José De Gregorio: Lessons and challenges on financial regulation

Introductory remarks by Mr José De Gregorio, Governor of the Central Bank of Chile, at the conference "Financial Regulation: Lessons from the Recent Global Crisis", Santiago, 17 August 2009.

I am very grateful to Luis Opazo for his contribution to this presentation.

* * *

What went wrong? This question has been at the center of recent discussions in academic, practitioner and political circles, and will probably stay with us for several years. This conference is a step forward towards finding answers to this question. Specifically, the main purpose of the conference is to discuss those aspects of regulation that may have triggered or amplified the current crisis, and those aspects of regulation that in some countries have contributed to financial resilience.

The Chilean financial system, as well as those of many other developing countries, has shown to be very resilient. Nevertheless, we also need to be involved in the discussions on building a safer financial system. Our countries have a lot to say on balancing financial innovation and financial soundness.

The global economy shows some signs of recovery, but it is not evident that the crisis and its effects have fully unfolded. More likely, they will continue to evolve for some time. However, it is not too early to discuss these topics. Hence, we hope that the presentations and discussions of this morning will shed light on the directions for regulatory change in the upcoming years.

Causes of the financial turbulences and their implications on financial regulation

The subprime crisis is the result of the convergence of several elements at the same time – what some observers have called a "perfect storm." Trying to keep things simple, the element that triggered this crisis lies in the U.S. mortgage sector and a process of rapid financial innovation. In this regard, the banking industry contributed to the lending and housing boom as follows. First, the traditional banking model – hold loans until they are repaid – was replaced by a distribution model, where loans are pooled, tranched, and finally sold via securitization to other financial investors, thus this process led to banks' off-loading risk. Second, the funding of highly leveraged financial intermediaries with short term liabilities increased throughout this period, which exposed those intermediaries to potential stress derived from changes in market liquidity conditions.

As we all know, the *originate and distribute* model led to the fast development of securitization markets characterized by an ever-increasing supply of complex financial instruments. Given the course of events, these turned out to be quite difficult to value. On this last point, the rating agencies are involved, as they are responsible for assessing the credit quality of such instruments, which is an essential piece of information for investors. Nowadays, these institutions are also under public scrutiny regarding their capacity and incentives to correctly evaluate risk.

My impression is that the fundamental causes of the current crisis were the same market failures that have played key roles in many previous financial or banking crises, which we all know well from our previous experience in emerging markets. The first of these are the distortions in financial intermediaries' behavior introduced by implicit or explicit bailout expectations. The second are the intrinsic vulnerabilities of financial intermediaries that finance long term (or illiquid) assets with short term debt.

What differs in the current crisis is the way in which these components showed up. As for excessive risk taking, the mechanism to deal with it was the securitization of high risk loans, which allowed banks to sidestep capital regulations by either creating off-balance-sheet agents or by bringing back loans packaged into highly rated assets, with low capital requirements. As for short term funding of long term (or illiquid) assets in the current crisis, this was prevalent in investment banks, SIVs and conduits.

Hence, the lessons to be learned from the current crisis fall into two categories. The first are broad reforms that seek to align incentives and reduce the vulnerabilities of financial intermediaries. Higher capital requirements, a broader regulatory scope, and reforms to management incentive schemes are all in this category. These are all important aspects. However, the devil is on the details, and the exact way they should be implemented is yet to be defined. For example, it has been argued that "systemic" financial institutions should be more closely supervised and be subject to a more stringent set of regulations. How exactly to define systemic institutions, and who should deem an institution systemic is far from clear. Closely related reforms are those aimed at reducing interdependence and, therefore, the systemic nature of institutions. The push towards central counterparties, in particular for derivatives, falls in this category.

The second category of reforms encompasses those directly related to the specifics of the subprime crisis. I would like to offer some comments on these issues. In particular, I would like to comment on a) accounting methods; b) liquidity; and c) rating agencies.

Accounting methods and valuation

At the onset of the financial turbulences, there were strong concerns on how precise was the information reported by banks, how large were the losses, and who was bearing these losses. This uncertainty was a critical factor in the shutdown of key financial markets. The International Accounting Standards Board (IASB) and the Financial Stability Board (FSB) have been working and promoting recommendations on accounting and disclosure standards for off-balance-sheet investment vehicles, and fair value methods, among others. However, these "information" requirements by themselves are not enough, and other measures could be necessary, such as forcing originators and other agents to hold part of the risk of the assets created.

