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Comments by Gill Marcus, Governor of the South African Reserve Bank, on the paper by Ross Levine entitled "The Governance of Financial Regulation: Reform Lessons from the Recent Crisis"

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Ross Levine has presented a stimulating paper that highlights the role that failures in the governance of financial regulation played in the global financial crisis. His analysis of these failures in the United States makes for compelling reading. However, as I will argue below, it does not follow that the solution lies in the creation of further layers in the regulatory environment.

In the aftermath of the crisis there has been a rush to reform institutions and regulations. This has created challenges for the relationship between governments, regulators and central banks, the banking and non-banking system, and society in general. I shall comment on the changing focus of central banks and the implications for their relationship with government, and then discuss general issues relating to regulatory relationships and some of the dangers inherent in the reform process.

Central banks and financial stability

It is clear that the core focus of central banks has changed. It is no longer the case that monetary policy can be conducted in a vacuum, and there has to be a focus on financial stability issues. The challenge here is to determine how best this is done. One has to determine what are central bank measures and what are not, and ensure that the core responsibilities of the central banks are not overwhelmed. Things will have to be done differently; central banks need to create better levels of knowledge and skill, perhaps collect different data, or change the way that they look at data.

There is still no general agreement on what the role of the central bank should be with respect to financial stability or, indeed, what financial stability actually means. But the discussions raise some important questions about the changes in the design of central banks, and possible changes in the relationship between the central bank and government. There needs to be an understanding of who is responsible for financial stability and how it should be executed. Clear parameters need to be set and formalised arrangements made.

There can be little doubt that the central bank should play a role in financial stability. In fact, most central banks already have an explicit or implicit responsibility in this regard. The question is, however, should this be the sole prerogative of the central bank? During times of crisis, it is usually the case that the first port of call of banks that are in trouble is the central bank. This is the case even if the bank supervision function is not located inside the central bank. The central bank has a role of lender of last resort, it generally oversees the payments system, it has the ability to inject liquidity into the markets in general or into specific dysfunctional sectors of the markets and, in many instances, it is responsible for the micro supervision of banks. But it does not necessarily follow from this that the macroprudential oversight or the financial stability mandate should be located solely within the central bank.

Financial stability requires a national response influenced by political priorities. During the crisis, the fiscal authorities in a number of countries made large capital injections into ailing banks and also provided government guarantees. Furthermore, any lender-of-last-resort activities have fiscal implications, even if they are initiated by the central bank.

Finally, there are other supervisory agencies and competition authorities that have an impact on financial stability. In South Africa, for example, a National Credit Regulator was established whose main objective is to promote responsible and efficient borrowing and lending practices in South Africa. One of its other objectives is to prevent reckless credit extension. In addition, there is the Financial Services Board that regulates the markets and the activities of the insurance industry. The bottom line is that it would be difficult to define a financial stability objective for the central bank alone, and it would be difficult for the central bank to carry out the financial stability functions on its own. This points to a shared responsibility for financial stability.

Therefore, a way needs to be found to co-ordinate with government as many of the policy options and their funding blur the boundaries between the central bank and the fiscal authorities. Financial stability decisions are generally more political, and require more interaction with government.

The South African Reserve Bank's suggestion, at this stage, is that while the compilation of data and analysis would primarily be the responsibility of the central bank, a financial stability committee co-chaired by the Governor of the South African Reserve Bank and the Minister of Finance could be considered. However, such a joint body raises a number of governance issues: What should the relationship be between the Monetary Policy Committee (MPC) and the Financial Stability Committee (FSC)? What happens when there are conflicts between matters relating to monetary policy and to financial stability? Does this give government a potential influence on monetary policy, thereby undermining independence?

I am not sure that I have the definitive answers to these questions. However, I would suggest that problems with co-ordination could be reduced or minimised to some extent by having overlapping membership of the two committees. At the very least, the Governor would chair (or co-chair in the case of the FSC), which would help to ensure coherence of policy. While conflicts between the two policies could arise, this is unlikely to be the norm. Monetary policy actions are likely to be far more frequent than those of the FSC, and in many instances are likely to be in the same direction, particularly if MPC mandates are broadened to be mindful of financial stability issues as well.

