Draft

What Went Right?

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What Went Right?

> For someone responsible for public policy, for a regulator, the obvious question is what failed for all of this to have occurred. But, given the magnitude of what has taken place, perhaps it would be better to ask what has not failed…
>
> José M. Roldán
> *Director General of Regulation*
> *The Bank of Spain*

> Peripheral care should be the central concern.
>
> George Soros
> *Financial Times*, March 22, 2009

There is no longer any doubt that the current financial crisis is global. Few countries have been spared, either from the initial financial disruptions or from the subsequent downward pressures on macroeconomic activity. While most economic actors remain focused on measures to survive the crisis, a few others—including participants in this meeting--are devoting time and energy to developing recommendations for reforms of financial regulation and supervision. One approach to designing and evaluating recommendations for reform has been to analyze errors made evident by the current set of events. Early reviews reveal failures on many levels and in varied domains: faulty national macroeconomic polices and related global imbalances, an architecture of finance and regulation that allowed regulatory gaps, inappropriate regulation or faulty supervision of good regulation. In the private sector, failures of corporate governance and oversight of risk management, opaque instruments, and outright fraud worked together to undermine the viability of individual institutions and of the U.S. investment banking model in general.

But the relatively better performance of financial institutions in a few countries leads us to suspect that there were places where things went right…where regulation held more closely to solid principles and supervision was implemented more effectively. Although contagion, spillover, and strong global financial and economic linkages make this a global crisis, individual countries are facing different costs (and prospects) for recovery. In a study completed in March 2009, the International Monetary Fund estimated the cost of financial support measures in various countries. These costs include direct support to financial institutions, the expected cost of guarantees, and costs to the central bank for providing liquidity. Although such estimates are clouded by uncertainty, it is striking that the estimate of costs for the United States (12.7 percent of GDP), Ireland (13.9 percent) and the United Kingdom (9.1 percent) are all quite high, while other countries face the prospect of more modest outlays.

This brief study looks at two developed economies where the direct and indirect central bank costs for supporting financial system recovery are contained at levels significantly less than their neighbors. Based on this measure, these central banks appear to have performed more effectively than their peers. In the case of Canada, the IMF estimates that the total cost of financial sector support will accumulate to 4.4 percent of GDP, while the costs in Spain are likely to be even less (3.7 percent).

What went right in these two countries? Were the central banks able to prevent some of the egregious errors of omission that proved so costly in other countries? One hopes that there may be ways of assuring that developing countries receive some protection from external shocks and that their banking supervisors can gain insights that will allow them to develop more resilient financial systems that help preserve an open growth path for the poorer economies. While the advice that George Soros gave in the *Financial Times* to tend to the periphery focuses on the role of international organizations, in particular by bolstering demand through infusions of credit from the International Monetary Fund (IMF), the international and national regulatory bodies also have an important role to play in strengthening financial structures.

The work of the United Nations Committee on Development Policy has focused on both these dimensions—on the role of the international community in assisting the poorest countries and on ways that countries can structure their economies to overcome poverty. Benefiting from the insights of Patrick Guillaumont, a Committee member, the group developed a methodology for identifying which poorer countries should be assigned to the category of Least Developed Countries. The LDC's face structural impediments to growth and demonstrate "economic vulnerability" as measured by a set of characteristics used to compute an index of economic vulnerability. This Index includes economic measures associated with wide cyclical variations in income flow; a characteristic that Guillaumont has shown to be associated with lower long-term growth (Guillaumont 1999). If one accepts that this instability in income and revenue places countries on a lower growth path, then economic and financial reforms at the national and global level should be designed to dampen income swings and mitigate the impact of shocks.

In recent months, there has been a growing recognition that financial systems may be inherently procyclical. The issue of procyclicality in financial systems and financial supervision and regulation has received attention from both the Bank for International Settlements (BIS) and the Financial Stability Forum (FSF)—recently transformed into the

Financial Stability Board. Procycality on a micro level can be increased by risk management techniques or regulations that exaggerate swings in market prices. On a macroeconomic level, positive feedback mechanisms serve to amplify shocks and exaggerate swings in the business cycle. Perhaps the most obvious (yet least restrained) example of procyclical financial practices is the accelerating credit expansion (often with observed decline in credit underwriting standards) that occurs in the midst of an expansion.

A supervisory approach that dampens shocks and encourages financial resilience, through the use of buffers, margin requirements or other instruments, may make the financial system neutral or somewhat countercyclical related to the swings in the real economy. At least one central bank—the Bank of Spain—has for years viewed countercycality as one of the primary principles of financial supervision. The other guiding principle of the Bank of Spain—consolidation—also deserves special attention when considering desirable characteristics of regulation and supervision.