Liquidity

The current financial turbulence has highlighted that for the banking sector liquidity considerations are as relevant as solvency issues. In spite of this, most of the attention in banking regulation has been focused on solvency (Rochet, 2008). However, some steps have been taken in this direction by the BIS in terms of contingent liquidity demand and related triggers associated with off-balance-sheet positions (BIS, 2008). The literature has identified several elements that could generate externalities related to liquidity, and therefore could justify some degree of regulation, where the main arguments are linked to asymmetric information and market incompleteness.[1] Moreover, policies put in place by central banks after September 2008 have made moral hazard concerns for liquidity management more pressing.

Nonetheless, there are still open questions as to the kind of regulation to reduce the potential consequences of the imperfections in this area. There are no straightforward answers on this matter. Some pending questions are: Should a capital charge be put in place for liquidity

[1] Allen and Gale (2000), Freixas and Rochet (2000), and Morgan, (2002).

risk? Is it necessary to impose an additional liquidity requirement to intra-day liquidity needs? Should central banks act as the lender of last resort in this market?

Credit rating agencies

The role played by risk rating in the subprime crisis is also an important corollary to the current crisis. To illustrate why some authors have gone as far as calling this "the credit rating crisis" (Benmelech and Dlugosz, 2009) consider that before the crisis more than half of the structured finance securities rated by Moody's carried an AAA rating and, during the period 2007-2008, the tranches rated by Moody's that were downgraded was close to thirty six thousand, where nearly one third of downgraded tranches bore the AAA rating.

This is a complex issue, especially due to the prevailing incentives in this sector. A recurrent area of criticism on the incentives side is the simultaneous role of advisor and issuers of ratings. But the spectrum of potential conflict areas could be broader, and thus more efforts must be devoted to understanding in detail the operation and linkages of this industry.

Final comments

The subprime crisis has opened a debate on the risks of financial innovation. It reminds us that higher levels of sophistication do not guarantee the normal operation of the financial system. A reasonable level of regulation, control and monitoring is required. I think we should move forward in innovation processes, as they are positive, but we must move forward with caution. It is important to implement policy changes gradually to provide an adequate level of information and transparency that will ensure an adequate assessment of the risks involved. It is also crucial to review in detail the incentives and potential conflicts of interest arising from the new tools and processes.

Another aspect that needs to be addressed is the role of adequate control systems and financial risk management. A proper system of financial risk control and management must start by defining policies at the highest level, the board of directors. It also requires the involvement of senior management in tracking and monitoring risk. And, ultimately, it needs the development of an organizational culture that is capable of properly combining the goals of profitability and leadership with risk sensitivity. In this regard, a topic that is central to the discussion of financial reforms is the overall structure of incentives of financial intermediaries. I believe this is an issue that all players in the financial system must follow with care.

As a result of the current problems, we will observe more regulation in financial markets and everyone, even those of us not at the center of these difficulties, must remain watchful. Problems of moral hazard, transparency and new ways to meet the requirements of central banks to provide liquidity are leading to a review of regulatory frameworks at the international level. We must be aware that more regulation leads to the search of ways of avoiding them, which may end up threatening financial stability. This last dimension must be taken into account in the analysis and regulatory proposals, which obviously introduces an extra element of complexity in this area.

Thank you.

References

Allen F. and D. Gale (2000). "Financial Contagion", *Journal of Political Economy*, 108(1).

Benmelech E. and J. Dlugosz (2009). "The Credit Rating Crisis", NBER Working Paper, 15045.

Freixas X., Parigi B. and J. Rochet (2000). "Systemic Risk, Inter-Bank Realtions and Liquidity Provision by the Central Bank", *Journal of Money and Credit Banking*, 32(2).

Morgan D. (2002). “Rating Banks: Risk and Uncertainty in an opaque Industry”, *American Economic Review*, 92(4).

Rochet J. (2008). “Liquidity Regulation and the Lender of Last Resort”, *Financial Stability Review*, Banque de France, February.