CURRENT CRISIS AND THE FUTURE OF FINANCIAL REGULATION

Keynote Address
by
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at
Annual General Meeting of the Institute of Bankers Pakistan
October 21, 2009

Ladies and Gentlemen, it is my pleasure and privilege to address this august gathering of eminent bankers and academics from the financial sector.

What I would like to talk about today is the changing financial landscape as we emerge from the 2007 crisis, particularly in the context of the future of financial regulation. As someone put it rather well, "the financial system before the crisis was ill-managed, irresponsible, highly concentrated and undercapitalized, ridden with conflicts of interest and benefiting from implicit state guarantees. What is emerging is a slightly better capitalized financial sector, but one even more concentrated and benefiting from explicit state guarantees. Can this be called progress?"

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. Since monetary policy transmission signals work through the channels of financial markets and bank-based intermediation, this link is even more crucial. The 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.

As the crisis has shown, systemic risk is THE risk financial regulation failed to capture. It is now a well established fact that supervising and regulating individual firms does not ensure that the whole system is resilient per se. Micro-level prudential regulation is not a substitute for a macro-prudential policy.

Effective Financial Regulation, while not a panacea for all ills, has a definitive role to play in preempting systemic risk, and mitigating the potential impact of events leading to a crisis when it happens. While concerns have been highlighted about the negative implications of *over-regulation*, it needs to be pointed out that the upheaval caused by the crisis calls for *more appropriate* regulation, and not just more regulations per se.

In its capacity as the regulator of the banking sector, State Bank of Pakistan has shifted its focus from a rule-based regulatory approach to a principle-based regulatory framework. While the financial regulatory framework in Pakistan has evolved considerably over the years, and is responsive to developments in its operating environment, we can still benefit from some of the debates and issues currently under contemplation in the global financial system.

Hence in my talk today I would particularly like to focus on some issues where debate has emerged in the post-crisis era, and which are also pertinent for the ongoing implementation of financial sector reforms in Pakistan.

1. The optimal regulatory model

The current financial crisis has brought forth several shortcomings of the international financial architecture. In particular, 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. In the process of an in-depth analysis of the modalities of financial regulation as practiced by western economies, several factors have come to light. Among other things, successively unfolding events since August 2007 have generated a debate on the optimal model of financial regulation. The concept of a separate, stand-alone regulator of the financial sector, adopted among others by Australia in 1998 (Australian Prudential Regulations Authority - APRA), and consequently by the UK in the form of a Financial Services Authority (FSA), was tested severely with the collapse of Northern Rock, plc in November 2007. The failure of the independent financial regulatory authorities to coordinate effectively with the central bank in case of bank runs / bank failure has actually led to the decision to merge BaFin (the financial regulator in Germany) with the Bundesbank earlier this month. Leading advanced economies such as the USA, UK and the EU are now in the process of evaluating their respective frameworks of financial sector regulation and supervision.

So where do we stand in Pakistan? The regulatory framework here 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 an MoU to undertake consolidated supervision to enable effective regulation of emerging financial conglomerates.

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.

2. Funding model of banks and financial institutions

Successively unfolding events since August 2007 have also brought forth the realization that the impact of this crisis would not have been so severe had banks[1] not virtually abandoned the traditional age-old model of banking i.e. raise funds by mobilizing deposits and exercise prudence

[1] The word bank is used to denote a commercial bank.

in lending them onward at a reasonable margin.[2] While this statement might be perceived as naïve, simplistic and in contravention of the accepted benefits of progress and innovation, the fact remains that: (1) the negative externalities of the complex financial structures under the guise of innovation have done insurmountable damage to the notion of confidence in the allocative efficiency of the financial system, and (2) with the drying up of wholesale funding sources and trading avenues for securitization instruments, various efforts to revive the financial system have focused on a back to basics approach. Admittedly, banking crises in particular and financial crisis in general cannot be avoided and are seen as an inevitable fact of life: history is replete with episodes of financial distress across various jurisdictions in financial systems at various stages of development. But the impact of the combination of two factors – a *gradual* as opposed to the *frenetic* approach towards financial liberalization, and the prudent, and maybe even interventionist model of banking supervision and regulation – is irrefutable in insulating the banking system in emerging economies in Asia, from risks of the nature seen in recent months.

Banks in Pakistan predominantly rely on their deposit base for funding their expansion in assets, but I would still emphasize on the need to strengthen prudent asset-liability management by banks, particularly in view of their maturity transformation.

3. Will Smaller Banks Make the Financial System Safer?

There is a lot of talk about whether *Too Big to Fail* is *Too Big to Exist*. Today the financial sector in Pakistan is moving towards increased consolidation with SBP's MCR requirements aimed at establishing larger and more resilient financial institutions. So in view of the events of the current crisis, the question is – are smaller institutions necessarily safer?

The answer actually lies in the governance of an institution, in its funding model and the extent of its leverage. It is not the size as such but the degree of interconnectedness which again is linked to the funding model. Large banks in western economies were interconnected due to their dependence on wholesale funding. It was not Lehman Brothers' size but its interconnectedness with the rest of the financial system which turned its failure into a problem. So we need mechanisms to reduce the impact of interconnectedness. Financial regulation should be designed for large banks to hold capital and liquidity buffers that account or the systemic risk they pose, and their organization structure should enable an orderly winding down.

Notably, large banks are useful for the economy and business, they have the capacity to finance, arrange and handle the complexity of large deals. Moreover, they can better afford the increasingly expensive investments in information technology, risk management and market infrastructure that are also conducive to enhancing financial stability. To reiterate, financial stability is about preventing systemic risk – size is a relevant but not a sufficient factor in identifying systemic risk.

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[2] Also referred to as the 3-6-3 model of banking, where bankers borrowed money at 3 percent, lent it at 6 percent and were on the golf course at 3 pm, Economist, March 7-13th, 2009.

4. Macro-prudential focus

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. As this crisis has shown all too clearly, individual institution stability does not necessarily translate into overall financial system stability, primarily because it fails to take into account the degree of interconnectedness of various financial institutions with each other.

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 conjunctural and structural trends in financial markets so as to give warning of the approach of financial instability. Elements of typical prudential regulations which include minimum capital and liquidity requirements, framework for supervisory inspection, deposit insurance and other safety nets, and problem bank resolution mechanisms, need to juxtapose with requisite tools for macro-prudential analysis such as establishing Early Warning Systems which can generate out-of-sample probabilities of crisis using historic data.

5. Pro-cyclicality of Financial Regulation

Procyclicality refers to policy actions or regulatory requirements which tend to amplify the stage of the economic cycle. While procyclicality is not a new concern, it has assumed a central role in the current crisis by serving to exacerbate the vulnerabilities of the banking sector by the continued requirement of high capital requirements in a recessionary cycle. Additionally, there is now the view that loan loss provisioning rules are not only backward looking, they also tend to have a short-term horizon, and in a way these tendencies allow excessive risk-taking during economic upswings. There is also the concern that the Basle II capital requirements could exacerbate the potential procyclical behavior.

Work is now underway by the various working groups and committees to formulate regulatory policies that would provide a counter-cyclical support to policy actions. Notwithstanding, any proposed framework would need to balance the considerations of a rule-based approach with discretionary prudential policy-making.

Conclusion

The current 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.

Having observed the 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. Effective regulation is the preferred route for central banks responsible for safeguarding both monetary and financial stability.