Yaseen Anwar: International regulatory initiatives to enhance global financial stability

Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the 9th Islamic Financial Services Board (IFSB) Summit, hosted by the Central Bank of the Republic of Turkey, Istanbul, 16 May 2012.

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Mr. Chairman, the Secretary General IFSB, Distinguished Guests, Ladies and Gentlemen!

It is a pleasure and an honor to join you at this 9th IFSB Summit. I am greatful to IFSB for inviting me to share my views on "*international regulatory initiatives to enhance global financial stability*" with this esteemed audience. In my remarks today I will briefly discuss the events that lead to recent reforms, importance of regulatory initiative introduced so far and Pakistan's standing.

The crises that hit the global financial landscape during 2007 remains the worst since the great depression of 1930s. Though originating from financial markets and innovative "opaque" financial products, it impacted virtually every aspect of the world economy with consequences affecting the masses. The instruments that were meant to disperse financial risks instead allowed financial institutions in general and the banking system in particular to become highly leveraged that ultimately lead to financial meltdown. As a result, it not only put the innovations in the financial markets under the spotlight, but also singled-out regulatory and supervisory weaknesses in assessing the risks associated with financial institutions, markets and innovative financial products. The Euro region still faces the effects of the financial turbulence in the form of sovereign debt crisis. The fragile GDP growth and the unemployment data in the UK, USA and other crisis hit advanced economies still falls short of the pre-crisis level.

On a positive note, the financial crisis provided valuable lessons for improving the effectiveness of financial system regulation and supervision. To policymakers, it reminded that the present state of the international financial system requires a complete overhaul of the functioning of the markets and institutions. From supervisory perspectives, it showed that the available prudential regulations are simply not effective and prudent enough to ensure financial system stability.

The lessons learnt from the financial crisis signify the far-reaching changes in the structure and functioning of the financial systems and institutions. The international regulatory bodies including Financial Stability Board (FSB), IMF and BIS along with national supervisory bodies have developed a set of regulatory and supervisory reforms that aim at increasing the effectiveness of financial sector supervision. Furthermore, the G-20 leaders at various Summits have endorsed the policy framework recommended by FSB and BCBS, which has made countries reach a consensus on the selection of a reforms agenda. Much of the focus of the reforms is on improving the soundness of the banking system, addressing the Systemically Important Financial Institutions (SIFIs), developing macroprudential policy tools, strengthening accounting standards, disclosure requirements and crisis resolution framework.

We know that excessive leveraging by the banking sector, particularly in advanced countries was one of the key reasons that lead to the recent crisis. Banks took excessive on and off-balance sheet exposures while maintaining an inferior quality of capital base with insufficient liquidity buffers. In order to avoid such situations in the future, the Basel Committee on Banking Supervision (BCBS) introduced fundamental reforms in the Basel II capital adequacy regime by issuing a number of reforms and enhancements of the existing the Basel framework. These enhancements commonly referred to as Basel III are aimed at raising the level and quality of capital, introduction of leverage ratio, capital conservation buffer, counter cyclical capital buffer and liquidity coverage and net stable funding ratios.

Similarly, in order to facilitate the national supervisory authorities and small and medium sized banks and to avoid a sudden credit crunch in already fragile economies, the BCBS also set a rather relaxed timeline from 2013 to 2019 for the adoption of Basel III. It is therefore expected that increased capital requirements and further consolidation in international banking will prove to be a major step towards promoting financial stability. However since Basel III only affects banks, the regulators of other financial sectors such as insurance are expected to encourage the implementation of solvency II for insurance companies in order to reduce the presence of shadow banking and restrict the risk to move towards less regulated entities or creating regulatory arbitrage.

In recent times, an important reforms measure being pursued is to improve regulation and oversight of Shadow Institutions, so as to limit arbitrage opportunities, arising from the transfer of risk to relatively less regulated areas/sectors. The regulators therefore, are now focusing on minimizing the regulatory gaps in the shadow banking framework. To bridge this gap, the Financial Stability Board (FSB) is working closely on the development of an effective regulatory regime for shadow banking system that would largely focus on a) mitigating any spill-over between regular and shadow banking as banks are part of the intermediation chain of the shadow banking sector, b) reducing buildup of leverage in shadow banking through securitization, c) assessing systemic risk posed by shadow banking, d) reducing pro-cyclicality incentives posed by secured lending (REPOs) and e) reducing vulnerability of Money Market funds to possible runs.

