Marion Williams: The nexus between regulation and compliance and the financial meltdown of 2008

Address by Dr Marion Williams, Governor of the Central Bank of Barbados, at a Compliance Education Seminar, hosted by the Barbados International Business Association (BIBA) in association with The Institute of Chartered Accountants of Barbados (ICAB), Bridgetown, 9 July 2009.

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First let me congratulate ICAB and BIBA for having the foresight to hold this seminar. The topic of compliance is a very relevant one in today's environment where it has been forcibly brought home to professionals across the globe the need to be vigilant in their activities and to guide clients in the direction of prudence and care in operations.

I will touch briefly on three aspects of the nexus between compliance and regulation in the context of the global financial problems. Adequacy or inadequacy of financial guidelines and rules, observance of operational rules and appropriate codes of behaviour.

Compliance and appropriate regulation must go hand in hand. That is, we must first ensure that our rules and guidelines are relevant and effective. We must then ensure that compliance with them is observed. Having accepted that, we must however concede that the current global financial crisis which started in the US was not a result of non-compliance. In the case of the sub-prime crisis, other deficiencies were more important. The BIS in its annual report notes that these deficiencies include "problems with incentives, flaws in techniques to measure, price and manage risk and the corporate governance structures used to monitor it, and failings of the regulatory system". They suggested too, that there was a willingness to mistake the complexity of the system for sophistication and that historical performance was being relied upon to measure price and manage risk.

Given that the past is not always a good guide to the future, particularly in an environment where new techniques and instruments were constantly being introduced, this was a serious error in judgement.

The problems in the international financial markets of 2008 have taught us many lessons. The most important lesson is that changes in the regulatory environment must keep up with changes in the financial landscape, in terms of instruments, institutions and approaches to the delivery of financial services.

Firstly, the financial failures of 2008 which followed the sub-prime crisis clearly illustrated the need for a wider coverage of the financial sector beyond commercial banks and for stricter coverage of the financial entities which actually were regulated. In terms of the existing regulations, capital criteria were inadequate. Indeed in the financial meltdown many banks had to be recapitalized by Government and by the private sector. Yet many of the impact studies of the Basel II guidelines which had been conducted up to that time, had shown that for developed country markets the Basel II guidelines would have led to lower capital requirements for most banks. Conversely, it is now believed that capitalization levels of most major banks have to be increased – significantly in some cases, and many have already taken steps to do so. Despite acceptance of this need, there is also increasing acceptance of the fact that capital levels cannot save a bank when a crisis hits. Operational probity is more important in preventing its occurrence.

It is also generally agreed that one of the most important considerations in ensuring good financial management is that risk assessment guidelines must be adequately implemented. Market risk assessments should have indicated that the rapid growth of the sub-prime market and the manner in which risks were assumed, carried inherent dangers. Investment banks were, it is true, sensitive to risks such as exchange rate risks and interest rate risks but were not sufficiently sensitive to credit risks or market risks particularly systemic risks. Though the Basel II guidelines, to its credit, placed a great deal of emphasis on credit risk, for the most part these guidelines were not in place in the US and the regulators there had only partially accepted them and only for the largest banks.

It is also well known that the scope of regulatory oversight of the investment banks was inadequate. Indeed, so much so that when the Federal Reserve Bank started to bail them out they were hard pressed to find the appropriate legislation under which to do so. Investment banks were very highly leveraged and it became clear as the drama unfolded that going forward the extent of permissible leverage needed to be controlled, a concern that is now beginning to find itself in modifications being made to guidelines being developed for financial institutions.

The situation was allowed to develop partly because there was a belief in the self-correcting mechanisms of the market and a belief that there should be as little interference in the market as possible. This idea of the supremacy of the market finds itself increasingly challenged today as the market has proven that it is often unable to correct itself.

While we cannot go overboard and reject the importance of market mechanisms, as they are fundamental to much of the pricing in the financial world, in the aftermath of the crisis we do need to ask ourselves what the continuing role of self-regulation should be. In the regulatory world, it is still generally believed that the idea of self-regulation is a useful one, but that it cannot be totally relied upon.

Many self-regulatory bodies began in an environment where they set the rules which governed them. In time it became clear that this was not enough and oversight bodies were established in most jurisdictions to oversee the implementation of the rules and to provide a forum for appeal to a higher body.

Regulation however requires a sensitivity to the stage of development of the market and to the norms of market behaviour, and emerging and embryonic markets may require that a balance be struck between the need for markets to achieve rapid development and the need for these markets to remain stable. Most developed country markets did not have a highly controlled regulatory environment into which they launched themselves. Emerging markets seem to be managing to achieve this balance as evident by the relative stability of markets in Latin America and the Caribbean.

