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BANCO DE ESPAÑA
Eurosistema

Global financial surveillance and financial stability

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International Conference

“Reforming Financial Regulation and Supervision: Going Back to Basics”

Madrid, June 15, 2009

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'Reforming Financial Regulation and Supervision'
WB-Banco de España conference, Madrid, 15 June 2009

Road map

- Financial stability and monetary policy
- Cross-border spillovers
- Cross-border crisis prevention and management
- Role of multilateral institutions

Financial stability and monetary policy: *macroprudential regulation*

- Prudential regulation of individual financial institutions not sufficient
- Sources of systemic risk
  - illiquidity or insolvency of one large complex financial institution (LCFI) can directly affect counterparties
  - parallel hedging or funding strategies of highly leveraged institutions – liquidity problems of an 'unrelated' firm can affect another's balance sheet and liquidity
  - correlated shocks may hit institutions simultaneously
- Hence need for systemic regulation that takes account of macro conditions (*Geneva Report*)

Many instruments available for macroprudential regulation

- Countercyclical capital adequacy ratios (CARs) – see Repullo *et al*. in Dewatripont-Freixas-Portes 2009
- Cap on leverage (also countercyclical)
- 'Dynamic provisioning'
- Cap on loan-to-value ratio for mortgages (also countercyclical)
- Tax on systemic risk posed by an institution – measure risk by 'connectedness' or leverage
- Alternatively, regulatory surcharge (higher required capital and/or liquidity, more aggressive provisioning) for LCFIs

How measure position in cycle?

- GDP growth rate
- Output gap
- Bank credit expansion
- Asset prices relative to historic norms

And asset price bubbles?

- Macroprudential regulation encompasses debate over whether central bank should try to identify and deflate asset price bubbles
- Broader issue is identifying and controlling systemic risk – and that should be focus

Host country regulator must do macroprudential

- Macro conditions are national → host country regulator…
- …while home country does microprudential
- Implication that *cross-border banking be through subsidiaries*, not branches (otherwise, differential treatment for banks operating in the same market)

Macroprudential regulation in mandates for monetary policy committees (MPCs)

- Countercyclical macroprudential regulation substitutes for trying to control bubbles with interest rates, which are in any case too blunt an instrument
- Beyond inflation targeting – with a second target (financial stability), need another instrument
- MPCs typically have appropriate institutional competence – cover macroeconomics and finance better than elswhere in central banks or in FSAs
- MPC independence important here – political pressures high, don't want politics to affect assessment of whether leverage is excessive

Cross-border spillovers

- Cross-border LCFIs
- Cross-border asset holdings
- Global financial markets
- Global liquidity pools
- Global labour market in financial sector
- Responses of markets to lack of coordination by national authorities

Cross-border LCFIs

- Cross-border transfers if an institution is liquidated (*e.g.*, Lehman Bros)
- Cross-border transfers if a set of contracts must be settled (*e.g.*, AIG)

Cross-border asset holdings

- *E.g.*, Germany complains that crisis came from US but it suffers more
- Indeed, German banks bought hundreds of billions worth of toxic securities issued in US
- Whose fault is that? – clearly, regulatory responsibility here is in Germany…

Global financial markets

- Interbank markets – interest rates (spreads) and counterparty risk, markets can freeze
- Derivatives markets – again, counterparty risk crosses borders
- Retail markets – different national deposit insurance schemes can induce depositors to cross borders

Global liquidity pools

- Market liquidity can easily be accessed across borders
- But initially central banks did not coordinate their liquidity interventions
- That was unsettling to markets until they saw coordination in December 2007
- But still not clear authorities learned lesson – apparently uncoordinated quantitative easing, for example

Global labour market in financial sector

- We already regulate menu of choices, should regulate incentives for choice among options (Bebchuk), *i.e.* bankers' compensation
- Historical U-shape – wages high to 1930, then low to 1990s, then way up (Philippon and Reshef)
- Human capital intensity and wages depend on deregulation, level of IPO activity, and credit risk – from mid-1990s to 2006, well above sustainable labour market equilibrium – so short-term rents likely to fall now
- And reregulation → outflow of human capital…
- …which will make it easier to get high-quality regulators
- But national authorities must watch out for spillovers across banks – labour is mobile!

