Marion Williams: Sustainable effective regulatory systems

Address by Dr Marion Williams, Governor of the Central Bank of Barbados, at the Meeting of Shadow GN 2009[1], Rome, 6-7 May 2009.

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Introduction

The presentation examines some critical areas in the development of sustainable effective regulatory systems, in the light of the G20, Group of Thirty on Financial reform and the recent IMF Report on Global Financial Stability. The presentation does not deal with a level of detail at which measures must be implemented but adds some important dimensions for consideration in their implementation: nor does the presentation focus on all possible measures to ensure sustainable regulatory systems. It accepts that many of the measures already in place are well thought through and focuses on some of important areas which need to be addressed or further modified. Though it analyses the issues in the context of the major financial markets it takes an emerging markets perspective on many of the issues and where there is a differential impact for emerging markets, tries to evaluate the different impact of the implementation of some of these measures on emerging markets.

Background to the financial crisis

It was clear that regulatory systems failed in the lead up to the financial crisis. Part of the problem was insufficient oversight, over-reliance on the market, weak underwriting standards and complex and opaque financial products, inappropriate incentive systems, insufficient regulation, but generally a lack of clarity about who should intervene and what measures the intervenor ought to take. In addition regulation had not kept up with the internationalization of transactions and with the increasing complexity in financial markets, nor was there clarity about which financial markets should be regulated and which, if any, should be self regulatory.

Some tenets of sustainable regulatory systems

In a rapidly changing financial environment, it is clear that regulatory systems must be dynamic and flexible bur must still avoid loopholes where financial institutions can circumvent regulation and benefit from regulatory arbitrage. At the same time regulation must not stifle innovation. The challenge will be therefore to develop systems that are flexible and comprehensive without being onerous.

At the same time regulatory systems must be effective in the sense that they must identify the key reporting factors, factors that are important for measuring the stability of the entity and the level of risk to which it is exposed and its future viability in stressed scenarios, as well as the impact on the stability of the system. Speed of response, given the level of

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[1] Shadow Gn 2009 is a meeting of a group of international experts and policy makers which is part of the International Policy Dialogue on International Governance Issues, a private sector funded organization operating under the auspices of Columbia University. The meeting of 6th and 7th May was held in Rome in partnership with Luiss University, Italy.

technological advancement will also be important. On-line real time reporting should be the objective, so as to avoid regulators learning about crises after the fact.

Common themes identified

The need for national authorities to take a greater role in regulation while at the same emphasizing the importance of international cooperation has been one of the frequently repeated messages coming out of the financial crisis. Another has been the need to mitigate pro-cyclicality, the need for reform of the International Financial Institutions and the need to strengthen the macro prudential role of the IMF. A greater level of consolidated supervision and the need to include insurance companies, broker-dealers and bank holding companies in the supervisory framework where this is not yet the case, were also emphasized in most reports on the crisis. Maintenance of liquidity under stress conditions and the need for review of accounting standards, particularly the mark-to-criteria were other areas identified by may studies. There are however a few areas which need to be further examined and developed.

Bailouts and rescue packages and implications for regulation

Many studies have identified the critical regulatory weaknesses in the operation of the major financial institutions and more importantly authorities have taken steps to correct the immediate problems at the operational level. Rescue packages have helped to encourage the return of stability to the system, are intended to urge the opening of the credit markets, and slow the widening global recession which has been a consequence of the collapse of the financial systems in US and Europe, with consequential effects around the world. While this is critical, it is important and urgent to improve regulatory oversight and to ensure that the remedial measures are both appropriate and implementable. Rescue packages will help the immediate problem but they are not preventative going forward. In addition, it is important that financial institutions do not start to expect to be rescued and that there does not develop a danger of their failing to take corrective action on their own without reliance on the regulator or the monetary authority.

Speed in putting corrective regulatory measures in place

Issues such as the large size of mega financial institutions and adequate capitalization in the financial industry remain matters which need to be addressed as a matter of urgency. While these matters have been flagged, actual corrective measures have not been put in place with a long term perspective, but have been mostly stop-gap measures. Perhaps, part of the problem of the slow response of the credit providers and suppliers of funds is that, bailouts notwithstanding, suppliers are aware that the corrective aspect of the matter has not moved far beyond problem identification.

