

Dealing with crises in a globalized world: challenges and solutions

Panel remarks by Athanasios Orphanides, Governor of the Central Bank of Cyprus, at the Twelfth Annual International Banking Conference "The International Financial Crisis: Have the Rules of Finance Changed?"

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A year has already passed since the peak of the worst financial crisis the world has experienced since the Great Depression of the 1930s. This extreme episode of financial instability has led to a severe and truly globalized economic downturn and highlighted the worldwide devastation that can result from a disturbance in just one area of the world with a highly interconnected financial system. The emerging signs of recovery are welcome, though unusually high uncertainty persists. The crisis has revealed a number of weaknesses in the global architecture of financial regulation and supervision as well as gaps in the toolkit available to policymakers for crisis management. An intense discussion on dealing with future crises is essential and it is reassuring to see that it is taking place in various international fora. Against this background, I would like to thank the organisers of this conference for their invitation to participate in this panel on challenges and solutions for dealing with crises in a globalized world. I will use this opportunity to share with you some reflections on three areas where I believe progress is needed for promoting financial stability at the global level: international cooperation and convergence; simplicity in regulation; and the role of central banks in promoting financial stability. The views I express are my own and do not necessarily reflect the views of my colleagues on the Governing Council of the European Central Bank.

This has been a crisis of the global regulatory framework. The fact that supposedly well regulated financial institutions have been the major source of problems is an embarrassment for the international community of regulators and supervisors. The financial turmoil has revealed serious gaps in the crisis resolution framework at the global level and highlighted the lack of coordination and harmonisation in accounting, regulation and supervision, even within common economic areas such as the United States and the European Union. It is an inescapable conclusion that these deficiencies have contributed to the severity of the crisis, which points to the urgent need for enhanced cross-border cooperation to establish consistent rules in all these areas.

The greater the heterogeneity across jurisdictions in accounting, regulation, supervision and crisis resolution practices, the greater is the potential threat of regulatory arbitrage

by financial institutions operating in multiple jurisdictions and thus the greater the pressure on local regulators and the risk of regulatory capture. International harmonisation and convergence is a practical way to minimise this risk.

Consider the continuing differences in accounting standards across borders that hinder international comparisons of banking institutions. The absence of a level playing field in the application of accounting standards creates an anomaly in international finance. The same rules and concepts need to apply globally, which requires urgent work to be done. It should be recalled that one of the aims of the creation of the International Accounting Standards Board (IASB) was precisely to achieve the goal of introducing a single set of standards across the globe and improving the governance of the standard setting process. Progress has been slower than desirable.

There is also a clear need for a harmonised regulatory framework across all major jurisdictions and markets. The lack of a consistent set of rules is bound to lead to competitive distortions among financial institutions and encourage regulatory arbitrage. Although the lack of a harmonised set of rules, for example in the definition of capital, at the global level is more than evident, regulatory inconsistencies even in the case of a single financial market such as the EU exist and are problematic. As noted in the de Larosière report (2009), the present regulatory framework in Europe lacks cohesiveness mainly due to the options provided to EU members in the enforcement of common directives. These options lead to a wide diversity of national transpositions related to local traditions, legislation and practices.

That said, as a result of the crisis, progress is being made. At the EU level, the European Council (2009) decided in June to establish a European System of Financial Supervisors (ESFS), comprising three new European supervisory authorities to succeed the current three Level III Committees, namely the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). These new bodies are expected to upgrade the quality and consistency of national supervision, strengthen oversight of cross-border groups through the setting up of supervisory colleges and create a European single rule book applicable to all financial institutions in the Single Market.

Another area that requires greater convergence in practice is the imposition of sanctions. Supervision cannot be effective with weak and highly divergent sanctioning regimes. It is essential that all supervisors across the world are able to deploy sanctioning regimes

that are sufficiently convergent and strict, thus acting as a deterrence. This is far from being the case now. The same exercise should be initiated with respect to supervisory powers. These also differ greatly from one country to another and this cannot be conducive to coherent and effective supervision.

As regards cross-border bank resolution and insolvency, once the financial crisis hit, weaknesses and differences in national and international approaches in these areas came to a head, mainly as a result of different resolution tools and safety nets applicable across the globe. Differences in bankruptcy legislation for financial institutions across countries and the absence of *ex-ante* rules governing cross-border bank resolution present a serious problem that has proven to be very costly during the crisis.