Lack of coordination → regulatory arbitrage and other spillovers

- Tax havens – coordination!
- Alternative investment sector – EU acting alone
- Regulatory havens – not much coordination yet
- 'Compensation havens' ? – no coordination
- G20 common position on toxic securities…
- …but little evidence of common approach, and no moves toward common resolution regime for LCFIs (see below)
- Macroprudential regulation – beginnings of coordination
- Derivatives markets…

Regulation of derivatives markets – no evidence of cross-border cooperation

- Counterparty risk important
- Industry argues that universal central counterparties, *a fortiori* exchange-trading, would unduly restrict specificity of 'tailor-made' instruments and reduce liquidity
- Indeed, don't want to stifle innovation, but could migrate new instruments to exchange trading as soon as they attain sufficiently large volumes
- Could introduce regulatory surcharge (through capital, liquidity or provisioning requirements) to encourage clearing of currently OTC instruments
- Consider Financial Products Safety Board, to examine not only particular characteristics of a new instrument but also its contribution to systemic risk

CDS market

- Most egregious case of dangerous deregulation (Commodity Futures Modernization Act 2000)
- CDS contracts should be exchange-traded – central counterparty and clearing do not give sufficient transparency
- And should ban 'naked' CDS – not insurance, and since there is no insurable interest, there is serious moral hazard
- Industry lobbying intensively on all these issues, because they profit from opacity and specificity

Exchange rates

- Zero interest rate policies and quantitative easing have clear cross-border macro implications
- New world in which several major monetary authorities take such actions simultaneously
- Could lead to series of competitive devaluations

Cross-border crisis prevention and management

- Institutional weaknesses no longer 'academic' worries – we have seen system break down
  - UK (and other countries') deposits in Icelandic banks
  - failure and 'rescue' of Fortis
  - full redemption of CDS contracts by AIG, involving massive payments from US taxpayer funds to foreign entities
- Some institutions TBTR as well as TBTF
- MoUs multiply, but when crisis comes, they divide…

Regulating individual institutions

- ‘Banks may be global in life, but they are national in death’
- UK (and others) blocking key feature of De Larosière report because it is unwilling to give ESRC powers that could commit UK taxpayers
- Hard to see how ESRC – a large, unwieldy body – could act quickly and decisively in crisis, any more than CEBS or CESR
- Still, ‘home’ country may account for relatively small share of total assets of a global bank

Need *ex ante* burden sharing rules

- Why indeed should ‘home’ country taxpayers be responsible for full cost of bailout or resolution?
- Calomiris: LCFIs should prepare detailed, regularly updated plans for intervention and resolution, specifying

  - how control would be transferred to prepackaged bridge bank if the LCFI became severely undercapitalised

  - formula for loss sharing among international subsidiaries – with pre-approval by relevant host country regulators

Capital markets

- Control currency mismatches (especially household sector borrowing in foreign currencies)
- Could require that advanced country financial institutions accept obligations only in currency of borrower (Krueger)
- Provide *credible insurance* to countries that forego further reserve accumulation

What sort of insurance?

- More central bank swap lines
  - Fed now has 14 facilities, drawings currently $175 b, down from peak of $580 b in Dec 2008)
  - China has facilities with several countries totalling $100 b
  - ECB has facilities with (only!) Hungary, Poland, Sweden
- Reserve pooling: intended transormation of Chiang Mai initiative network of bilateral swaps into a multilateral swap
- IMF: Flexible Credit Line the right instrument, Mexico and Poland showing the way, should be more

Role of multilateral institutions

- ‘Early warning’ – hard to do, political resistance
- Somewhat less difficult: identifying systemic vulnerabilities – IMF, BIS, FSB – should centralise this
- ‘Enhanced micro surveillance’ – this must be at national level, but need for international coordination
  ‘US to press Europe for tougher bank stress tests at level of individual institutions’
- FSB to coordinate regulation
- IMF should follow macro and exchange-rate effects of QE and ZIRP

The institutions themselves

- WB has clear role in financial sector development of low-income countries
- But WB and especially IMF need greater legitimacy – major quota redistribution – key is EU
- Either IMFC should run IMF (disband Executive Board) or EB structure and role should change radically – let management manage
- FSB should expand secretariat – and take over capital markets functions from IMF?
- FSB and OECD on 'rules'
- G20 right forum to avoid free-riding
- But can't fix system without fundamental agreement to reduce global imbalances