Indeed, while there has been a fair degree of consensus on problem identification, the authorities have not approached the matter of remediation of the regulatory and oversight issues with the same immediacy as they have the bailouts. There seems to be the view that this can be done in a more leisurely fashion. However, market participants may not be of this view, hence the reluctance to open the credit markets.

Lender of last resort facilities – how wide should it extend?

Investment banks have been the most significant players in the international credit markets but the issue of lender of last resort facilities to the non banks and insurance companies in post crisis situation needs also to be addressed. It is not clear that crisis-related lender of last resort facilities are intended to become a statutory right. Will the involvement in the US of Government and of the Fed as providers of liquidity become a continuing source of funds availability going forward? What lessons are there here for other central banks. And will the face of central banking change in the light of these expectations? What are the conflict of interest implications of such involvement, and what are the implications for risk–taking? In many of the situations of involvement of the regulatory authority, the problem can arise also of an appropriate exit strategy. This should be identified early.

The cost of financial crisis and who bears it

At the global level, seriously affected developing countries and emerging markets who can least accommodate the global recession which has resulted from the failure of several major financial institutions, are looking at ways to pass on some of the business costs of these collapses and near collapses away from their countries and institutions, but find that there is no scope for so doing, as they remain price takers in the credit markets, in a situation worsened by unavailability of financing. It is important that these costs be shared by the creators of these difficulties. This introduces moral obligation problems whose solutions are difficult to pinpoint. It is noted that while additional borrowing on flexible terms from the IMF is appreciated many emerging markets are highly indebted and therefore require grants and not financing. This is so even for middle-income countries which have no fiscal space.

Reform of the incentive system

Perverse incentive systems in the industry have been identified as areas in need of review. There has been much debate about the size of compensation and incentive systems but not sufficient analysis of the manner in which this can be reconfigured to reduce risk assumption over the medium term by originating firms. In addition, the need to restrict the ability to securitize risks away on to the portfolio of others may require some time frame for holding of the asset prior to securitizing and distribution. Indeed, there is a view in some quarters that the originator should be required to retain some portion of the asset to maturity. How much damage this would do in discouraging innovation in the industry remains to be assessed. Overall, risk assessment techniques and the ability to transfer poor risks on to the books of other unsuspecting investors must be corrected, particularly given the role played by the credit rating agencies in failing to alert investors to these risks. Indeed, should finance specialists be compensated in ways which relate to sales? Or is there a moral hazard here.

Review of Basel II in light of the financial crisis

The proposed Basel II regulations pertaining to self assessment via the Advanced Internal Ratings Based Approach, in light of the failure of banks in the US and Europe to properly self assess, must be seriously questioned. This will involve also a review of the important proposed role for rating agencies in the Standardized Approach of Basel II, given their failure to provide early warning signals with respect to lack of awareness of the imminence of the financial crisis.

The use of risk mitigation techniques

The role and the prominence given to risk mitigation techniques and the fact that risk mitigation is only as reliable as the skills of the risk mitigator and the strength of the entity which assumes the insurance will need to be addressed. Interlinkages between insurance and banking in the presence of credit default insurance must be regulated or the danger of double jeopardy will be repeated where the two activities are too interlinked. In this regard, a relevant question is: should there be stricter guidelines for risk mitigators and should credit default insurance be more strictly supervised and should such paper should be allowed to be bought by banks whether or not the credit insured is their own?

Should there be limits on size?

The issue of "too big to fail" has been a mantra frequently heard over the past several months in explanation of the need for bailouts. However, the US economy has anti-trust legislation. It may be useful to re-examine this with a view to developing special laws for the banking industry, in order to deal with mega banks at levels which minimize the risk of becoming too big to fail. This could reduce the profitability and scale economies of banks, so the benefits and costs of these approaches require analysis and careful study. Another option is to increase capital requirements progressively when companies get too large. There would be a need for a clear definition of "too big". Should this be defined in terms of market share or the limit on the ability to be bailed out?