While focusing on improving the soundness of financial institutions, the reforms emphasized heavily on the global and national Systemically Important Financial Institutions (SIFIs) and the moral hazards they pose while being vulnerable. Since the initiation of reforms, there has been considerable debate on the identification of SIFIs and the institutions that have the capacity to become SIFIs. Factors such as institution size, suitability and interconnectedness including “time varying judgment based assessments” have been prescribed for identification of SIFIs. Under the new reforms agenda, emphasis is on changing Too Big To Fail (TBTF) status of SIFIs and for devising a resolution regime as well as a safe exit mechanism for these entities. Further, supervisory authorities are focusing on enhanced supervision of SIFIs to mitigate the financial risks propagated by them through interconnectedness with other institutions that cause system-wide distress. Similarly a multipronged strategy has been adopted for addressing the risks posed by G-SIFIs (Global SIFIs) that comprise development of a new international standard for resolution regimes, more intensive and effective supervision, and requirements for cross-border cooperation, recovery, and resolution planning. The reforms also impose a cost on the SIFIs in the form of increased capital requirements *ranging from 1% to 2.5% of Risk Weighted Assets* for enjoying economies of scale and scope and to have higher loss absorbing capacity. As per FSB and BCBS assessment, the long term economic benefits of this additional capital requirement in terms of greater resilience of these institutions far exceed the modest temporary decline of GDP over the implementation horizon.

Another significant regulatory initiative in the post-crisis period has been greater focus on adopting a macroprudential framework along with traditional inflation targeting and monetary policy models. Central banks and regulatory bodies who traditionally have been using microprudential tools to ensure financial system stability are now increasingly using macroprudential tools along with traditional microprudential tools to ensure the soundness and stability of the financial system. The scope of the macroprudential policy framework is very broad and includes (a) identifying, monitoring and limiting systemic risks, (b) designing and calibrating instruments for executing macroprudential policies and (c) building institutional and governance arrangements.

Though at initial stage, the macroprudential framework has already started delivering key results including broader coverage of central bank financial stability analysis and monitoring of systemic risks. Furthermore, much work is done in closing data gaps and coming up with techniques to assess systemic risks and development of new macroprudential tools that have the capacity to identify systemic risk in a forward-looking way. The stress testing frameworks have also been redesigned by the regulators that incorporate extreme shocks (tail risk) to capture systemic risk and to identify the effects of macroeconomic vulnerabilities on individual institutions as well as on the overall financial system. However, the challenging task of building institutional and governance arrangements call for additional debate among policy makers.

The post crisis reforms also stress the need to improve and bring uniformity in international accounting standards. In this regard, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) initiated a convergence project of their accounting standards and practices. The FSB made recommendations for converged accounting standards of IASB and FASB in four areas including lending activities, impairment of financial assets, addressing valuation uncertainty in fair value measurement guidance and offsetting/netting of financial instruments. Accordingly, the IASB and the FASB are jointly developing a common impairment model to assess and record the impairment in the value of financial assets/instruments. Both Boards have also agreed to expand the scope of their joint project of financial instruments to address netting financial assets and liabilities on the statement of financial position.

Furthermore, disclosure requirements have also been revisited in the reforms agenda. Much of the focus has been on improved disclosures on structured credit products, instruments and exposures taken in Special Purpose Entities (SPEs), and on- and off- balance sheet items of banks. Similarly, Basel III also improved its disclosure requirements for exposures in securitization, off-balance sheet exposures and exposures in asset-backed papers and mortgage-backed securities. In a recent survey organized by the FSB it was found that the disclosure recommendations have improved the disclosure practices in certain OECD countries. However, it is felt that the disclosure on SPE securitization and exposure before and after hedging need certain improvements.

The financial crisis resolution framework has also been revisited in the post-crisis period and its scope has been enhanced to an integrated crisis management and resolution framework. Similarly, the FSB has put forward the principles for cross-border cooperation on crisis management that includes effective coordination amongst the national supervisory agencies, central banks and government finance ministries for making advanced preparations for managing the financial crises.

