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Conference Paper

Strengthening financial institutions

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Security: Creating a Safer World

Strengthening Financial Institutions

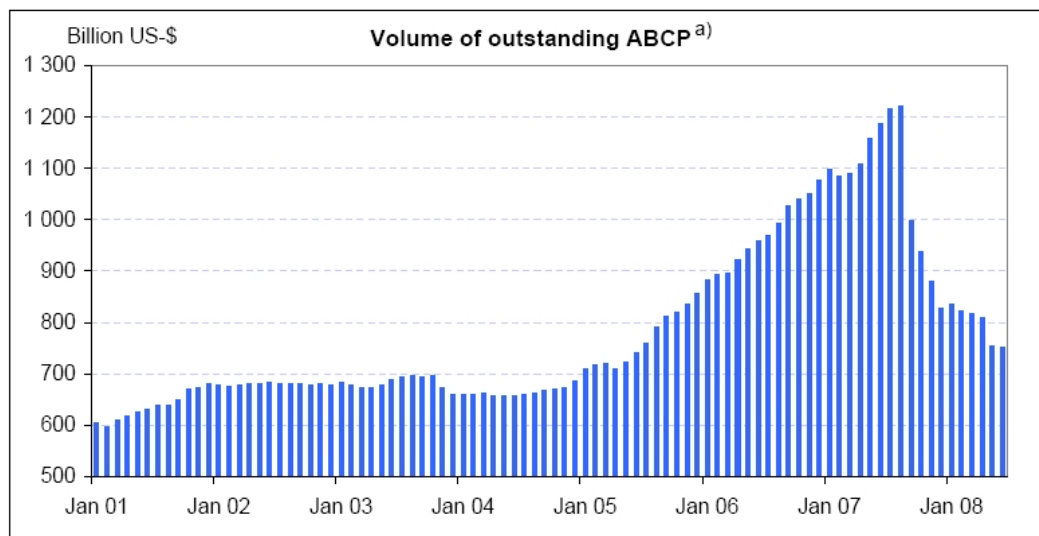
Summary

The repeated reoccurrence of financial crises since the early 1990s has led to calls for institutional reform. The most recent example is the crisis that began with the problems on the sub-prime segment of the US housing market. Numerous commentators have observed that the interactions between commercial banks, other financial intermediaries, credit rating agencies, financial regulators, national banks and governments were partly responsible for the financial unrest. There is a need for better management and regulation of diverse, interrelated risks.



How can existing financial institutions be reorganized or restructured to permit improved risk management and supervision, more effective techniques of hedging and distributing financial risks, and more effective disclosure of risk exposures and financial valuation methods to the public? What is the future role of banks and financial intermediaries in risk management?

Once all measures to prevent financial crises have failed, how should national authorities address stresses in troubled financial institutions and how should they deal with impaired assets in the presence of disruptive write-downs? And finally, is the current international monetary system optimal to guarantee financial stability or does it need overhaul? What exchange rate regimes and international governance structures would improve financial stability?



a) Asset Backed Commercial Paper.
Source: Federal Reserve Board.



Proposed Solutions

Expert Opinion

The repeated reoccurrence of financial crises since the early 1990s has led to calls for institutional reform. The most recent example that is the crisis that began with the problems on the subprime segment of the US housing market. Numerous commentators have observed that the interactions between commercial banks, other financial intermediaries, credit rating agencies, financial regulators, national banks and governments were partly responsible for the financial unrest. There is a need for better management and regulation of diverse, interrelated risks.

It is evident that especially the fundamental change of the characteristics of the financial sector calls for an adjustment of the regulatory framework. In response for instance to the blurring of traditional boundaries between banking, securities and insurance, and the formation of large financial conglomerates there is a need for a consolidation of supervisory power that is still rather fragmented in most countries. In a similar fashion, the increasing importance of innovative investment vehicles calls for a revision of accounting and disclosure standards for off-balance sheet entries.

