

Ajith Nivard Cabraal: Ensuring stability and integrity of the world's financial system over the next few years

Keynote address by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, 27th International Symposium on Economic Crime, Jesus College, University of Cambridge, Cambridge, 5 September 2009.

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Chairman, Professor Barry Rider, Distinguished Delegates,

Ladies and Gentlemen;

I am delighted to be here this afternoon at the historic University of Cambridge to deliver one of the closing addresses at your 27th International Symposium on Economic Crime. Thank you very much for your invitation, which I am honoured to accept. I am also happy that this year, 2009, marks the 800th Anniversary of this great institution. Therefore, I would like to take this opportunity to congratulate the University of Cambridge on reaching this amazing milestone, and extend my best wishes for the centuries ahead.

Mr. Chairman, at your invitation, I would, today, discuss the ways and means of ensuring the stability and integrity of the world's financial systems in the future.

As in the case of all serious and complex reviews, our starting point should necessarily be to critically examine the basic and underlying reasons for this crisis. In that regard, there is now reasonable global consensus that the origin of the turmoil could be traced to excessive risk taking due to pure and simple greed; recklessness driven by intense, unadulterated greed; leading to the creation of massive "bubbles" in many developed economies, that were not supported by a robust, representative real asset base. No doubt, such risk taking had often been fuelled by lax and short-sighted regulation. To make matters worse, many rating agencies too, tacitly and indirectly, encouraged the excessive risk taking by assigning top ratings to toxic financial instruments, thereby helping to blow up the bubble even bigger. The bubble creating drivers had also been strongly supported by the global ability to transact business at unbelievable speeds and in mind-boggling volumes. This capacity provided the scope to move capital, wealth and resources across borders instantaneously, almost without restrictions or regulatory oversight, at the press of a button. But whatever may have been the drivers, the end result was that this greed and its ill-effects created and nurtured massive "bubbles" in many developed economies; and the subsequent puncturing of these massive bubbles has now revealed just how hollow and empty the financial structures that we relied upon, had been.

However, even at that stage, the usually conservative multi-lateral "watchdogs", rating agencies and experienced academics could not realize, let alone predict, that the world's financial system was fast reaching breaking point! Perhaps, from everyone's point of view, the going was too good to obstruct; the expansion was too exciting to discourage; the resulting luxuries and wealth were too wonderful to hold back. No wonder therefore, that the financial world continued to happily tootle along this unrealistic path, at break-neck speed. Logically, the accident had to happen, and happen it did, and what an accident that was! A crash landing that was sudden and unbelievably disastrous, not only to the developed world, but to all economies of the globe!

Mr. Chairman, the events of the recent past clearly suggest to us that the world's financial and economic communities have, albeit unintentionally, placed the entire civilized world's systems and structures at intense risk, and perhaps even endangered the gains of civilization built over several centuries. However, to the eternal credit of the world's political and economic leaders, we could be relieved that we have been able to face that shock and

emerge out of it, bruised and battered no doubt, but fortunately, with our systems still reasonably intact.

Nevertheless, the major down-turn suffered by the world economy as a result of these shocks is yet to be fully overcome. The tight liquidity crunch that is suffocating our credit markets; the stubborn toxic assets that won't go away; the suspicions with which banking and financial institutions view each other, are yet continuing, although there are signs of some abatement. The embarrassing summersaults that various governments had to perform by unceremoniously ditching some of their most sacred and fundamental policies, have also been better understood, by many communities.

Now, what is needed is to move forward decisively within this new paradigm. To do so effectively, we have to essentially place some barriers to deal with unsustainable risk taking. The freedom of the wild ass that supported unfettered and reckless economic actions to create things out of nothing has to be dealt with. At the same time, we need to revisit some of the fallacies that developed over the last decade or so, including those that indirectly said: "Don't worry too much about a few bubbles"; "markets are always right", "innovation should not be discouraged"; "state intervention is dangerous", etc. In a way, some of these positions perhaps prompted a kind of an unconscious regulatory anarchy! The resulting subdued regulatory reactions were of course exploited by the greedy market and the rest is history! This time round therefore, the wisdom of such concepts and absolute reliance on them, would need to be critically reviewed.

What then should we do? Maybe, we could start by making a "Wish-list", and then moving towards making a "To-do list" to realize such wishes.

What could we wish for? First, perhaps we should wish for effective "immunization" mechanisms to safeguard national financial systems from the contagion effects of globalized viruses and cross border toxic elements. Second, we could wish for lesser volatility in markets, greater credibility of regulatory and enforcement systems, and more responsible and prudent lending standards. Third, let's wish for much higher attention being paid by all stakeholders towards risk management, better governance practices and more relevant disclosures; and Fourth, we could wish for top priority being given by regulatory authorities, rating agencies and auditors towards risk and risk mitigation, with tough and decisive action being taken in the event of any unhealthy developments.

These, in my view, would be the broad wishes, but each of these "wishes" would probably have a series of sub-wishes to expand the scope of the main wishes, and consequently many more could be added, depending on various national and international imperatives.

Mr. Chairman, as with all good wishes, it is easy to wish, but a lot more difficult to make the wishes come true! Unfortunately, even the highly creative financial community will not be able to perfect some "mantras" or conjure up some suitable derivatives to make these wishes come true! Necessarily therefore, a lot of painstaking work will need to be done in order to translate these and other wishes into reality.

Let me now dwell briefly on a seven point framework, which in my view, would be useful to ensure stability and integrity of the world's financial system over the next few years.

