent US case, earlier in the year, Government intervened and mandated that some customers must be given time to reorganise their debts. However, accounting rules do not predispose to making arrangements with ones creditors. The verdict is out on how the Spanish solution of dynamic provisioning has solved the problem. The counter-argument is that these system prolong the period over which debt is collectible and in the meanwhile might be misrepresenting the value of the asset. Discussion and dialogue with the accounting associations seem to be critical to resolving this problem which has the potential for preventing recovery of debt over the longer term.

Review of Basel II Accord

The new Basel II Accord is expected to eliminate some of those anomalies, but it is not perfect. Still, Basel II covers more comprehensive range of risks, better align regulatory capital to underlying risks, integrates capital requirement to a larger framework and provides for the role of supervisors in evaluating risk and market discipline. Since it provides options to banks, it appears to encourage improvements in the risk management processes. Policy makers have already realised the importance of this new accord, and presently it is in different stages of implementation across the globe. However, the implementation in itself demands even more concentrated efforts and capacity building both with regulators and concerned stakeholders. However, following the sub-prime crisis in the US there are growing concerns about the advanced internal based approach which gives banks flexibility to develop their own risk assessment systems, in light of what happened in the investment banking community when these institutions had total autonomy to do so and did not.

The role of market needs to be enhanced to discipline businesses indulging in excessive risk-taking. But this is not going to be an easy task, especially in the economies that have built-in safety nets which translate to negative incentives and which hamper market discipline on one hand and in turn encourage excessive risk taking by banks on the other.

Moral hazard and market discipline

The usefulness of market discipline in augmenting the supervisory roles cannot be overlooked, but has to be reworked. While some of these safety nets are indispensable, we should seek ways to reduce associated moral hazard, and perfect the market discipline framework to complement supervisory practices. The extent to which markets discipline themselves is however being questioned and it is becoming clearer that there must be penalties for inappropriate and risky behaviour which threaten system stability.

Improved disclosure about risk profile, risk management practices and performances and related matters facilitates market discipline by enabling the market participants as well as supervisors to assess the soundness of a bank given the level of risks it assumes. The market assessment of the bank's soundness as reflected in the pricing of its products by the market could be used as an indicator for devising effective policy responses.

A great deal of effort has been put into the introduction of Basel II by the BIS and in most organizations there is a tendency to protect one's creation. However, it is important that given the questions that have been raised about certain aspects of Basel II in the contest of the sub-prime crisis and the moral hazard of self assessment, that the architects of Basel II revisit some of the major tenets of the new proposed regulatory framework, especially the advanced approach.

The role of ratings

In a Basel II-regulated world, and in a world where market discipline matters greatly, ratings will become even more important. Ratings should reflect risk and prompt more responsible behaviour by financial institutions who value their ratings. This too has its challenges since in many instances pricing is based on a risk rating, itself the product of analysis of information that has been provided to the ratings agency by the specific issuer. Following the sub-prime fallout, the validity of ratings, rating agency modeling, methodology and their compensation has been called into question. Therefore, any enhanced programme aimed at improving the governance of the global financial system may require some changes to the ratings infrastructure and the extent to which ratings reflect risk and are not overly influenced by massive corporate profits of high-risk institutions. Indeed a special rating for risk may be appropriate – that is both for risk in the firm and transferred risk – i.e. risk transferred by the firm to the system.

There needs to be a series of major changes to plug the loopholes in the system and regulators need to ensure that they are as proactive as possible.

Global liquidity management

Over the past several years the liberalization of the financial system has created the need for liquidity to be provided, not to governments through the IMF as was the case in the past through stabilisation programmes but directly to financial institutions. The internationalisation of finance and the existence of mega –banks emphasises the need for liquidity support across large financial institutions. This may very well be beyond the capability of monetary authorities. There is a need to identify how this problem can be solved and how that liquidity can be provided before the problems occur. What is more serious is that where these problems are systemic and are not restricted to any individual bank, then access to liquidity could be very problematic. This eventuality needs to be considered before it occurs.

Towards a revised global governance structure

The question of developing a multi-pronged over-arching monitoring body is an important factor in a revised governance system. The nucleus of this exists in the BIS and the FSF and the IMF. The BIS already has in place, in addition to the Basel Committee on Banking Supervision, several useful sub-committees, for example, the work on Policy Development Group which has a number of sub committees – on Risk Management and Modelling, Liquidity, Definition of Capital, on Trading Book matters, and on Cross-border Bank resolution. The down-side of this arrangement is the degree of possible tunnel vision since most of the sub-committees arose out of Basel II Accord, which now appears needs some modification in light of recent events.

One issue is global acceptability. Most of these groups, even the International Liaison Group – that with the widest representation – falls short of international representation, of an organisation like the IMF with 185 members. The question is, how much is lost in terms of global stability by the exclusion of these countries? Is their inclusion in the IMF – albeit even there in a notional way – enough, or are they destined to continue to be excluded on the grounds that they are not systemically important?

The Financial Stability Forum attempts to function as a critical issues forum with representation beyond banking. This Forum, despite its G7 focus includes a number of international financial regulatory organisations. It trys to project that it is not an arm of the BIS, but is housed in BIS. This comes closest to being a multipurpose oversight body, but lacks global representation, something which probably needs to be remedied if it wants to be considered a global body with the ability to speak to other countries with authority. This group therefore, by reporting to the IMF is able to give itself some legitimacy. The report of the FSF of April 2008 on enhancing market and institutional resilience is an example of its work; a good analysis with general recommendations with specific recommendations promised later. Who, however will determine whether and how the recommendations are implemented is the key question? The IMF?

Summary

This paper attempted to analyse the international financial governance system, its strengths and weaknesses and in the course of the paper a number of issues were ventilated and a number of recommendations made.

They include:

- The need for clear rules and processes for securitisation and an oversight body whose authority is observed in this regard.
- The need to better understand current approaches to measuring risk and to track risks in securitised loans and to improve the internal reporting systems in mega-banks.
- The need to revise incentive systems so they do not reward those who transfer risks to others.
- Focus on financial risk generally and not on bank risks in particular.
- Concretise measures of financial stability and develop international comparability.
- Conduct more in depth studies on financial system vulnerability to inflation.
- Develop a clearly defined role for a body with multiple financial oversight responsibilities and determine whether this is the FSF and if so deal with its global legitimacy.
- Develop more information on risk transfer mechanisms.
- Develop systems of forecasting liquidity needs which result from globalisation.
- Determine the split of responsibilities between the regulator which set the guidelines, the regulator which ensures compliance and the authority which finances bail-outs.
- Clarify the role of governments and guard against moral hazard of saving financial institutions at all costs.
- Ensure that accounting guidelines do not frustrate debt recovery arrangements.

- Re-visit the self-assessment guidelines in the advanced approach of Basel II.
- Educate investors to rely less on ratings and to use independent judgement.
- Increase the levels of capital adequacy and support this with flexibility for supervisors to call for increased capital based on risk assessments.

This paper does not call for a total revamp of the financial governance structure but rather for a number of key improvements; among them dealing with the issue of legitimacy and also importantly, since some of these issues had been identified prior to the difficulties early in the year, ensuring that systems and regulated entities accelerate their responses to the recommendations.