Shadow GN 2009
Sustainable Effective Regulatory Systems
Outline of commentary
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The presentation will examine the extent to which recent reports G20, Group of Thirty and similar reports have identified the critical regulatory weaknesses in the operation of the major financial institutions and more importantly whether steps have been taken to correct the problem and to prevent a repetition . The many rescue packages have helped to encourage the return of stability to the system, are intended to urge the opening of the credit markets, and slow the widening global recession which has been a consequence of the collapse of the financial systems in US and Europe, with consequential effects around the world. While this is critical, it is important and urgent to improve regulatory oversight and to ensure that the remedial measures are appropriate and implementable. Rescue packages will help the immediate problem but they are not preventative going forward.

Issues such as the large size of mega financial institutions and adequate capitalization in the financial industry remain matters which need to be addressed as a matter of urgency. While these matters have been flagged, actual corrective measures have not been put in place with a long term perspective, but have been mostly stop-gap measures. Perhaps, part of the problem of the slow response of the credit providers and suppliers of funds is that, bailouts notwithstanding, suppliers are aware that the corrective aspect of the matter has not moved far beyond problem identification.

Indeed, while there has been a fair degree of consensus on problem identification, the authorities have not approached the matter of remediation of the regulatory and oversight issues with the same immediacy as they have the bailouts. There seems to be the view that this can be done in a more leisurely fashion. However, market participants may not be of this view, hence the reluctance to open the credit markets.

Investment banks have been the most significant players in the international credit markets but the issue of lender of last resort facilities to the non banks and insurance companies in post crisis situation needs also to be addressed. It is not clear that crisis lender of last resort facilities are intended to become a statutory right. Will the involvement in the US of Government and of the Fed as providers of liquidity become a source of funds availability going forward? What lessons are there here for other central banks. And will the face of central banking change in the light of these expectations?. What are the conflict of interest implications of such involvement , and what are the implications for risk–taking.

At the global level, seriously affected developing countries and emerging markets who can least accommodate the global recession which has resulted from the failure of several major financial institutions, are looking at ways to pass on some of the business costs of these collapses and near collapses away from their countries and institutions, but find that there is no scope for so doing, as they remain price takers in the credit markets, in a situation worsened by unavailability of financing.

Perverse incentive systems in the industry have been identified as areas in need of review. There has been much debate about the size of compensation and incentive systems but not sufficient analysis of the manner in which this can be reconfigured to reduce risk assumption over the medium term by originating firms. In addition, the need to restrict the ability to securitize risks away on to the portfolio of others may require some time frame for holding of the asset prior to securitizing and distribution. Indeed, there is a view in some quarters that the originator should be required to retain some portion of the asset to maturity. How much damage this would do in discouraging innovation in the industry remains to be assessed. Overall, risk assessment techniques and the ability to transfer poor risks on to the books of other unsuspecting investors must be corrected, particularly given the role played by the credit rating agencies in failing to alert investors to these risks. Indeed, should finance specialists be compensated in ways which relate to sales? Or is there a moral hazard here.

The proposed Basel II regulations pertaining to self assessment via the Advanced Internal Ratings Based Approach, in light of the failure of banks in the US and Europe to properly self assess, must be seriously questioned. This will involve also a review of the important proposed role for rating agencies in the Standardized Approach of Basel II, given their failure to provide early warning signals with respect to lack of awareness of the imminence of the financial crisis.

The role and the prominence given to risk mitigation techniques and the fact that risk mitigation is only as reliable as the skills of the risk mitigator and the strength of the entity which assumes the insurance will need to be addressed. Interlinkages between insurance and banking in the presence of credit default insurance must be regulated or the danger of double jeopardy will be repeated where the two activities are too interlinked. In this regard, a relevant question is :should there be stricter guidelines for risk mitigators and should credit default insurance be more strictly supervised and should such paper should be bought by banks whether or not the credit insured is their own?

The issue of “too big to fail” has been a mantra frequently heard over the past several months in explanation of the need for bailouts. However, the US economy has anti-trust legislation. It may be useful to re-examine this with a view to developing special laws for the banking industry, in order to deal with mega banks to levels which minimize the risk of becoming too big to fail. This could reduce the profitability and scale economies of banks, so the benefits and costs of these approaches require analysis and careful study.

The question of cross-border supervision needs to be fine-tuned. To what extent do regulators share responsibility for cross-border supervision of financial entities in situations where bailout funds come from the national treasury of particular countries; and who has responsibilities for overseas branches? Splitting responsibilities for providing liquidity is one aspect of the problem, since liquidity is intended to be temporary and will be repaid, but bailouts tend to be permanent and one-way. This introduces the issue of the extent to which the manner in which subsidiary legislation is written should take precedence over the obligation for ensuring shared financial stability

not only in the country of headquarters but in the country where branches are located. It might appear that some international protocol may be required to clarify the rights and obligations of the parties.

The role of a single regulator and the separation of regulation of the banking system from central banking has always been appoint of difference among central banks. It would be useful to review the stability of the financial systems in various countries to evaluate which system has had fewer regulatory problems? Some case of separation did not work out very well. Is there likely to be a trend back to the status quo before separation?

A very important response of the G20 was the establishment of the Financial Stability Board, an institution with wider representation than the Financial Stability Fund. In this regard there is a question of the scope of the Board. There is an interesting issue which begins to emerge from the first correspondence coming from the Financial Stability Board which gives the impression that their mandate includes the cross- border activities of firms. It seems important to clarify whether theirs is a mandate which extends beyond banks to the wider corporate world. It is however true that globalized mega corporations can become weak links in an increasingly interconnected world, and that the same kinds of issues that arose in global banks could arise in global corporations in the real sector. This leads to the question of cross border flows and the authority to deal with these issues. It is not clear how the Financial Stability Board will move from problem identification to implementation of recommendations without greater authority.

The emphasis in the regulatory world has been on the systemically important countries. However, the example of the last six months has shown that though it was the most systemically important country which created the problem, it affected the entire world. This is vindication of the argument that developing countries should have a bigger voice in setting supervisory standards, because when they fail, developing countries are seriously affected even though they had no part in the construction. Gradual steps are being made to in recognition of these facts and more is expected.

The post crisis period has been seeing an increased level of disintermediation where brokers are bringing the larger borrowers and lenders together and where traditional arrangements are being avoided. It would seem that this has even greater risks than the institutional approach, since at least they were guidelines and provisos, whereas in private party contracts, the parties are just covered by the law of contract and other very generalized rules governing setting and fulfillment of obligations. This must be watched.

One concern coming out of the collapse of the financial system in US and Europe is that just as in the post Enron situation, there was an over-reaction in the form of the Sarbanes Oxley legislation, that very shortly there will be an over-reaction in the financial regulatory domain, and that this will have adverse implications for financial liberalization and financial innovation. It will be important that we learn from that experience and that the right balance be struck.