Current efforts to enhance global financial supervision[1]

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I would like to start by thanking Janet Yellen for her kind invitation to participate in this important and timely conference. It is always a pleasure to return to the Federal Reserve Bank of San Francisco and especially to the Bay Area, where I spent some of my formative years.

The 2007–09 crisis and its aftershocks have led to a profound rethinking of assumptions about the interaction between the real economy and the financial system. Regulatory and supervisory frameworks are especially overdue for re-evaluation, as are the monetary and fiscal policies frameworks that complement regulation to help deliver high, stable growth and low, stable inflation.

One place where we have been forced to re-examine long-held assumptions is the balance between the benefits and costs of global financial integration. I use the term *global financial integration* broadly to refer to a process where, as time passes, national boundaries impose fewer and fewer barriers on the activities of lenders, borrowers, investors and intermediaries.

If we survey the events of the past three years, it is only natural to ask whether the benefits of an integrated global financial system are worth the risks and costs. Unsurprisingly, there is particular concern about costs that stem from the spread of financial and economic instability. National borders can act as firebreaks against contagion, keeping out problems that originate in other jurisdictions.

The crisis also brought out a glaring mismatch between the global activities of large banks and the constraints of national sovereignty. In the absence of a global financial regulator, central bank or fiscal authority, it proved difficult in the recent crisis to ensure the safety and soundness of globally active financial institutions *ex ante*, and almost impossible to address their liquidity and solvency problems *ex post* without causing further systemic disruptions.

These are genuine, serious concerns. But I will argue that we can ensure that the benefits of global financial integration outweigh the costs. Keeping local problems from turning global requires both strengthening and harmonising financial supervision across borders.

Before I address the significant progress that has been made in applying the lessons of the crisis to regulatory reform, I want to touch on a fear that has been voiced about the proposed

[1] The views expressed here are those of the author and do not necessarily reflect those of the BIS. I would like to thank Ben Cohen, Bill Coen, and Haibin Zhu for their contributions.

changes: namely, that if banks are forced to hold stronger capital and liquidity buffers, lending will be choked off, damaging the fragile global recovery. This is a concern that is taken very seriously by policymakers. Earlier this year, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) asked me to chair an effort to assess the impact of stronger requirements. In response, and in close collaboration with the IMF, I formed a group of expert macroeconomic modellers drawn from 14 national authorities, as well as the ECB, the European Union and the BIS.

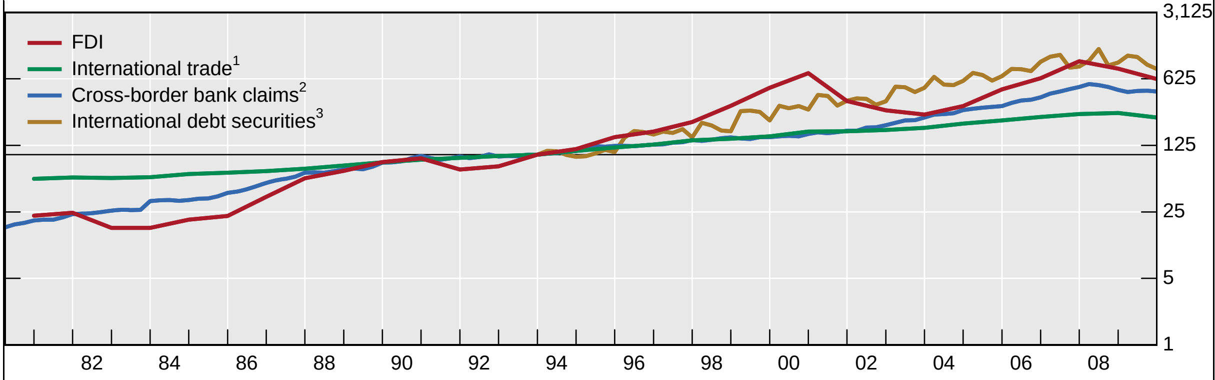
Using a variety of models, we are looking at how different scenarios for stronger capital and liquidity rules will affect baseline forecasts for credit, investment and growth. Our preliminary findings are reassuring. Assuming that banks have enough time to implement the changes, the impact on GDP is likely to be mild. Indeed, the impact is likely to fall far below the typical size of typical revisions to the GDP gap, much less any actual forecast errors. Furthermore, these modest costs will be offset by the significant gains that the new policy is likely to deliver: reduced volatility in GDP, less frequent crises, and lower risk premia across the board. Overall, this suggests that we are on the right track towards a system that better balances resilience against sustainable growth.