First, as a global financial community, we should establish pragmatic standards in relation to the creation and sustenance of globalized financial instruments, (particularly complex, structured finance products). Any drug, before it is introduced into the market, has to undergo a quality testing process because a substandard drug, if allowed to be marketed, could hurt people badly. If so, why shouldn't financial products that could hurt the global system, not be subjected to stringent pre-tests? Accordingly, we need to develop institutions to recognize and approve norms for derivative frameworks and structures.

Second, we have to ensure greater transparency in reporting and valuation methods. Notwithstanding the robust application of international accounting standards and other globalized approaches, we still have too many subjective features in our valuation and

reporting systems, and these need to be addressed. It must also be noted that even after years of debate, many of the advanced financial markets still use their national financial reporting frameworks.

Third, we need to develop financial and business professionals who would regard their own reputations and integrity ahead of that of their institutions. In order to ensure that this happens, we may need to put in place, rewards schemes, laws and sanctions that support and encourage such behaviour.

Fourth, we have to ensure that individual national regulatory authorities would take a greater interest in safeguarding the quality of the balance sheets of the financial institutions within their purview, without conveniently abdicating that responsibility to a mythical “global” regulator.

Fifth, we have to build long-lasting and stable partnerships amongst central banks and regulators. By doing so, we could put in place a mechanism to ensure the effective supervision of conglomerates, particularly in the case of cross border institutions that are today described as those that are “too big to fail”.

Sixth, we need to create large pools of global or regional funds that could be conveniently accessed by regulators in times of impending crisis for purposes of bail-out, so that crises are not allowed to spin out of control. In this regard, it may perhaps be easier for central banks in a particular region or a regional economic zone to provide leadership for the creation of such funds for the mutual benefit of the participating countries.

Seventh, we have to develop mechanisms that ensure that there is greater transparency in rating methodologies and rating decisions. Credit rating agencies should be compelled to elaborate on their rating methodology and ensure strict compliance with Standards of Conduct which should be carefully reviewed in the light of the present gaps. We should also consider introducing serious penalties for inappropriate rating practices.

There may, of course be some overlap of policy actions when we implement these strategies; but, by and large, if these are focused upon diligently, there is a reasonable likelihood that it would be possible to realize some of our key wishes and with it, ensure the stability and integrity of our financial systems.

Mr. Chairman, in a strange and a paradoxical sort of a way, it is somewhat “fortunate” that the current financial crisis shocked (and indeed, almost ruined) the world’s financial system, at the present stage of evolution of the worldwide financial landscape. If, on the other hand, this crisis had not impacted us at this time of history and consequently we had happily progressed at the same pace for a further 10 years or so, and then in 2017 or 2018 this shock had hit us, can anyone imagine the magnitude of the disaster at that time? In fact, I am quite sure that, if that eventuality had taken place, this crisis would have been too much for the world’s financial system to bear, and the resulting catastrophe would have crippled the world’s financial systems, as well as the world’s political, security and social systems with disastrous consequences. Perhaps some keen film maker might even consider doing a simulation of such a scenario, and then making a gripping and horror filled movie, allowing those of us with horror appetites to experience such a dreadful tragedy!

Mr. Chairman, while we are putting into effect various initiatives to improve our processes and procedures to respond to the crises, we must also be conscious that we should not throw the baby out with the soiled bath water. Yes, the bath water has been terribly muddied and needs to be replenished. However, at the same time we must realize that the baby although rather dirty, is still quite wonderful. The world’s current financial system with all its imperfections, can still deliver enormous value. Already, the bold and far reaching steps introduced by many governments and regulatory authorities as well as by the “victims” of instability, have shown us that the “baby” could recover and grow. In fact, many economies are showing signs of recovery and are seeing light at the end of their respective tunnels. In the light of these developments, we must maintain our energy levels and optimism. Even in

the midst of the crisis, we have observed many systems that are solid, and frameworks and institutions that are strong, reliable and credible. These institutions must be recognized and encouraged to provide the leadership and direction to bring stability and credibility back, quickly. It is also time for the productive sectors of economies to re-invigorate themselves and deliver higher outputs, so as to support a faster turn-around.

Mr. Chairman, it is also now abundantly clear that the world must collectively approach the present unprecedented threat. Already, the integrated actions of several governments and central banks, by virtue of the successes achieved so far, have proved this point. But there is a lot more to be done. In that endeavour, the consolidation of the thoughts and ideas of academics, activists, practitioners, regulators, and policy makers at fora such as the one you have so efficiently organized, would undoubtedly enrich this process and policy debate. These in turn, will surely accelerate the global recovery.

Mr. Chairman, in good times, we normally take the stability and integrity of our systems for granted. Perhaps one of the key lessons from the current crisis is that we should never, ever, take stability and integrity as being “given” conditions, in the future. But, let’s remember that memories are short. This global crisis will almost certainly be forgotten in a few years time. It is also likely that if we enjoy a strong run of growth and prosperity for a few years, our minds too will probably dismiss thoughts of instability. Today’s grim discussions would then be relegated to the drab background, and in its place, the glitz and glamour of fast growth, handsome profits, stunning incentives, and fabulous wealth would reign supreme. Unfortunately, Mr. Chairman, if and when that happens, the world would unconsciously drift into the danger zone yet again. Needless to say, if we do not want such an eventuality to take place, the price would be intense vigilance on the part of the regulators, governments, media and the academia. I know that is going to be tough, but in the interest of all stakeholders, I sincerely hope it works and that the academia, governments, media and regulators would face up to that challenge.

May I therefore, at the concluding session of this important Symposium at the historic University of Cambridge make an appeal to the global financial community to continue to keep the events of 2007/2009 fresh in mind, continue to protect and improve our systems, and continue to build sustainable frameworks to deliver prosperity to the people of the world. Thank you.