While this brief examination will focus on these two principles, it is worth noting that in both the case of Spain and Canada, actions of the private financial sector enhanced the stability of the system. Both countries have been hard hit by “second wave” effects associated with declines in housing prices and dramatic job losses (Spain) and a sharp fall-off in demand from the major trading partner (Canada). Nevertheless, decisions made in the financial sector provided some resilience in the face of these shocks. Such practices, related to corporate governance and risk management, may have their roots in the corporate incentive structures as well as in the regulatory environment; further research in these areas may yield additional useful guidelines for reform. There are also calls for research on the integration of financial issues with macroeconomic analysis. From his perspective of José Roldán, director of supervision at the Bank of Spain, the failure to integrate macroprudential dimensions in macroeconomic models may contribute to policy errors in both economic policy and financial regulation (Roldán 2009).

Despite the need for further analysis of the interactions of regulation and supervision with the real economy, the macroprudential perspective itself holds certain advantages that underscore its value for any future reforms. Table 1, taken from the BIS

Table 1*
The macro- and microprudential perspectives compared

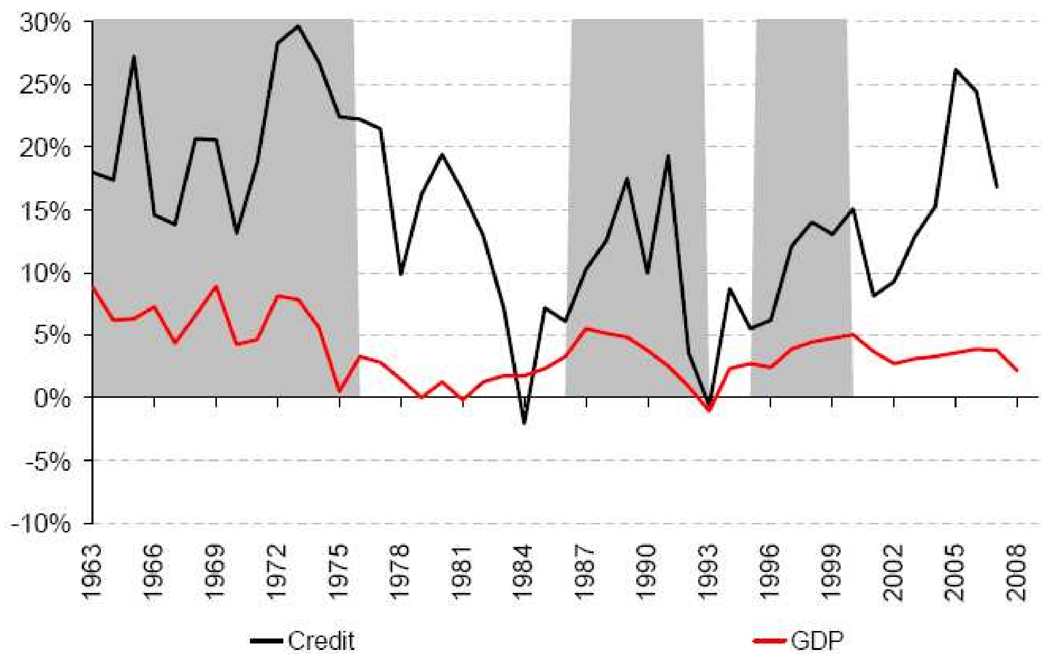
	Macroprudential	**Microprudential**
Proximate objective	limit financial system-wide distress	limit distress of individual institutions
Ultimate objective	avoid output (GDP) costs linked to financial instability	consumer (investor/depositor) protection
Characterisation of risk	Seen as dependent on collective behaviour ("endogenous")	Seen as independent of individual agents' behaviour ("exogenous")
Correlations and common exposures across institutions	important	irrelevant
Calibration of prudential controls	in terms of system-wide risk; top-down	in terms of risks of individual institutions; bottom-up

* As defined, the two perspectives are intentionally stylised. They are intended to highlight two orientations that inevitably *coexist* in current prudential frameworks.

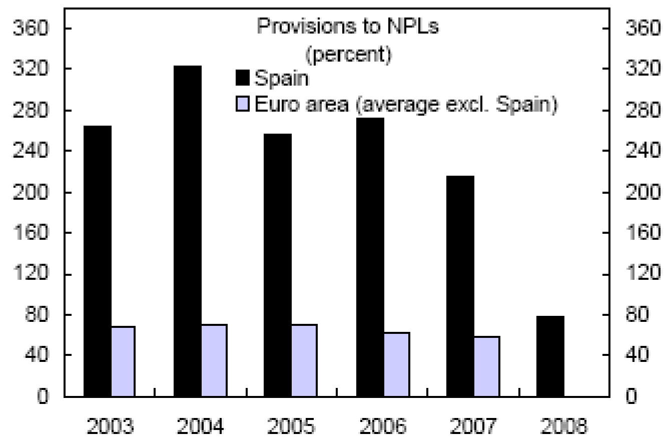
study on a framework for addressing financial system procyclicality (BIS, 2008) compares the macroprudential perspective with the microprudential perspective most commonly associated with financial regulation.

