Choongsoo Kim: The challenges of surveillance and coordination

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the International Symposium of the Banque de France: Regulation in the Face of Global Imbalances, Paris, 4 March 2011.

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I. Introduction

I would like to express my gratitude to Governor Noyer for inviting me to this symposium. I also want to thank all the other Banque de France officials for preparing today's symposium.

As you will recall, last month G20 Finance Ministers and Central Bank Governors agreed on indicative guidelines to address global imbalances.

The final indicative guideline should be approved at the coming April G20 meeting, and I am sure that France as the G20 Chair will successfully demonstrate its leadership in producing concerted and coordinated deliverables.

II. Global imbalances, surveillance and policy coordination

As President Sarkozy mentioned at the press conference in January, there have been 125 banking crises during the past 40 years, and their occurrence has picked up extraordinary speed over the last 20 years. This clearly underlines how global imbalances are now building up ever faster.

A financial crisis is no longer a ***"tail risk"*** with a low probability of occurrence. It should rather be regarded as a ***"normal risk"*** that can materialize at any time and at any place in new and diverse forms.

A capacity to pick up promptly on the build-up of fresh imbalances calls for preemptive and proactive surveillance by central banks and supervisory authorities.

What is more, closer attention must be paid to the mounting importance of crossborder and cross-institutional policy coordination in the process of resolving such imbalances.

On October 8th 2008, the US, Canada, the UK, the ECB, Sweden, and Switzerland together decisively lowered their policy rates in a concerted move. The six of them demonstrated their resolve to overcome the crisis through such international coordination, and this effectively tamed the raging turbulence of market sentiment and helped restore stability.

This experience teaches us the valuable lesson that international coordination can lessen market uncertainty in times of global crisis.

International coordination, therefore, is undoubtedly the key to resolving the global imbalances. Arguably it was the framework of international policy coordination through the G20 Summit that made it possible to overcome the global financial crisis earlier than anticipated and allowed the swift introduction of Basel III.

On the other hand, there are a number of obstacles that stand in the way of the seamless conduct of surveillance and policy coordination. I would now like to run through the challenges that particularly strike me.

III. Challenges of surveillance and coordination

Let me first point out the four factors that complicate the exercise of surveillance.

1. Blurred designation of accountability due to the complexity of financial instruments

First of all, the recent financial crisis is set apart from previous crises in the sense that it is difficult to put your finger on the exact locus of responsibility for those specific elements that gave rise to it. This very fact itself represents a substantial hurdle for surveillance. For example, more than one thousand people were held criminally liable when many US savings and loans associations folded in the 1980's. On the other hand, with the possible exception of a handful of cases such as that of Bernie Madoff, no criminal prosecutions were undertaken against the staff and management of financial institutions during the recent crisis.

Today, it is much more difficult to pinpoint those players who actually give rise to risk because the ***"originate and distribute"*** model passes on and spreads out heavy risks into a myriad of lesser risks. "***CDOs*** (Collateralized Debt Obligations)", frequently cited of the major causes of the sub-prime crisis, are a case in point.

When CDOs go through "originate and distribute" process numerous times, the riskcreating entity cannot be clearly identified. For this reason, regulatory authorities were unable to fully comprehend the trade mechanism and the relevant data of CDOs when Lehman went bankrupt in September 2008.

The purpose of surveillance is "to detect problems ahead of time and correct faulty elements". Nonetheless, if the structures and transactional processes of financial instruments are too complex as with CDOs, in which it is too difficult to identify the problematic entity, surveillance becomes a path fraught with difficulties.

2. Financial innovation incentives

Secondly, the incentives for innovation by financial market players themselves turn into barriers to effective surveillance.

The market reacts spontaneously and swiftly to new regulations by innovating techniques and products to circumvent them. Innovation on the part of market participants can be expressed in other words as "the build-up of a new risk or imbalance that is not immediately apparent to the relevant authorities."

During the period of transition to Basel III, banks will attempt to minimize the burden imposed by the new regulations. This change in the regulatory environment will create new side-effects with the potential for triggering the eruption of new and unanticipated imbalances or risk build-ups. I see this very point as throwing up the greatest challenge for surveillance in the coming years.

For instance, Global-SIFIs that are subject to systemic capital surcharge requirements will attempt to pass on the additional cost to their counterparties. These counterparties will, in turn, react to such attempts. If unexpected side-effects or imbalances crop up during this process, the need for additional regulatory measures will have to be discussed. In this case, G-SIFI regulation may not fulfill its original objective of reducing systemic risk, but merely give rise to the implementation of additional regulatory requirements. We may fall into a vicious circle in which the imposition of one regulation itself gives birth to another and so *ad infinitum.*

3. Missed risk factors

Thirdly, the difficulty of identifying newly emerging imbalances in a timely manner is another stumbling block on the road to effective surveillance.

The complex network interlinking financial institutions is effective in diversifying the risks during a business expansion phase. In a critical financial situation, however, the same network functions as channel of risk contagion.

The aggregate risk of the financial system as a whole during a crisis is amplified and taken to a much higher dimension than the simple arithmetic sum of firm-specific risks.

A lesson to be drawn from the global financial crisis is that regulatory authorities placed too much emphasis on microprudential surveillance, and as a result, they ignored or indeed turned a blind eye to the adverse effects of the accumulation of aggregate risk.

It was only after the recent crisis that the authorities came to realize that network systemic risks expand as interconnectedness among banks intensifies.