In the backdrop of the recent Global Financial Crises, the remuneration of Directors and Executives of banks and financial institutions have lately come under scrutiny around the globe. In order to put things in the right direction, there has been a growing effort globally to address the issues related to rationalization of compensation in the financial sector. Institutions like BIS, FSB and many national regulators like FSA, APRA and HKMA, among others, have made purposeful attempts to bring the issue of excessive remunerations to the forefront and make it more transparent and fair, not only by making enhanced disclosure requirements, but also drawing a detailed structure of requirements and guidelines for determining the remuneration and compensation of executives. FSB issued “Principles for Sound Compensation Practices” in April 2009 and relevant “Implementation Standards” in September 2009. Both these documents were later adopted in a consolidated form by the Basel Committee on Banking Supervision in January 2010.

Pakistan is a small, open economy, with domestically an active financial sector with limited interconnectedness with advanced economies. Like many other developing countries, it did not face the direct impact of the crisis on its banking system and financial markets. In terms of banking concentration, top 5 banks (all locally incorporated) account for 51% of industry assets; while foreign assets of the system are 10.4% of total assets. Moreover locally-incorporated banks and most foreign branches don't have significant exposures to the complex financial assets that caused the financial meltdown in the U.S. and Europe. SBP has always required banks to meet higher capital and liquidity standards, exceeding international norms in several areas. More importantly, we have a strong legal framework, which has been tested for effectiveness during the last decade and half. SBP has successfully restructured a number of banks, successfully demonstrating the problem bank resolution regime.

SBP being the regulator of the banking sector, has introduced and implemented key regulatory reforms and prudential measures to ensure financial system stability. Further, in order to align its regulatory framework with international regulatory standards and best practices, it regularly reviews and evaluates the standards issued by them for their possible implementation keeping in view our own local legal, regulatory and economic environment.

Similarly, SBP has taken steps to improve the effectiveness of macroprudential supervision by revising its prudential regulations like rationalization of loan classification and loan loss provisioning requirements whereby the loan loss provisioning framework was made more stringent during economic booms and relaxed during stressed economic conditions. In addition, SBP has devised a stress testing mechanism that not only stress tests the solvency and liquidity profile of the banking system under various extreme scenarios but also conducts macroeconomic stress testing under which macroeconomic indicators are set to influence the financials and solvency and liquidity profile of the banks.

We are also working on the subject of Consolidated Supervision of Conglomerates having direct or indirect holdings or influence on banks through shareholdings as well as large exposures. A legal framework is being formulated in consultation and coordination with the regulator of the non-banking sector i.e., Securities and Exchange Commission. We believe that this framework will provide an overarching supervisory control over the major stakeholders of the financial services. Additionally, the disclosure standards for banks are being revised to make performance of the banks more transparent and management of the banks more accountable.

While the regulatory reforms agenda being pursued vigorously by policy makers and regulatory bodies across the globe is likely to strengthen the financial system and may possibly be instrumental in preventing financial crisis in the foreseeable future, history says that reforms initiated after each crisis could not prevent the next crisis and each time the nature and dimension of the crisis was different from the earlier ones. This suggests that there may be fundamental and structural problems with the financial system like risk transfer rather than risk sharing, development of speculative products in the name of risk management instruments (derivatives), allowing unprecedented growth of the financial sector without any comparable growth in the real sector etc. Incidentally, these are some of the key features and principles of Islamic Finance as it believes in risk sharing, encourages growth of the financial sector in tandem with the real sector and prohibits investment in speculative activities. I would thus suggest that national and international supervisory authorities to objectively evaluate the potential of Islamic Finance principles in mitigating the existential risks faced by the financial system. I would also request Islamic Finance scholars and practitioners to reach out to their conventional counterparts to highlight the potential of the Islamic Finance system addressing the issues faced by the financial system.

Finally, I will reiterate that every crisis brings an opportunity, and it is upon us how we benefit from it. Let this crisis be the one whose lessons help us in improving the soundness and stability of international and domestic financial systems.

Thank you.