Professional bodies have become very important contributors to the stability of the regulatory framework and guidelines issued by many professional bodies have tended to become the accepted norm. Indeed the term “Generally Accepted” is a term used to describe GAAP guidelines or principles. As the world became more globalised efforts have intensified to make guidelines and principles in each area of discipline internationally acceptable, since companies and institutions were now operating globally. The merging of accounting rules and IAS, FASB and GAAP into IFRS regulations are an example of this global trend. In this way self-regulatory organizations and professional organizations have had a tremendous impact on the regulatory world in promoting uniformity, reliability and comparability of information across the globe. Today regulatory guidelines and guidance notes issued by professional bodies governing operations across the globe on a broad range of topics have been widely encouraged and accepted.

However, compliance with guidelines can become an issue in itself – as I am sure this seminar has illustrated as entities and countries are at different stages of development. Even the Basel guidelines, particularly Basel II guidelines are a case in point. Because of the wide differences in levels of development and sophistication, it was necessary to have 3 levels of Basel II, standardized and IRB and Advanced IRB.

Generally, because compliance is voluntary, what has happened is that reputational risk is increasingly being used as an enforcement tool and has become very important, since a statement by an international organisation that an entity or even a country is not compliant is itself a damaging statement. This was taken to inordinate lengths at the time of the OECD saga in 1999 in respect of offshore financial centres to the detriment of the Caribbean. Barbados was more fortunate in 2009. However, while Barbados was in the top tier of the recent list of financial centres issued by G20, and therefore had no problem, the principle being applied was one of encouraging compliance through the power of reputational risk. As a consequence many countries within the region have hastened to put corrective actions in place.

It now becomes clear that insurance companies are now being more closely monitored as entities which have significant potential for impacting financial system stability. Following developments in the US, we in the Caribbean have realized this to our chagrin. Indeed one of the results of this realization was an extension of support by Government to a major insurance company in the US and more recently in Trinidad and Tobago in not too dissimilar circumstances.

Indeed, it is interesting to note that the BIS has included a unit in its office in Basel for monitoring the financial stability of insurance companies, entities which were not formerly included in the financial institutions covered by the BIS.

Other developments in terms of the widening scope of regulation are evident from the fact that whereas central banks in most developed economies previously had stated objectives of price stability and monetary stability, today many Central Banks who primarily focussed on a price stability objective are widening their expressed mandates to include financial stability. However, as a consequence some Central Banks are concerned that there is a disconnect between the responsibility for maintaining financial stability and the dependence on others for oversight of a number of financial entities which can influence that stability. However, the Jacques De Larossière Report presented recently to the IMF comes down squarely on the side of placing responsibility for financial stability on the Central Banks.

These developments underscore the importance of the synergies between regulation and compliance. We cannot defer compliance until all the needed revisions to oversight systems are put in place. It must be a simultaneous task. We must work with what we have even though there is need for adjustments. We must ensure that the guidelines we issue continue to be relevant and are framed to best achieve the desired objectives. Given the rapid changes in technologies and instruments now available we must be sure that we are targeting the correct regulatory goals.

Much of my presentation has tended to deal with compliance in financial institutions. However I am aware that today's seminar is a joint seminar with Institute of Accountants, so your concerns will not only be about financial firms.

Compliance in the corporate world will be high on your agendas. In this regard, if I may comment on some general lessons to be learned by most professional coming out of the global financial crisis, it is that codes of behaviour are important but minute regulation is almost impossible. For example, I am not sure that there is any particular rule that should say to a lender that it is inappropriate to require from a borrower monthly payments which exceed the monthly income of that borrower. This was happening in the sub-prime mortgage market. It was influenced by the fact that the lenders' compensation was based on the volume of credit he originated and not on the quality of the credit. It would seem that general codes of behaviour rather than explicit rules are important here since one cannot anticipate every situation, nor can we devise a rule for every possible eventuality.

In the Caribbean and in Barbados in particular, generally speaking our commercial banks and finance companies have been quite compliant. Banks and finance companies in Barbados have tended to be well regulated and have observed the guidelines issued by the Central Bank. In addition the Board of the Central Bank at the end of 2008 took the decision to position itself to extend some aspects of regulation and consequently access to liquidity support facilities to finance companies as well, so we have broadened our coverage.

To conclude, the nexus between regulation and compliance is a mutually supportive one. Regulations, guidelines, standards and codes must first be appropriate, relevant and up-to-date but compliance with the guidelines is critical to the reliability, comparability and international acceptance of financial statements and for verifying the financial status of companies in the corporate world generally, but especially in the financial world.

Barbados has done relatively well in this regard. Our recent challenges have originated from outside, but the overall level of compliance has been for the most part, exemplary. However, we must be vigilant, and it is important that this is so of the entire corporate world.