Developing wider norms for cross-border supervision

The status of cross-border supervision needs to be fine-tuned. To what extent do regulators share responsibility for cross-border supervision of financial entities in situations where bailout funds come from the national treasury of particular countries; and who has responsibilities for overseas branches? Splitting responsibilities for providing liquidity is one aspect of the problem, since liquidity is intended to be temporary and will be repaid, but bailouts tend to be permanent and one-way. This introduces the issue of the extent to which the manner in which subsidiary legislation is written should take precedence over the obligation for ensuring shared financial stability not only in the country of headquarters but in the country where branches are located. It might appear that some international protocol may be required to clarify the rights and obligations of the parties.

A single regulator? Complexity versus collaboration

The role of a single regulator and the separation of regulation of the banking system from the central banks monetary role has always been a point of difference among central banks. It would be useful to review the stability of the financial systems in various countries to evaluate which system has had fewer regulatory problems? (Those where the central bank is regulator and those where it is not.) There is evidence that some cases of separation did not work out very well. Is there likely to be a trend back to the status quo before separation? It is sometimes argued that each area of regulation is becoming increasingly specialized and a general knowledge is no longer what is required. Is it reasonable for a single regulator to have the depth required in each field? Yet there is undoubtedly need for regulatory collaboration given the increasing inter-relatedness of financial transactions. How is this best achieved? It may be possible to have regulatory collaboration and in depth expertise in specialist areas with out having a single regulator. Rules of collaboration would need to be worked out to make this work.

International oversight: the scope

A very important response of the G20 was the establishment of the Financial Stability Board, an institution with wider representation than the Financial Stability Forum. In this regard there is a question of the scope of the Board. There is an interesting issue which begins to emerge from the first correspondence coming from the Financial Stability Board which gives the impression that their mandate includes the cross-border activities of firms. It seems important to clarify whether theirs is a mandate which extends beyond banks to the wider corporate world. It is however true that globalized mega-corporations can become weak links in an increasingly interconnected world, and that the same kinds of issues that arose in global banks could arise in global corporations in the real sector. This leads to the question of cross border flows and the authority to deal with these issues. It is not clear how the Financial

Stability Board will move from problem identification to implementation of recommendations without being given greater authority.

A greater role for emerging markets: the asymmetry between cost and control

The emphasis in the regulatory world has been on the systemically important countries. However, the example of the last six months has shown that though it was the most systemically important country which created the problem, it affected the entire world. This is vindication of the argument that developing countries should have a bigger voice in setting supervisory standards, because when they fail, developing countries are seriously affected even though they had no part in the construction. Gradual steps are being made in recognition of these facts and more is expected. However, it brings us back to the question of legitimacy, voice, representation and ensuring compliance.

Is disintermediation increasing?

There are small signs that the post crisis period has been seeing an increased level of disintermediation where brokers are bringing the larger borrowers and lenders together and where traditional banking arrangements are being avoided. It would seem that this has even greater risks than the institutional approach, since at least they were guidelines and provisos, whereas in private party contracts, the parties are just covered by the law of contract and other very generalized rules governing setting and fulfillment of obligations. This must be watched.

Over-regulation as a possible over-reaction

One concern coming out of the collapse of the financial system in US and Europe is that just as in the post Enron situation, there was a perceived over-reaction in the form of the Sarbanes Oxley legislation, that very shortly there could be an over-reaction in the financial regulatory domain, and that this could have adverse implications for financial liberalization and financial innovation. It will be important that we learn from that experience and that the right balance be struck.

Regional regulatory organisations

The suggestion coming out of the Turner Report for the development of regional regulators seems to be a useful one. The development of colleges of regulators is another option for achieving collaboration but the issue of national sovereignty and regional authority will need to be addressed.

These points expand on, or are additional to those made in the G20 report. In general, the problem identification process has gone well. There is clearly a great deal of work to be done to ensure that oversight systems in the financial sector are repaired to the extent where financial crises such as this does not re-occur. The experience of this crisis however has underscored the need to redefine what is “systemically important” more in terms of the inter-related nature and international nature of transactions and not merely in terms of size of the entity. But it has also emphasized that because of public resource constraints, something needs to be done to prevent entities from becoming “too big to fail”.