

October 21, 2009

Salim Raza underscores need for effective regulation of world's financial system

Syed Salim Raza, Governor State Bank of Pakistan has observed that effective regulation is the preferred way forward for central banks responsible for safeguarding both monetary and financial stability.

Delivering a keynote address on 'Current Crisis and the Future of Financial Regulation' at the 59th Annual General Meeting of the Institute of Bankers, Pakistan in Karachi today, Mr. Raza said that in the context of recent experiences of the global economy, the way forward for the financial sector is to maintain both the simplicity and transparency of product structures and a gradual pace of implementation of financial liberalization to enable the financial sector in meeting the needs of the real economy and to expand further in an efficient manner.

Mr. Raza dwelt at length on some of the issues arising out of the current global crisis and shared his perspective on various aspects of financial sector reforms, which are also pertinent to Pakistan.

SBP Governor said that recent global crisis is unique in the sense that it was caused by an unfettered parallel financial system which was driven by the excessive pace of financial innovation and deregulation in advanced economies. It is to be noted that the emphasis of the various working groups and committees is on fixing the financial regulation framework in the leading developed economies. While fora like the G-20 now also carry the representation of emerging economies such as China, Indonesia and India, financial regulation in emerging and developing economies is still progressing, given that the evolution of the financial sector and the associated regulatory framework is shaped by the need to extend the outreach of financial services and increasing financial depth, rather than putting aside the basic function of financial intermediation to engage in financial engineering focused on profiteering.

"As we move forward to make the financial system in Pakistan less prone to crisis, we would have to bear these various issues in mind," he added.

Mr. Raza pointed out that the world's financial system before the recent crisis was ill-managed, irresponsible, highly concentrated and undercapitalized, ridden with conflicts of interest and benefiting from implicit state guarantees. He said that as one contemplates the lessons of the crisis, and the reasons for the prolonged period of financial instability, the foremost thing that comes to mind is the role of central banks in safeguarding and maintaining financial stability, in addition to their primary objective of ensuring price stability.

“Central banks, whether or not responsible for the regulation of any component of the financial sector, nevertheless have a crucial role in safeguarding financial stability given that monetary and financial stability are closely linked, not in the least through the lender of last resort function,” he said and added that rapid succession of bank failures during the crisis reinforced the realization that there is no institution, besides the central bank, that can create liquidity quickly in a crisis, and with an eye on both monetary and financial stability, can take necessary actions to preempt and prevent systemic risk.

Mr. Raza opined that the ‘light touch’ model of financial regulation in vogue in advanced economies is seen to be one of the key reasons for the magnitude and protracted duration of the crisis. He said the regulatory framework in Pakistan operates on the basis of two regulators: SBP, with its primary focus on price stability, is also the regulator of the banking sector, and is mandated to safeguard financial stability, while SECP governs the non-bank finance companies, the insurance sector and the securities market. While the issue of transferring deposit-taking institutions back to SBP was under consideration until last year, SBP and SECP have signed a MoU to undertake consolidated supervision to enable effective regulation of emerging financial conglomerates, he added.

“Notably, the perimeter of financial regulation has strived to strike a balance between light regulation and over-regulation, while at the same time ensuring that all important sources of systemic risk in the financial services industry are regulated and supervised,” Mr. Raza emphasized.

SBP Governor said the events since August 2007 have brought forth the realization that the impact of the recent global crisis would not have been so severe had banks not virtually abandoned the traditional age-old model of banking i.e. raise funds by mobilizing deposits and exercise prudence in lending them onward at a reasonable margin. He said the banks in Pakistan predominantly rely on their deposit base for funding their expansion in assets and emphasized on the need to strengthen prudent asset-liability management by banks, particularly in view of their maturity transformation.

Mr. Raza stressed that financial regulation should be designed for large banks to hold capital and liquidity buffers that account for the systemic risk they pose, and their organization structure should enable an orderly winding down. He said that the pre-crisis prudential regulation regimes generally lacked a macro-prudential focus, which is essentially based on the assessment of the financial system as a whole, instead of simply the assessment of a collection of individual entities. He said that given the cost of financial crises, there has been a renewed emphasis on attempting to contain or, in the least, mitigate systemic risk by adopting macro-prudential surveillance, which is defined as monitoring of conjectural and structural trends in financial markets so as to give warning of the approach of financial instability.