Returning to the subject of regulatory reforms, the strengthened framework, because it is harmonised across countries, will make it possible for global financial integration to proceed in a way that stabilises domestic financial systems. Financial integration is best understood as part of the general trend towards global economic integration. Whether or not international finance is *essential* to international trade and direct investment, the growth in all these activities over recent decades has been dramatic. As Graph 1 shows, trade, FDI and cross-border finance have increased at average rates of more than 10% per year for three decades. That means that, today, these measures of real and financial flows are roughly 25 times what they were when I received my PhD nearly 30 years ago across the Bay at the university where President Yellen was, for many years, a distinguished faculty member!

Graph 1

Long-term growth in international trade, investment and financial flows

Logarithmic scale for vertical axis; end-1993 = 100



[1] Global trade volume of goods and services. [2] Outstanding amounts, by residence. 3 Gross issuance (announcements), by residence.

Sources: IMF IFS; IMF WEO; BIS international banking statistics; BIS international debt securities.

Looking at the relative slopes of the lines in the graph, we see that cross-border financial activity has tended to grow at the same long-run pace as foreign direct investment but faster than international trade. The rise of large global banks suggests that bank managers and customers perceive tangible benefits from having certain transactions take place within a single organisation, rather than among separate banks. And many national authorities have moved to reduce barriers to cross-border flows and the entry of foreign banks in recent years, anticipating potential benefits such as new sources of capital, funding, know-how and competition.

As I suggested at the outset, the recent crisis has brought the costs of international financial integration into greater relief. The US financial sector created a wide range of securities and sold them to banks and investors around the world. In some cases, the underwriting was bad and risks were improperly appraised. But even when this was not the case, currency mismatches were created on the balance sheets of non-US holders of the dollar-denominated assets. These assets were financed by a combination of wholesale borrowing, where a non-US bank would simply borrow dollars from a bank that had them, and foreign exchange swap arrangements, where the bank would swap its domestic currency liabilities into dollars. Importantly, both of these funding mechanisms – borrowing and swaps – are short term whereas the dollar assets held by the banks are long term.

How big is this problem? My colleagues at the BIS have used the international banking statistics to separate banks into those with more dollar assets than dollar liabilities, labelled *long dollar*", and those with fewer dollar assets than liabilities, labelled *short dollar*.[2] Graph 2 shows these two groups not only for dollars, but for other currencies as well. I would like to focus your attention on the red line at the top of the graph's left-hand panel. What this line means is that the banks – these are Canadian, Dutch, German, Swiss, UK and Japanese banks – require an estimated aggregate of $1.2 trillion (net) in US dollars. During the crisis, because of disruptions to these markets, these obligations ultimately could only be met through international FX swap arrangements among central banks. And, critically, over the last three years this number has not fallen! If you were wondering why the swap arrangements had to be reinstated on 9 May, now you know.

Graph 2

Long-dollar and short-dollar banks' net FX swap positions, by currency

In trillions of US dollars

USD-long banks[1] | USD-short banks[2]

[1] Includes Canadian, Dutch, German, Japanese, Swiss and UK banks. [2] Includes Australian, Belgian, Danish, Spanish, Finnish, French, Italian, Luxembourgian, Norwegian, Portuguese, Swedish, Hong Kong SAR, Greek, Turkish and Taiwanese banks. [3] Positions booked by offices located in Switzerland (for CHF) and in the United Kingdom (for GBP). CHF and GBP positions reported by offices located elsewhere are included in "Other".

Sources: BIS consolidated statistics, immediate borrower (IB) and ultimate risk (UR) basis; BIS locational statistics by nationality.

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2 See McGuire, P and G von Peter (2009), "The US dollar shortage in global banking and the international policy response", BIS Working Papers, no 291, October.

