Marion Williams: Governance and regulation of the financial sector – post meltdown: what has changed?

Remarks by Dr Marion Williams Governor Central Bank of Barbados, at the Seminar on "Governance and Regulation of the Financial Sector – Post Meltdown: What Has Changed?", Bridgetown, 14 October 2009.

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Senator The Hon. Darcy Boyce, Distinguished speakers, Members of the Board of The Central Bank of Barbados, Deputy Governors, Members of Management and Staff of the Bank, Managers of Financial Institutions, Specially Invited Guests, Distinguished Ladies and Gentlemen:

Welcome to the Central Bank of Barbados and to today's Seminar on Governance and Regulation of the Financial Sector – Post Meltdown: What has changed? I extend a special welcome to our overseas speakers Mr. Geoffrey Bell, Ms. Jane Darista, Mr. Amar Battacharya and Mr. Osbourne Nurse. We thank you most sincerely for taking time out from your busy schedule to be here. The high level of attendance this morning suggests a keen interest in international and regional developments and their impact on the financial sector.

Our distinguished speakers will be discussing several critical issues as the world tries to chart a way forward for the financial sector. I will offer some preliminary remarks about the areas which I expect that we will cover.

Attitudes and perspectives

The global financial crisis and its bank failures, collapses, scandals etc. cannot be undone. Whatever its genesis – developed and developing countries, offshore or onshore financial centres, we all need to change attitudes, perspectives and strategies in order to ensure that institutions all across the globe are strengthened and that we restore consumer confidence and trust, globally, in financial systems.

The interconnectedness of financial systems is such that the failure of an individual systemically important financial institution can reverberate globally. The dramatic changes in the global financial landscape over the past year have been historical in their proportions. In a period of such tremendous changes it will be necessary to take stock of where we are and to question how the financial sector is being governed, regulated and supervised. Without doubt there will be changes in global rules as we have already seen and in global cross–border movement of funds, ownership structures and similar types of arrangements.

Research and discussion is needed on important subject areas that will be discussed today.

Basic questions

Even basic questions about who should have responsibility for regulation and whether the lender of last resort function should be separated from the regulatory function are now becoming important issues on the table. In the UK it now has political dimensions. The breath of responsibilities of the regulator are now also being revamped, particularly in the US, as is the question of how much should be left to the market and how much should be directly regulated. The age of deregulation may well be about to witness some fundamental changes and reversals.

Governance

Good governance aids regulation. Regulators are therefore calling on institutions to institute voluntary governance practices to deal, for example, with excessive risk taking, rather than opt for a system of imposed over-regulation. Adequate oversight by Boards is important, as is adherence to codes of ethics.

Importance of collaboration

What has become very clear, and we have seen it even in the Caribbean, is that there is now significantly more emphasis being placed on collaboration among regulators, and on reducing regulatory arbitrage – that is, the ability of entities to cherry pick where they do business, so avoiding the stricter type regulatory domiciles, because of differences in regulation. This is particularly important in single economic zones like the Caribbean, and on a larger scale, the EU.

Derivative trading

While the Caribbean has not been too heavily involved in derivative trading, the regulation of derivatives has attracted a lot of attention, since many of the problems in the credit markets were attributable to the ability of financial firms to originate poor credits and redistribute them to others, thus leaving the burden of poor credits which they had originated on the books of others. It is important that solutions are found to this issue.

Branch/subsidiary operations

The branch subsidiary responsibility and where it lies has also surfaced in many jurisdictions. Because an entity is setup by way of subsidiary rather than a branch does that give the parent an escape route? Or should the parent shoulder its responsibility even though the entity is set up as a subsidiary?

Adequacy of capital

Another issue of importance is the question of the adequacy of capital. This has become an important matter in the post meltdown period. Many jurisdictions have taken steps to increase capital adequacy. Even before the global crisis Barbados had taken such steps. However, the adequacy of capital is being increasingly critical. Will capital ever be a fail-safe requirement? If it were, capital levels would have to be so high as to stymie the development of financial institutions. What therefore is the balance which has to be struck? And what are the accompanying requirements which must support capital requirements? These are important areas to be considered.

Too big to fail

We have seen, even here in the Caribbean that there is such a thing as “too big to fail”, or rather, “too big to be allowed to fail”. There is currently a debate as to whether large financial entities should have a progressive scale of capital requirements, which require bigger entities to hold more capital pro-rata. The other concern being debated is whether financial entities should be allowed to become too large.