Without common bank resolution rules or modes of collaboration, supervisors' obligations to their own taxpayers lead them to minimise liabilities to non-residents and maximise control of assets. For example, in the face of an imminent collapse of Icelandic bank branches under the authority of Icelandic supervisors, and in the absence of assurances that UK bank liabilities would be covered (or guaranteed), UK supervisors ring-fenced Icelandic bank assets; the failure of Lehman Brothers also triggered discriminatory and potentially inefficient ring-fencing of assets outside the US.

Measures to improve cross-border crisis resolution should focus on introducing compatible legal frameworks for bank resolution. In this respect, a key issue is the convergence of banking legislation by home and host countries of the cross-border firms along a number of fronts. Specifically, early remedial actions, including common criteria on triggers and timing of resolution or bankruptcy procedures of a global firm; resolution tools to allow quick and well-synchronised action by the relevant authorities across countries to preserve the failing firm's franchise value and ensure fair treatment of all creditors; and deposit and investor protection schemes to ensure that depositors/investors are covered by the scheme prevailing in each jurisdiction, regardless of whether the entity is a subsidiary or a branch.

To achieve these objectives, there will need to be more active and effective multilateral mechanisms for cross-border regulation and supervision. These mechanisms could build on the existing frameworks of the Financial Stability Board (FSB), the Basel Committee and the other standard setters. The IMF could also play an important role, for instance in developing guidelines for dealing with cross-border bank supervision and resolution. This could address best practices such as in the areas of triggers and deposit protection.

Moreover, the Fund's FSAP assessments could provide a platform for evaluating the adequacy of countries' oversight of cross-border financial firms.

It is encouraging that on this front, two international initiatives on bank resolution frameworks are making progress. Earlier this month, the Basel Committee published the report and recommendations of its Cross-Border Bank Resolution Group, which includes recommendations for authorities on effective crisis management and resolution processes for large cross-border institutions. The IMF and World Bank initiative on the legal, institutional and regulatory framework for national bank insolvency regimes is also expected to produce a final report in the spring of 2010, which will review the principal impediments to effective resolution of a cross-border financial institution.

This has been a crisis of the global supervisory framework. Numerous examples suggest what, after the fact, was recognised to be lax or nonexistent supervision. How can supervision become more foolproof? One way is to reduce the complexity of the supervisory process.

In the years leading to the crisis, some financial institutions developed and traded highly complex derivatives. In retrospect some of these derivative products added little or no social value but imposed a burden on regulation as the difficulty in their evaluation resulted in systematic mispricings.

A perennial issue in regulation and supervision is that given any set of rules (regulation), profit seeking financial firms may always attempt to find ways to circumvent them in a manner that would let them maximise the return on their capital. Supervision, that is the monitoring and enforcement of the letter and the spirit of the rules, is more successful the easier it is to verify compliance. And this can be done more easily when the rules are simple. In other words, there is a trade-off between complexity in regulation and its effectiveness. Complexity makes supervision harder to implement and risks introducing gaps between presumed and actual effectiveness of regulation. For that reason, regulation must, in principle, discourage complexity. Simple rules are harder to circumvent and render their supervision more effective.

In the lead up to the crisis, the tendency was to move away from simple rules and towards more refined (and more complex) regulatory frameworks. Consider, for example, the Basel II international capital framework for banks aimed at aligning regulatory capital requirements more closely with the underlying risks that banks face. But the added complexity imposes additional demands on supervisors to assess and

verify the trustworthiness and accuracy of the associated banks' internal risk assessments. As events from the current crisis have demonstrated, the potential for mistakes is very real and the consequences can be very costly.

Simple rules such as leverage ratios, liquidity ratios, or loan-to-value ratios in lending practices, may appear overly restrictive to bank managers who, based on their internal risk management systems, might wish to push the envelope of their activities a bit further. However, they can help improve the robustness of the regulatory and supervisory framework, and render the financial system more stable.

There is a parallel with the design of rules for monetary policy. Simple rules may appear deficient to a theorist who could proclaim that they cannot deliver the most efficient or theoretically optimum outcomes. But achieving a theoretical ideal is not a good guide to policy, in light of our imperfect understanding of economic behaviour. Appropriately designed, simple rules can serve as robust guides and help avert major mistakes.