History has shown that rapid financial liberalisation without effective supervision can be hazardous. The same is true of rapid integration without an effective international supervisory and regulatory framework. Had regulatory standards been higher, I feel certain that the crises would have been less severe; and that financial integration would not now be tarred by association with distorted incentives of market participants, flawed business models, and unpredictable patterns of contagion.

In theory, there are several paths the international response could follow. One extreme would be to establish a global supranational authority to regulate cross-border activities. Given the challenges to national sovereignty, I find it hard to imagine a supranational supervisor emerging anytime soon. At the other extreme is a ring-fencing model that requires the host country authority to regulate cross-border banks. This would be a major setback, forcing us to give up the benefits of financial integration.

Probably, the best we can do is follow a middle path in which national authorities formulate and agree on a harmonised international regulatory framework, with the appropriate flexibility to allow local situations to be addressed. Indeed, this has been the dominant approach to regulation at the international level over the past twenty years. Consistent with this, financial authorities from the major economies have been hard at work in the wake of the crisis to develop a framework focused on harmonised supervisory standards for internationally active banks, as well as stronger capital and liquidity buffers, the elimination of gaps and overlaps in the existing framework, increased transparency and improved market discipline. The new framework will promote harmonised enforcement activities and strengthen supervisory cooperation and coordination, including supervisory colleges. Moreover, it will involve the establishment of legal and policy frameworks for cross-border crisis resolution.

By harmonising the international regulatory framework, we aim not only to create a level playing field for global banks but to safeguard financial stability while maintaining the benefits of financial integration. I should emphasise that this work does not prejudge different banking business models any more than is necessary to safeguard financial stability. That said, regulatory reform may ultimately involve some reconsideration of banks' global business models.

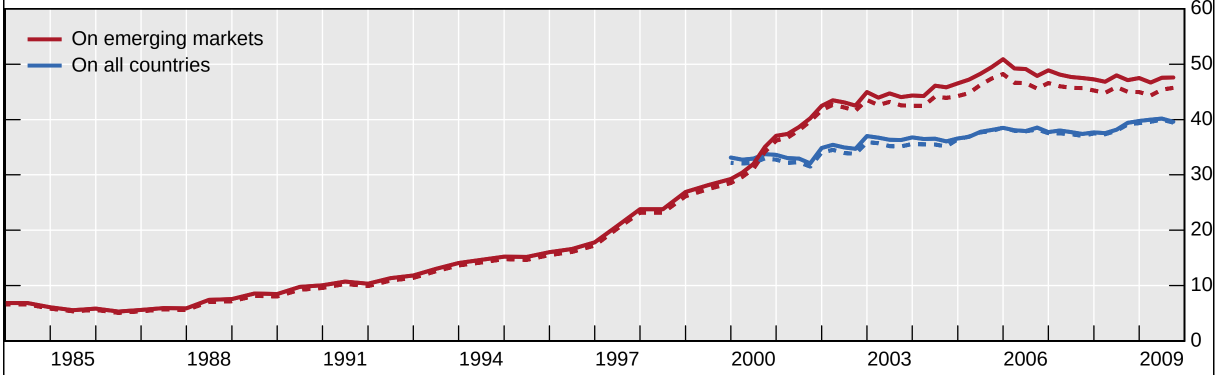
Most global banking tends to follow one of two broad business models.[3] The first might be termed a *multinational* bank. It operates sizeable foreign branches and subsidiaries in multiple jurisdictions and, in its extreme form, funds those positions locally in the host countries. The other is an *international* bank. This is an institution that operates across borders out of the home country base. While the pattern varies substantially across countries and regions, there has been a shift towards the multinational, locally funded model over the past two decades. This is particularly true for banking activities in emerging markets. To see this, look at Graph 3, which shows how local currency claims rose from 6% of foreign banks' claims in emerging economies in the mid-1980s, to 47% currently.

3 See McCauley, R, P McGuire and G von Peter (2010): "The architecture of global banking: from international to multinational?", *BIS Quarterly Review*, March, p 25–37.