Transparency, accountability and trust

Another important factor observed during the meltdown was that the more sophisticated securitization became, the more opaque the instrument, so that is was often not possible to tell what the risks of the instruments were and who was bearing that risk. So much so that entities then bought back some part of the securities they had distributed without realizing it. A way needs to be found to track the risks in these securitized instruments.

Processes and practices

The micro prudential approach to supervision has emphasized protection of the small depositor and reducing the likelihood of failure of an individual institution. In the past, this might have been sufficient to bring comfort to many consumers. However, by re-focusing on the financial system as a whole, we reduce the risk of concurrent failures of systemically important institutions. Such a change is necessary to enable us to withstand and rally against future shocks and developing a framework for macro-prudential regulation will be an important step. This is another important area of focus on the post meltdown period to which attention must be paid.

Emphasis on the risk behavior of both bank and non-bank financial institutions, and the counter-cyclical approach of building buffers in good times is another needed change. Indeed, the pro-cyclicality of the system has been frequently criticized.

Another area of interest is the scope of regulation. Given the propensity of risk to migrate from regulated to less regulated sectors, requires that corrective approaches be equally considered in both the bank and non-bank sectors. This wider regulatory coverage already exists in Barbados in respect of non-banks but steps are in train to strengthen oversight of other entities which will fall under the New Financial Services Commission. On a global scale, the form which increased regulation will take is still being developed. I am sure that we will get some early indications from our speakers on how this is likely to develop.

What the global crisis has taught us is that there is need to take the time out from managing complex technical issues to ensure that there are crisis management plans that can be activated when financial stability is under threat. I am pleased to say that, in the Caribbean case, this project is well underway and is being piloted by the Caribbean Group of Banking Supervisors.

Additionally, communication can instill confidence and trust by fostering a better understanding of the financial markets and thus engender increased participation. On this point, I am pleased to say that the Central Bank of Barbados recently launched a National Financial Education Programme in August 2009, which will enhance the financial capability of Barbadians and so lend to renewed participation in financial markets. We would like to believe that if consumers in the US were more savvy the sub-prime crisis might have been avoided. The important question is, to what extent can financial literacy prevent these problems for the consumer?

Infrastructure

Efforts to find the optimum regulatory architecture are varied in form and pace. As we rebound from the crisis and crystallize the lessons arising, it is important to proceed at a pace that is steady and appropriate to the environment. Reform of the supervisory framework is being paced addressed by several global and sub-regional groups. I am sure that we will learn about the new European Risk Council and European System of Financial Supervision, as well as the debate on whether to expand the powers of the Federal Reserve. Barbados has accepted that change is needed in the regulatory architecture and the new Financial Services Commission is targeted for establishment in mid 2010.

As we move to effect change, care must be taken to take stock of the status of the economic crisis. We must be mindful that the combined impact of new requirements, such as the introduction of anti-cyclical regulation (e.g. capital and liquidity buffers), should be timed such that the core business of financial institutions (for example lending) can continue. Fortunately, in the Barbados case there were significant liquidity buffers, but generally, policy makers in instituting new requirements may need to set longer-term strategies rather than attempt overnight correction.

The pre-lunch sessions speak to a range of interesting subjects. These include perspectives on the economic activity in industrial countries, interest rates, prices, commodity prices and exchange rates; changes in the global economic architecture; the approach of industrial countries and organizations to international business and offshore financial centers; and multilateral surveillance. We will also hear of issues surrounding rebuilding transparency, accountability and trust; the ongoing refashioning of the regulatory landscape; and regulation outside the box will surely stimulate further discussion. Lastly, what needs to be done with respect, inter alia, to Basel II; macro prudential regulation; International Financial Reporting Standards; mechanisms to address global market stability; and governance of remuneration/compensation schemes, securitization, and off-balance sheet operations are issues which require further debate.

The post-lunch session is especially interesting as it brings a regional perspective to the fore. The wealth of experience of the panelists will ably highlight the challenges and changes needed to address matters relating to the CSME and the pace of harmonization of economic and financial sector policies and regulation; cross-border banking, financial conglomerates, financial holding companies – implications for regulation and consolidated supervision; deposit insurance Schemes; and cross-border crisis management and crisis resolution for systemically important financial firms.

My final point is that sometimes it takes a crisis to spur action and the search for voice and participation for developing countries has improved tremendously since the crisis with the establishment of G20. This is the first step and we look forward to others.

In closing, let me thank those who have gone to much effort to be here and I look forward to the presentations.