There is now growing consensus that the excessive leverage of many banks was a major contributing factor to the global financial crisis. Moreover, the inevitable de-leveraging currently taking place is imposing further stress on the system. To enhance the longer-term resilience of the financial system, effective regulation to curtail banks' build-up of leverage is required. Not surprisingly, this has brought under the spotlight the use of a simple measure of leverage complementing the more complex risk-sensitive capital requirements in an attempt to put a lower bound on banks' leverage. This will effectively serve as a safety valve against the weaknesses and shortcomings of the Basel II capital requirements. A supplementary leverage ratio ensures a minimum capital buffer that protects banks against unexpected losses and underestimation of risk. As we have learnt from the current crisis, the failure of risk models may quickly turn banks that seem adequately capitalised into ones which are poorly capitalised. Adding a simple leverage ratio to Basel II should reinforce banks' capital, strengthen capital regulation and contribute to a more stable international financial system.

There are a number of benefits of a gross leverage ratio. The most direct is that it helps limit balance sheet size. The current risk-based capital framework encourages banks to assume exposures that attract a low risk weight, as the capital required to be set aside for these exposures is relatively small. As a result, in absolute terms bank balance sheets can become highly leveraged and can include assets that would be difficult to liquidate in times of need without incurring large haircuts. Hence, the prudential leverage ratio can serve as an additional measure for constraining banks from becoming

excessively leveraged in the upswing, as seems to have happened in recent years. Another benefit of such a ratio is that it helps reduce regulatory arbitrage. The risk-sensitive nature of Basel II can result in the perverse incentive to structure products in order to obtain a high credit rating, so that they qualify for a lower prudential capital requirement. When this incentive is collectively exploited, the system is likely to end up with high concentrations of structured exposures attracting low prudential capital requirements. The prescription of a minimum leverage ratio, among other measures, can dampen such an incentive.

In this light, it is noteworthy that earlier this month the Group of Central Bank Governors and Heads of Supervision (the oversight body of the Basel Committee) reached agreement towards, among other things, the introduction of a leverage ratio and a liquidity ratio as supplementary measures to the Basel II risk-based framework. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting.

Next I turn to the role of central banks. The crisis has revealed a general underappreciation of systemic risks in micro-prudential supervision, and highlighted the need for a more systemwide macro-prudential approach towards supervisory oversight to ensure overall stability in the financial system. By definition, micro-prudential supervisors focus on individual institutions and cannot effectively assess the broader macroeconomic risks that pose a threat to the financial system as a whole. This is a task best suited to central banks.

The recent moves to reinforce macro-prudential oversight internationally are in the right direction. At the EU level, the European Council (2009) decided in June, based on the recommendations of the de Larosière Group, to set up a European Systemic Risk Board (ESRB) in order to increase the focus on systemic risk in the EU framework for financial supervision. As with the ESFS, draft legislation on the establishment of the ESRB was adopted by the European Commission earlier this month. The main activity of the ESRB will be to identify, monitor and assess potential threats to financial stability and, where necessary, issue risk warnings and recommendations for action and monitor their implementation. Analytical, statistical, administrative and logistical support for the ESRB will be provided by the European Central Bank, also drawing on technical advice from national central banks and supervisors. At the international level, the envisaged closer cooperation between the IMF and the FSB is expected to contribute towards better surveillance of macro-prudential risks in the international financial system. The ESRB is also expected to liaise effectively with the IMF and the FSB.

In the United States, the US Treasury (2009) recommends that the responsibility for macro-prudential supervision be assigned to the Federal Reserve. Furthermore, the legislative proposals released by the Treasury last July to address systemic risk give the Fed the authority to regulate and supervise all large interconnected financial firms deemed to be systemically important.

There are important informational synergies between micro-prudential supervision and systemic risk analysis that make this proposal quite attractive. Central banks can benefit from and rely on extended access to supervisory information and intelligence, especially on systemically relevant intermediaries, in order to appreciate risks and vulnerabilities of the financial system as a whole.

In addition, in the area of crisis management and resolution, the financial market turmoil has showed the importance of close interaction between the central banking and supervisory functions, in particular when the provision of Emergency Liquidity Assistance (ELA) becomes necessary. The activation of the ELA requires speed and detailed information regarding the conditions of vulnerable financial institutions seeking assistance. In this regard, a supervisor has greater likelihood of possessing institution-specific information, which is vital for a central bank to perform effectively the role of "lender of last resort".