This macroprudential perspective informed the framework for supervision and regulation in Spain, with the Bank of Spain taking the lead in developing an approach to provisioning that is designed to mitigate credit procyclicality. As shown in Chart I, credit in Spain is not only procyclical--it amplifies the business cycle (from Fernandez de Lis and Garcia, 2009).

Chart 1: GDP growth and that of Credit over GDP



The Spanish developed regulatory requirements for loan-loss provisions that would have the net effect of building up a "buffer" of provisions during periods of credit expansion. This buffer would then be drawn down, in a controlled, prescribed fashion, during periods of increasing loan losses which were associated with business downturns. In addition to holding "specific" provisions against identified losses, Spanish banks also hold "general" provisions against potential losses. Bank loans are divided into categories, each of which is assigned a provisioning coefficient (scaled by expected losses that are based on historical experience). The Spanish use of dynamic provisioning as a tool of banking regulation has recently met with accolades from international organizations. The International Monetary Fund estimates that Spanish banks accumulated €24 billion in provision cushions that afforded coverage rations over 200 percent at the peak of the cycle, compared to the European Union average equivalent of just over 60 percent (IMF, 2009).



The recent positive assessment is in contrast to the initial reception for this regulatory instrument that went into effect in 2000. The current Governor of the Bank of Spain, Miguel Fernández Ordóñez, recalls that when Luis Angel Rojo, then Governor, introduced dynamic provisioning, "…it aroused understandable rejection by Spanish banks and was met with indifference on the part of the international community of banking regulators and supervisors." (Fernández Ordóñez 2008). Some critics viewed the Spanish dynamic provisioning as a kind of profit smoothing. The Bank of Spain, convinced of the value of this instrument, made certain accounting changes to conform with International Financial Reporting Standards, but to retain the countercyclical attributes of the framework. The conviction of the Spanish regulators was bolstered by empirical evidence that dynamic provision functioned in the countercyclical way for which in was designed, with an increase of one percentage point of GDP reducing the capital buffers by 17 percent, based on estimates taken across 1986 to 2000--an entire business cycle (Ayuso, Pérez, and Saurina 2002).

Despite the attention paid to dynamic provisioning, the principle and practice of consolidation appears to have played an important role in both Spain and Canada. While bank regulators throughout the world espouse consolidation as a principle of regulation, there appears to have been diversity in the application or translation of this principle in banking supervision. The Spanish regulators focus on consolidated supervision, assuring that that they have cast a comprehensive "perimeter" of supervision--from the perspective of including all banking-like activities on the bank balance sheet, but also from the perspective of including all bank-like institutions within the purview of the supervisor.

In a recent analysis of the impact of securitization on financial markets, Roldán addresses the question of whether structured investment vehicles should be consolidated onto the balance sheet. These questions, related to the ultimate holder of liquidity risk, the credit-like qualities of the instruments, and ultimate control of the vehicle, leads him to conclude that—taken together—these factors point to consolidation of these structured investment vehicles onto the balance sheet. One assumes that such consolidation would have substantial impact on corporate risk management, by imposing a broader perspective and the application of consistent valuation practices across the entire bank. Even more importantly, the application of an appropriate "perimeter" that involves bringing all credit and bank-like corporations under prudential regulation is another example of getting things right. In two recent papers, Roldán details the risk of "shadow banking systems" that include firms such as the mortgage brokers in the United States. Driven by the "originate to distribute" model and the associate fees, this firms practices underwriting standards that would not have survived the scrutiny of a bank examiner. And while Spanish banks are limited to loan/value ratios of 80 percent, some of the loans in the shadow banking system matched the assessed values of the homes.

Further research

This paper has pointed to the actions of certain central banks that served to mitigate the impact of the ongoing financial disturbances. Yet it has not been able to address questions that relate to the kind of central bank independence that both Spain and Canada are demonstrating. While most studies of central bank independence focus on independence from partisan political control, central banks must also avoid regulatory capture and remain independence of the banks and financial institutions that they regulated. What attributes of the governance structure of these two authorities have bolstered their independence? Does the governance structure of the Bank of Spain differ from that of its peers within the EuroSystem? Has the reporting structure and parliamentary committee structure of the Bank of Canada enhanced its authority in the last ten years? These and other questions should lead to fruitful explorations.

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