Graph 3

Local currency claims as a share of foreign claims

In per cent



BIS reporting banks' local claims in local currencies over total foreign claims, by type of borrower country. The dashed lines show the estimates holding the population of reporting banking systems constant through time.

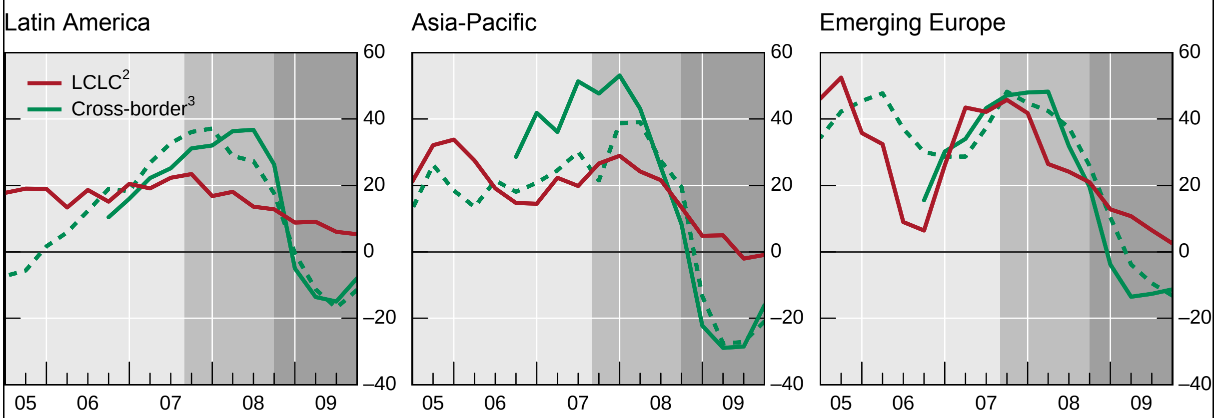
Sources: BIS consolidated banking statistics (UR and IB basis).

The financial crisis is likely to strengthen the trend towards local funding. In this natural stress test of banks' international funding models, local claims showed greater resilience than cross-border claims. We can see this from Graph 4, which shows that cross-border lending to emerging markets had been growing at a 40% annual rate immediately ahead of the crisis, before falling by about 20% between mid-2008 and mid-2009. By contrast, banks' local positions, particularly local currency positions, grew less rapidly ahead of the crisis but also slowed much less as it unfolded.

Graph 4

Foreign claims on emerging markets[1]

Year-on-year growth, in per cent



Latin America = Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela; Asia-Pacific = China, Chinese Taipei, India, Indonesia, Korea, Malaysia, the Philippines and Thailand; emerging Europe = Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia and Turkey.

[1] Based on exchange rate-adjusted data, corrected for the change in reporting by US banks in Q1 2009. The shaded areas start from end-Q2 2007 and end-Q3 2008. [2] Local claims in local currency. [3] Cross-border positions. The solid green line shows growth in cross-border positions (UR basis) excluding inter-office positions, while the dashed green line shows the growth in cross-border positions (including inter-office) reported in the locational banking statistics.

Sources: BIS consolidated banking statistics (UR and IB basis); BIS locational banking statistics by residency.

Of course, it is worth emphasising that the adjustment in banking business models, which has been under way for several decades, appears to be largely driven by market pressures. But banking regulation can foster the stability-enhancing aspects of these developments. For instance, the new global liquidity framework proposed by the Basel Committee will oblige banks to more closely match their funding sources and uses. This should reinforce the trend towards financing a greater share of local assets in local currency.

As noted above, I believe that a tougher and more robust regulatory structure would have reduced the length and severity of both current and past financial crises. It is with this in mind that the Basel Committee and others are doing their work. So, let me now say a few words about the proposed regulatory reforms, starting with the work of the Basel Committee.

The Committee's reforms comprise both traditional, bank-specific and broader, system-wide measures. Inoculating us against future financial instability requires that we combine vigorous supervision and robust standards. Improved capital and liquidity standards are the key parts of these core financial reforms.

The Committee, together with its governing body of central bank governors and heads of supervision, agrees on the need to raise the level, consistency, quality and transparency of the capital base, as well better risk capture. There is also agreement we need a simple leverage ratio as a supplementary backstop to the risk-based capital framework, and capital conservation measures that lead to buffers that can be drawn down in periods of stress.