Indeed, many central banks have found the presence of financial supervision, especially banking supervision, under their aegis and the information flows within the same organisation as essential in enabling them to deal with the current crisis. This has reinforced the arguments in favour of combining the central banking and supervisory functions under one roof.

Bringing micro-prudential supervision under the umbrella of the central banks may also be the most effective manner for preserving the institutional independence of supervision---an important defence against political pressures and the threat of regulatory capture. Invariably, central banks are among the most independent institutions in democratic societies as a high degree of central bank independence is required to ensure monetary stability. On the other hand, the concern that adding micro-prudential supervision may jeopardise a central bank's independence and compromise its ability to pursue its price stability objective is an argument against bringing micro-prudential supervision under its aegis. This is certainly a serious concern that makes the central banker's job more difficult. However, I believe that the social

benefits emanating from the synergies between micro- and macro -prudential supervision outweigh the potential risks.

Another argument in favour of placing micro-prudential supervision under central banks in countries where this is not already the case, is the excellent international cooperation among central banks, as demonstrated during the present crisis. In light of this excellent cooperation, the micro-prudential supervision of systemically important institutions by the central banks would enhance stability in the international financial system.

For a central bank to be successful as a macro-prudential supervisor, it needs to be provided with the appropriate tools. In general, a central bank does not face a trade-off between price stability and financial stability. Rather, most of the time these two goals reinforce each other. Price stability prevents the arbitrary redistribution of wealth and income between borrowers and lenders which could result from unanticipated price movements and lead to financial stress and potential default. In addition, anchoring inflation expectations results in the stabilisation of economic activity and avoidance of debt-deflation spirals. Conversely, financial stability enhances the effectiveness of monetary policy by facilitating the monetary transmission mechanism. However, there may be occasions when monetary policy directed at preserving price stability may not suffice to minimise financial stability risks. An example would be an episode of persistently high credit growth in an environment of price stability. Under such circumstances, the central bank should, in addition to its interest rate instrument, have at its disposal macro-prudential levers with which to contain the risk of a potential financial disturbance. These could comprise the power to vary capital requirements, leverage ratios, loan-to-value ratios, margin requirements and so forth.

Could the current crisis have been averted if this macro-prudential framework had been in place a few years earlier? Such counterfactual thought experiments are very difficult to evaluate with precision, but the following example may illustrate how history might have differed if the Federal Reserve had broader supervisory powers half a decade ago.

The example concerns Fannie Mae and Freddie Mac, the two housing-related government sponsored enterprises (GSEs) in the United States that, according to Calomiris (2008), played a pivotal part in the crisis. In brief, these two GSEs represented systemically important institutions that could have been under the supervision of the Federal Reserve if it had appropriate regulatory powers, as defined by the Treasury Report. These GSEs were allowed to expand their portfolios of assets virtually without limit and with an implicit government guarantee, despite the objections of the Federal Reserve.

As then Chairman of the Federal Reserve Alan Greenspan stated in testimony before the US Senate in April 2005: "We at the Federal Reserve remain concerned about the growth and magnitude of the mortgage portfolios of the GSEs, which concentrate interest rate risk and prepayment risk at these two institutions and makes our financial system dependent on their ability to manage these risks... To fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventative actions are required sooner rather than later" (Greenspan, 2005, p. 3).

Unfortunately, these warnings went unheeded and the systemic failure that had been a source of concern at the Federal Reserve materialised. In retrospect, if the Federal Reserve had already been the systemic regulator and had the appropriate authority, it could have taken the necessary action and the failure may have been averted.

This example also illustrates that to assure financial stability it is not sufficient for the central bank to have the responsibility to identify risks and to issue warnings. The central bank must also have the authority to enforce corrective action.

In conclusion, the financial crisis has highlighted significant weaknesses in the international financial regulatory and supervisory framework as well as the need to strengthen the resilience and oversight of the financial system. Although we have avoided the worst, difficult challenges still lie ahead. Incorporating the lessons from the crisis we should strive to build a more robust global financial regulatory and supervisory framework. In this respect, I have focused on the importance of going forward in three areas: moving towards harmonised rules and greater international cooperation; striving to reduce complexity in financial supervision; and enhancing the role of central banks in macro-prudential supervision. The worst of the crisis may now be behind us. We should not allow complacency to stand in the way of making progress towards a more robust global financial order.

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