Decisions relating to interest rates will still be made by the central bank without government pressure or interference, but it may be inevitable that there could be some encroachment on monetary policy independence at the margin if financial stability decisions reinforce or contradict the direction of monetary policy. However, it is not always easy to disentangle the financial stability and price stability objectives, as they are not always independent of each other. Nevertheless, there will have to be clear specifications of the roles and responsibilities of the different bodies to ensure appropriate clarity of responsibility and accountability, and at the same time preserve monetary policy independence. Monetary policy independence is also not absolute. The central bank has independence in decision-making with respect to monetary policy, but it is not independent of the political economy.

General regulatory political economy issues

The global financial crisis has spurred a review of banking regulations, but there are dangers inherent in this approach that should be highlighted. There is the danger that the crisis will result or has resulted in excessive politicisation of regulatory issues in a quest to ensure that someone is seen to be responsible for the crisis. This has the potential to create a new moral hazard by giving the impression that the system is safe. Yet the regulators do not run the institutions and there are no guarantees of safety. However, if things do implode, it will be the regulator that is seen to be responsible.

There is also the danger that there has been too much of a focus on banks, rather than on the broader financial system. Over-regulation of banks could not only reduce lending, but it could result in more disintermediation, thus preparing the ground for the next crisis. What the recent crisis has shown is the inventiveness of financial markets to come up with products or institutions that will circumvent existing regulations.

The robustness of the regulatory environment and the financial system – including the payments system, the exchanges and banks – needs to be enhanced and individual failure managed in such a way that not seen as, or is a risk to, systemic failure. Furthermore, monetary policy and regulatory practice themselves must not become sources of financial instability. For example, keeping interest rates too low for too long could generate asset price bubbles, and "light touch" regulation or supervision could encourage risky lending practices.

In reforming the regulatory environment, it is not clear that the solution to the problem is the creation of additional layers in the regulatory and supervisory process. Should the endeavour not be to try to improve the existing regulatory framework, and make the existing structures more responsive or accountable and responsible for doing their jobs? Was the problem not that there a lack of appropriate implementation; that regulators and governments had the powers but did not use them?

I am therefore not convinced that the solution is to create an additional regulatory body such as the Sentinel, as proposed by Levine. It is also not easy to create a purely technocratic or politically independent regulatory body. Supervisory agencies, which are supposed to provide an independent check on the decision-making of financial institutions, are in fact subject to the same collective euphoria and myopia that characterise periods of excessive optimism. There is no reason to believe that new regulatory agencies will be any more or less subject to such influences.

Furthermore, supervisory agencies are also operating in a particular ideological climate. In the lead-up to the crisis, the climate at the time favoured free-market solutions and strategies, and tended to downplay the role of intrusive regulation. There is no doubt, however, that the pendulum has shifted in this respect (perhaps even too far), and that the predominant mood may have swung to one of over-regulation and excessive supervision. So, in reforming institutions, the prevailing political environment, as well as political relationships that exist, should be borne in mind.

The relationship between regulators and complex banks is also impacted by the relative skills capacity in the supervisory and regulatory bodies. This could impede these bodies and prevent them from being adequately equipped to assess the implications of financial innovation and new products. The financial markets are therefore generally ahead of the regulators in this respect. What is needed is a partnership without regulatory capture. The danger here is one of regulatory capture if banks or other financial institutions have the expertise, and influence the regulator to the degree that they determine their own environment. Therefore, the more effective the parameters set and sound regulatory framework created with the regulators having the authority and ability to enforce and act, the more likely is a sound banking system. Central banks and regulators are there for the system, not only for the individual institutions.

Finally, societal pressures on banks cannot be underestimated. Society's general reaction to the crisis is also important. There has been a breakdown of trust between society and banks, the government and regulators. Ordinary people are being asked to bear the brunt of the austerity adjustments to the crisis, through loss of jobs or significant cuts in income which, in some cases, could stretch the fabric of society. The question and challenge is how to rebuild trust and confidence.

There are risks that the political dynamics could be so overwhelming that the regulatory relationships become dysfunctional, resulting in central banks getting caught up in all of these conflicts and the decline in levels of trust extending to central banks as well. This then undermines the credibility of the central bank, which is supposed to be a beacon of stability in the economy.