Once a banking crisis has materialized, the responsible state authorities should follow a well specified contingency plan that obeys certain general principles to be announced well in advance. As far as central banks are concerned, a clear distinction should be made between guaranteeing the stability of the financial system on the one hand and the stabilization of the macro economy on the other. This has been the policy of, for example, the European Central bank in recent months. In order to avoid the risk of a systemic crisis, liquidity should be provided to counter major disruptions on money markets. Individual banks may get access to liquidity, for example, at the discount window, if they can provide sound collateral. One of the principles could be Bagehot's rule: They could borrow money at a penalty rate. In order to avoid the moral hazard problem, it should be made clear in advance that a bailout of banks is not the policy of the central bank or the government. Otherwise, there would be the risk that the probability of a new crisis would be higher. The same would be true if central banks would pre-emptively follow an expansive monetary policy in response to problems in the financial sector. As experience shows, this may lead to another crisis in the future.

From the perspective of the world economy, the movement towards less volatile exchange rates (along the vision of a world currency) would clearly help to decrease the risk of financial turmoil and banking crisis. A possible path would be to first stabilize exchange rates, then implement a fixed exchange rate regime between the major currencies, i.e. US-Dollar, the Euro and the Yen. This would constitute the core of a quasi-monetary-union, which could finally be extended gradually to other countries.

Strategy Perspectives

Global Crises Require Global Responses

Domingo Cavallo

Chairman and CEO, DFC Associates

The current global financial crisis will induce changes in the regulatory framework under which the local and global capital markets operate. There will be, very likely, a widening of



the boundaries of the regulatory system and related “safety net” policies, which in practice have already been extended, at least in the US and Europe. There will also be changes in regulations to reduce the pro cyclical instability induced by the current system of capital requirements and fair value accounting, the extent of maturity transformation, the limitation of the “Originate to Distribute Model” and issues of clearance and settlement related to derivative contracts.

There are several groups of experts working on proposals for Financial Reform on these lines, and rather than giving a personal opinion on these issues, I want to reflect optimism on the outcome of this process, as far as the future pricing of risk is concerned.

But I am not optimistic about the future ability of central banks and national treasuries to ameliorate the effects of the current and future financial crisis on the real economies.

From my experience in Argentina and as an observer of the many financial crises that have taken place in the emerging markets since the eighties, I feel that most of them originate in domestic imbalances that are induced by unsustainable public policies that are maintained for too long when waves of optimism provide financing for the happy time.

When a financial crisis occurs, it is because those economies face a sudden stop of financing and the real adjustments cannot be delayed any longer. Therefore, the crisis of the real economy that follows is not the consequence of the financial crisis, but of the disequilibria that preceded it. These disequilibria, having been ignored by investors and financial intermediaries, found easy financing for too long a period of time. If the public policies that are designed to cope with the financial crisis try to prevent the real adjustments that are required to cope with those disequilibria, the renewal of growth and the restoration of price and monetary stability may be unduly delayed.

In today’s global economy, without global public institutions capable of conducting global monetary and financial policies, there is a clear risk that national governments will conduct their own public policies seeking to prevent real adjustments within their national economies and, in so doing, will generate global instability. I have the impression that at least part of the commodity inflation observed in recent months is a reflection of the interaction of national policies, particularly those of the United States, Europe and the Asian Countries, that do not reflect any degree of coordination.

In my opinion, to improve global policy coordination in the monetary and financial fields, it is key to look at the experience of emerging market economies with financial crises, paying particular attention to the cross responsibility of domestic disequilibria and international shocks in feeding those crises and in making it difficult to find good solutions for them.

Strengthening Financial Institutions

Thomas Cooley

Dean, Stern School of Business

A Starting Point

A starting point for this discussion could be to recognize that the current financial crisis, like many previous financial crises began with an asset price bubble. The severity of this particular crisis is enhanced by the fact that the asset in question is highly indivisible and quite illiquid. This raises the obvious question of whether financial institutions can do more to recognize and deter bubbles. This very discussion was held in the U.S. in the late 1990’s at the Jackson Hole conference.