The addition in Basel III of macroprudential overlays – such as countercyclical capital buffers, forward-looking provisioning, and systemic surcharges for SIFIs – is based on the repentance of the previous microprudential surveillance framework.

It is downheartening to say it but we must admit the very strong possibility that we may still not pick up on newly emerging risks in a timely fashion. Regulators should bear this firmly in mind and be appropriately humble in their approach, never underestimating what they are up against.

4. Distorted incentive structure

Fourthly, I would like to point out two cases where incentive distortion challenges surveillance.

If an attitude of forbearance prevails, it may well distort the outcome of surveillance.

When low interest rates remain in place for a long time, the market tends to blindly expect that those bad loan assets that should be written off will revert to normal status. In turn, forbearance toward the redemption of these loans comes to prevail, in what is known as a game of ***"extend and pretend"***.

If this ***"evergreening practice"*** in the accounting treatment of delinquent loans as normal loans becomes common, there can be little confidence in the outcome of surveillance.

Moreover, the symbiotic relationship between credit rating agencies and financial institutions, and conflict of interest problems within the agencies themselves represent another factor that threatens the credibility of surveillance outcomes.

According to a report in the New York Times (June 3, 2010), certain credit rating agencies stand accused of distorting the rating outcomes in collusion with the issuer institutions being graded.

This distortion of ratings can largely be seen as essentially a structural problem. In the current structure of the ***"issuer-pays model"***, the issuers themselves pay the rating fees and rating agencies are able to provide consulting services to these issuers. In order to hide their assessment errors, credit rating agencies tend to persist in assigning high credit ratings even when an issuer faces a high probability of insolvency. Of course, surveillance outcomes using such less than adequate ratings undoubtedly hamper appropriate policy decision-making. Recently, FSB has finalized proposals for reducing reliance on CRA ratings. I look forward to this plan being put in place in the near future.

The obstacles to policy coordination can be classified into global and domestic dimensions.

1. Global dimension

As the interconnectedness of global economies has intensified, the need for international policy coordination has grown to a great extent.

If a national jurisdiction imposes capital controls in the absence of policy coordination with its neighboring jurisdictions, the risks may spill over to other neighboring countries as opportunities for regulatory arbitrage open up.

We ought to take a closer look at the recent experience of those emerging market economies that, after the onset of the financial crisis in September 2008, put in place a ***"blanket deposit guarantee"*** and consequently transferred the risks to their peers and neighboring countries.

In addition, emerging economies' excessive accumulation of foreign reserve to counter sudden surges in capital outflows will itself accentuate global imbalances. International policy coordination to resolve this problem is embodied in the global financial safety nets (GFSNs), which took on detailed form at the Seoul G 20 Summit. In this context, notable advances were achieved last year in the improvement of the IMF Loan Facility. There remain, however, some aspects of it in need of further refinement. Therefore the French initiative set out this year in this area is greatly welcomed and I look forward to its successful realization.

No jurisdiction is opposed to the idea of international coordination in principle, but when the interests of individual countries are in conflict, when the benefits from coordination are not obvious, or when there is no urgent call for it, then it is very hard to bring about international policy coordination in practice. That at any rate was Korea's experience as the G 20 chair last year.

It seems there is already a firm consensus among the G 20 member countries as to the overarching imperative of policy coordination through the G20 framework for the synchronous growth of the world economy. This being the case, it binds us all to put into practice in all good faith what we may term the mutual trust built up through negotiation and agreement.

2. Domestic dimension

From a domestic perspective, the coordination problem lies in the institutional arrangements in relation to macroprudential policy. If the institutional setting for macroprudential policy is not configured properly, its coordination with monetary, fiscal, and other policies may well become problematic.

As macroprudential policies are thrust into the spotlight, it is possible, misguidedly, to take the view that it is feasible to deal with inflation by means of macroprudential tools. Accordingly, monetary policy is increasingly likely to be adversely affected by the overzealous use of macroprudential tools. Hence, it is critical that there should be a clear understanding that ***macroprudential policy*** does ***"not substitute"*** for monetary policy but rather ***"complements"*** it.

IV. The way forward

Lastly, I wish to draw attention to the following two issues that may shed some light on the trail that lies ahead.

First, potential imbalances in the future may arise from entirely new sources. As the boundaries between differing spheres are being dissolved in the process of globalization and increasing interconnectedness, social political and geopolitical risks once remote may well spill over more easily to the real economy and result in increased economic risk.

One example springs readily to mind. The current events unfolding before us in the Middle East are upping the geopolitical risks and triggering such economic threats as an oil price shock and financial market turbulence.

I would like to call this ***"global systemic risk"*** as opposed to ***"financial systemic risk."***

Piling Pelion on Ossa, in addition to international financial instability, ***international social instability*** represents an issue that must be dealt at an early date in order to avoid a new type of crisis. With this problem of social instability very much in mind, particular emphasis was given to the "development issue" in the talks at last November's G20 meetings in Seoul.

It follows on from this that discussions are required within the G 20 framework on surveillance and policy coordination with particular reference to “global systemic risk”.

Next, the institutions with a mandate for global surveillance (such as the FSB and the IMF) can be readily identified. On the other hand, it is difficult to clearly delineate exactly those that are responsible for arbitrating conflicts between differing parties within the global policy coordination framework. To my mind, this underscores yet again the imperative for a further strengthening of the G20’s role in international policy coordination.

Thank you for listening so attentively.