Beyond the need for more and better capital to absorb unexpected losses, the crisis highlighted the risk of poor liquidity management. Certain shortcomings in the regulatory framework for liquidity have been already addressed by the Basel Committee. I mentioned earlier one of the Committee's proposals to require that banks manage their maturity mismatches in a prudent manner. Another feature is the introduction of liquidity buffers: for instance, banks must hold a sufficient stock of high-quality liquid assets to allow them to survive a whole month's loss of access to funding markets.

Thus far I have talked about how we can improve systemic stability by strengthening the solvency and liquidity of financial institutions. But, along with institutions, we also need reforms addressed at two other "i's": instruments and infrastructure.

Balancing safety and innovation in financial instruments requires that space is left for innovation while limits are set on the capacity of any individual security to weaken the whole system. The solution is some form of product registration that would constrain the use of instruments according to their degree of safety. In a scheme akin to drug regulation, the safest securities would be available to everyone, much like non-prescription medicines; next would be financial instruments available only to those with a licence, like prescription drugs; then would come securities available only in limited amounts to qualified professionals and institutions, like drugs in experimental trials; and at the lowest level would be securities deemed illegal. An instrument could move to a higher category of safety only after successful tests – analogous to clinical trials. Testing would combine real-world issuance in limited quantities with simulations of how the new instrument would behave under stress.

Such a certification system creates transparency. As in the case of pharmaceutical manufacturers, there must be a mechanism for holding securities issuers accountable for the quality of what they sell. This will mean that issuers will bear increased responsibility for assessing the risk of their products.

Information asymmetries are the fuel that feeds financial panics. In the recent crisis, we saw contagion ignited by uncertainty over counterparty exposures – not knowing who will bear losses should they occur. Transparency and information are the keys to any solution, and one way to promote improved transparency is through the third "i", that of infrastructure. A core market reform is the move to establish central counterparties (CCPs), so that more derivatives trading takes place on registered exchanges. A well designed CCP improves the management of counterparty risk because the CCP is the counterparty for both sides of a transaction. It simplifies multilateral netting of exposures and payments. And it increases transparency by making information on market activity and exposures available to regulators and the public.

Legislators and regulators are making progress in this direction. In May 2010, the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) jointly released two companion reports that provide guidelines for the establishment of CCPs[4] and trade repositories in the OTC derivatives markets.[5] Together with other initiatives as mentioned above, such CCPs will help to improve the resilience of the financial system in the face of large shocks.

One important area not yet fully addressed by the international policy agenda is the application of regulatory standards to institutions and markets outside the traditional banking sector. If we are not careful, stringent requirements on banks could end up driving financial activity into the shadow banking system. Maturity mismatches and risk management failures at special purpose vehicles and money market funds played an important role in the unfolding of the crisis. Steps are being taken at the national level, for example, with the SEC's recent actions to tighten rules for money market mutual funds. But this is one area where international action is lagging and should be addressed soon.

The measures that I've discussed certainly won't eliminate all financial instability or the risk of crises. Yet they can help to reduce the risk that problems in one part of the financial system – in a specific market, or category of institutions, or geographic region – will spread to the rest of the system through a generalised pullback from risk-taking. This is because such measures will increase the confidence of market participants in the underlying resilience of markets and institutions. In turn, lower contagion risks reduce the need to place artificial barriers in the way of global financial and economic integration. The cost of the transition to these arrangements, if we allow enough time for implementation, is likely to be modest. And the benefits will include greater stability for the financial system and global economy, which may even be conducive to higher long-run growth.

Thank you for your attention.

4 See the CPSS and Technical Committee of IOSCO, Consultative report: Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs, http://www.bis.org/publ/cpss89.htm, May 2010.

5 See the CPSS and Technical Committee of IOSCO, Consultative report: Considerations for trade repositories in OTC derivatives markets, http://www.bis.org/publ/cpss90.htm, May 2010. A trade repository is a centralised registry that maintains an electronic database of the records of open OTC derivatives transactions.