One popular view is that Fed policies actually caused the bubble. Can this be true? Greenspan argues in his own defense that the rapid growth of securitization and leverage and the apparent absence of risk premiums as the bubble expanded came not from low interest rates but from the abundance of global savings flowing into the U.S. market. He is right about that: just look at the path of the U.S. Current Account Deficit for the past 15 years. This was a movement of global investment driven by long-term demographic changes combined with the widely perceived stability of the U.S. financial system. Alan Greenspan certainly wielded a great deal of power during his tenure at the Fed. But his power had limits. He didn't and couldn't magically create an economy that was immune to shocks and crises. He did not lead some people to make bad loans or others to take on too much debt. He didn't encourage people to believe that the market could only move in one direction – up. Moreover the housing bubble was not confined to the U.S.

Should they have done something about the bubble as many recent commentators have argued? That is a more difficult question. There was an important and noteworthy discussion of this issue at the Fed's Jackson Hole Conference in 1999. One argument often made is that it is difficult or impossible to know when we are experiencing a bubble – when asset prices are not being determined by fundamentals. That is undoubtedly true as a purely academic matter but there was a point in the both the Nasdaq and housing bubbles when you didn't have to be the sharpest knife in the drawer to know what was going on. My personal indicator was the handyman who did odd jobs around my house. In 1999 while the Fed was debating bubbles he told me he was too busy to fix the gutters because he had become a day trader. By last year he had evolved to a "real estate investor."

What is the central bank to do about bubbles? Jawboning clearly doesn't work as Alan Greenspan was not misunderstood when he talked about "irrational

exuberance." Mervyn King, the governor of the Bank of England has been talking about the U.K. housing bubble for several years to little effect. The alternative then would seem to be a sharp shock to monetary policy. Because asset prices are so volatile tracking them would make monetary policy more volatile and attempts to shock the market could have dangerous collateral effects. These considerations make central bankers very cautious about assuming responsibility for deflating bubbles. This remains an important issue for discussion.

When the Tide Goes Out

When the tides goes out a lot of jagged rocks and slime are exposed, and, as Warren Buffet famously said you see who has been swimming without a bathing suit. In the current financial crisis what has been exposed are the flaws in the existing financial institutions and the regulatory frameworks not just in the U.S. but elsewhere. And the flaws are many – the ratings system, the growth of off balance sheet vehicles, the limited supervisory regulatory and lender of last resort roles of the central banks, the ways of distributing financial risk, the incredible growth of leverage.

When we think about solutions it is worth keeping in mind that there are very different systems in place. For example there is a big difference between rule based in principle based regulation. The U.S. system has a chaotic, costly patchwork quilt of regulations that govern U.S. financial markets and corporations. Recently there has been a lot of concern that it is overregulated and that this is undermining American competitiveness and shifting the financial center of the world to London and Hong Kong.

The U.S. system has evolved over many decades as the result of the whack-a-mole response to crises and scandals. We address each new failing of the system with regulations, legal opinions, exchange regulations, and legislation in response to new failures in financial markets, corporate scandals and so on. Some have always argued that a



simplified, principles-based regulatory structure like that in place in the U.K. would do much to restore U.S. competitiveness in this area.

The recently proposed Blueprint for Regulatory Reform, issued by the U.S. Treasury Secretary indicated that discussion in this area had begun as early as March 2007, when industry leaders and policy makers met to discuss issues of capital market competitiveness at a conference convened by the Treasury Department. And then came the major liquidity crisis in the markets and the concomitant need for action, the reasons for which have been well-rehearsed in the financial press and elsewhere. The proposed reforms consolidate a number of regulatory functions in the SEC, adds a separate oversight over institutions that carry implicit government guarantees, and gives the Federal Reserve Bank broad new supervisory and regulatory powers over financial institutions that require access to the Fed's lender of last resort facility.

It's clear that one intent of the proposed reforms is to forestall a legislative regulatory reaction to the specifics of the current liquidity crisis. These proposals would not necessarily have prevented liquidity problems, but they put in place a structure that is better equipped to handle shocks to the credit market.

Part of the reform is exactly right. J.P. Morgan, following the panic of 1907 that led to the founding of the Fed, saw the need for a central bank that would keep financial markets functioning and liquid and that could be lender of last resort. There is no more clear regulatory mandate than that. Paulson's proposals speak exactly to this need by extending powers over the very firms that could threaten the orderly functioning of financial markets. The markets are now infinitely more complex and interwoven than they were in J.P. Morgan's day. So it is essential that the Fed be able to supervise and regulate and, if necessary, lend to a wider range of institutions. The complexity of financial markets makes this an extremely tall order for the Fed as the recent credit market crisis illustrates well.

The current proposals shift responsibility from the SEC to the Fed. But that is the logical choice. First, the SEC has neither the regulatory capacity to oversee the liquidity and solvency of the institutions in question nor the ability to be lender of last resort. Only the Fed can do both. Secondly, the SEC is conceptually and historically positioned to represent the interests of individual investors – not the broader collateral interests of the markets.

Lending without supervisory power can lead to big trouble. The Northern Rock debacle is a perfect example. When the British Government gave the Bank of England independent authority to set interest rates in 1997 it consolidated a lot of regulatory power, including bank supervision in the Financial Services Authority. When Northern Rock got into trouble because of the problems in the credit markets it turned to the FSA for help. The Bank of England – unclear as to whether Northern Rock was simply illiquid or insolvent – took a tough stand, essentially arguing that its lender of last resort facility should not be used to bail out institutions that had taken excessive risk. What ensued was a run on the bank, a most unwise assurance to depositors by the Chancellor of the Exchequer that they would face no risk and an enormous bill for British taxpayers. Northern Rock is now owned by the U.K. government.

The lesson here is to be careful what you wish for. The U.K. system appeals to many because of its simplicity and its reliance on general principles. But when it most needed to work, it didn't.

Solutions

As the world economy becomes more interlinked and more complex the nature of financial institutions has to evolve. But it has to evolve with care. Regulation is in many ways a nasty business – because the law of unintended consequences is always there to show how we



got it wrong. There is almost no chance of getting it exactly right. Moreover, what is politically feasible in one country may not be feasible in others. But, here are some proposed criteria solutions.

Predictability: Just as we want monetary policy to be predictable we need to understand what the central bank will do and when. The Federal Reserve's intervention in the Bear Stearns collapse was a one off undertaking that doubtless created moral hazard by bailing out the creditors of BS. It was a band aid applied in the face of the fear that a failure would have systemic consequences at a very vulnerable time. To replace this band aid we need a predictable policy. That in turn requires some deep discussion of systemic risks and where they lie in the financial system. What are the lending facilities to be made available to the shadow banking system and what are the supervisory and regulatory requirements that go along with that?

Transparency: The securitization of debt is not a bad thing – it is a good thing. Subprime lending is not a bad thing either – in some parts of the world it is called micro-finance. As long as the risks are priced and the people holding them know what they have. What is bad is that risks are priced and holders of securities know what they have. Unfortunately, the ratings agencies and the monoline insurers have not done their job in this respect. One option is to encourage more competition in ratings and monoline insurance.

Breadth: The current system is designed to deal with the types of financial institutions that existed many years ago and that operated largely domestically. It has adapted only slowly to the role of hedge funds, counterparty banks etc. and the growth of GSE's that have themselves evolved very rapidly. We have to decide where in the regulatory framework these various institutions fit and it has to be broad enough and flexible enough to encompass them.

Global Economic Symposium: Strategic Perspective

Richard Holmes

CEO Europe, Standard Chartered Bank; Co-Chairman, Private Banking, Standard Chartered Bank

Background

Standard Chartered derives more than 90% of its operating income and profits from Asia, Africa and the Middle East. A top 3 UK bank, for the past 5 years income and profits have more than doubled. In one of the most difficult periods in global financial services history, Standard Chartered recorded a 31% rise in pre-tax profits in last month's interim results.

Standard Chartered has benefitted from the fact that it has a relatively low exposure to sub-prime investment vehicles compared to other international banks and its strategy has historically excluded the US and European mortgage markets, instead tapping into the potential banking markets that are less mature and growing in size. However, emerging markets pose their own set of challenges; both endemic, market specific risks as well as indirectly through their exposure to the US and European markets. Consequently, there is a need to strengthen financial institutions and Standard Chartered is well placed to look at an international solution, from a unique perspective.

Strengthening Financial Institutions

The current crisis in financial services should also be viewed as an opportunity to strengthen financial institutions and this cannot be achieved on a unilateral basis but through international cooperation. Globalisation has meant that no market is immune from the large scale economic downturn and thus the solution needs to be international in nature.



More Regulation Will Not Solve the Problem

The global credit crunch is already 13 months old and has had a devastating impact on many financial services institutions. Key decision-makers are under pressure to prevent a reoccurrence of the credit crunch and there is a temptation to tackle the crisis with more regulation. In Europe, there have been calls for the creation of a supranational European regulator, national depositors insurance and an increase in the volume of regulation designed to prevent another subprime crisis. Far from strengthening financial institutions, over-regulating may in fact handicap the financial services community, removing its flexibility and further deepen the crisis.

Meanwhile, in emerging markets, regulators are questioning the validity of following the European or US regulatory models and are looking for a third way.

Solutions

1. More Even Regulation, Not More Regulation

The global disparity between regulatory standards causes significant problems for financial services, creating credibility gaps for transnational regulators and the uneven application of international rules. It is essential that the channels of communication between financial institutions and regulators are kept open. More research is needed on gaps between international standards and where those gaps result in regulatory arbitrage.

2. Including Regulators from Emerging Markets

More should be done to facilitate discussion between regulators where best practise can be shared. The Prime Minister and Chancellor have been working with 16 leading British financial institutions to set up the International Centre for Financial Regulation (ICFR). The ICFR will be launched at the end of 2008, as an independent, genuinely international centre providing cutting edge research and training for practitioners and businesses, including in emerging markets, on financial regulation. The ICFR's interim executive committee is currently chaired by Mervyn Davies, Chairman of Standard Chartered and is seeking partnerships in emerging markets to ensure that the ICFR reflects global regulatory standards and includes emerging markets' economic challenges and aspirations.

3. Including Dialogue with Investment Vehicles

There needs to be an inclusive dialogue around systemic risk on an international basis to identify ways to prevent further exacerbation of the credit crunch and to build a stronger international financial system going forward. An open dialogue should be extended to investment vehicles, in order to build trust and confidence.

Sovereign wealth funds have often been treated with suspicion while they have an important role to play, especially in ensuring the free flow of capital. They have long been engaged and investing in countries that have otherwise been bi-passed by globalisation. They can provide huge wealth in an era of diminishing liquidity and it is arguable that they have played a stabilising role in this year's financial turmoil by buying financial assets when other investors could no longer. Sovereign wealth funds provide liquidity to global markets and can generate wealth both for their home countries and receiving markets.

Sovereign wealth funds have eased the ability of commodity producers to smooth out their earnings cycles thus helping to ease global imbalances. Economic management is much easier for oil producers who can put money aside for a rainy day. Last year total issuance of US Treasuries, Euro-bonds and UK gilts was \$461bn while global foreign exchange reserves [including SWFs] went up by about \$1,200bn. Even if countries involved wanted to hold their



funds in traditional reserve assets they would find this increasingly difficult. Sovereign wealth funds also tend to be long-term holders of equity and other assets, reducing market oscillations.

4. Encouraging Transparency and Disclosure

International regulators should cooperate in enhancing transparency in their markets. Many cities including Mumbai, Hong Kong, Kuala Lumpur, Seoul and Shanghai aspire to emulate London and New York's success by becoming regional financial services hubs. A pre-requisite for success as an international financial centre is to create an even playing field for domestic and international companies in terms of regulatory transparency as well as market access. Without foreign participation, a financial hub cannot become truly international.

Financial institutions will be strengthened by increasing dialogue around systemic risks and extending that dialogue to regulators from emerging markets. The current crisis in financial services will be managed better by avoiding the temptation to curtail the flow of capital through overregulation.