REGULATIONS, GOVERNANCE AND FINANCIAL SYSTEM STABILITY - RELEVANCE TO THE GLOBAL CRISIS

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1. Financial Crisis : 2007 - 2009

Financial crises are not new. In fact, they appear to occur periodically and take markets and regulators by surprise. They generally arise in an unexpected fashion or area, which is hardly surprising, as it is almost axiomatic that a crisis, particularly a financial crisis, is not foreseen. Presumably the ones that were foreseen were forestalled. What then sets the current crisis apart from others that have occurred in the past few decades? Every crisis has been followed by regulators and supervisors attempting to learn from the experience and ensure that such a crisis does not recur. Why then has this particular crisis led to a fundamental questioning of regulatory and supervisory paradigms?

This short paper will examine these and related questions, and consider what changes are likely to take place, going forward. The focus will be on issues of governance and regulation in relation to financial system stability. The ideas presented will attempt to provide some insight, though they will certainly not be exhaustive.

2. What makes this crisis different?

One could perhaps suggest three main features that make this crisis stand out.

a. Its magnitude
b. Its origin/source
c. Its implications for regulatory and supervisory regimes, and even for fundamental economic beliefs.

a. The magnitude of the crisis

No conclusive value of the impact of the crisis is likely to be computed[2]. What is clear

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[1] The views expressed in this article are those of the author and not necessarily those of the Central Bank of Sri Lanka.

[2] However, a recent estimate put the total value of all country and regional bailouts at US$ 2.7 trillion, the value of all country or regional guarantees at US$ 6.9 trillion and the total value of all country or regional stimulus packages at US$ 9.7 trillion. -*Global Financial Crisis: Bailout/Stimulus Tracker* (17 July 2009) (http:\\www.grailresearch.com)

however, is that at the height of the financial/banking crisis, financial markets, as we know them, for all practical purposes, ceased to function. The world was given a stark reminder that modern economies and markets function on confidence. A significant erosion of such confidence can and did paralyse the most 'sophisticated' and 'efficient' financial markets in the world. Further, the crisis in the financial sector led to a crisis of such intensity in the real sector that the world economy has experienced a recession not seen since the dark days of the Great Depression of the 1920s and 1930s.

b. The origin/sources of the crisis

The financial crises faced by the world in the last few decades have originated in the emerging or 'developing' markets. The threat to stability in the 1980's originated in Latin America, while the crisis in the late 1990s commenced in East Asia, before spreading to Russia and other countries. In these instances, the blame for the crises was placed on the unsustainable economic policies, the inadequate regulation, the market inefficiencies, etc., of these countries or regions. Such problems, it was argued, could not possibly arise in the well functioning, well regulated markets of the developed economies. However, events have clearly proved that the current crisis originated in the sub-prime mortgage market in the US, a small part of the largest financial market in the world. The term 'sub-prime crisis' has now virtually become synonymous with a disastrous sequence of events.

c. Implications for economic beliefs and regulatory and supervisory regimes

The crisis was so far reaching that the basis of free market economics itself has been questioned. The magnitude of the problem, and the failure of markets to correct themselves, compelled many OECD country governments to intervene directly to resolve issues of liquidity and confidence. These interventions resulted in de facto nationalisation of financial institutions in economies which had hitherto been utterly averse to such actions.

Moreover, it has become apparent that weaknesses in regulatory and supervisory regimes that were regarded as 'exemplary', exacerbated the problems. In addition, the models of regulation and supervision that have evolved in the past few decades, e.g., the multiple regulator systems adopted by the USA and UK, were found to have contributed to the failure of the system.

From a central bank perspective, the crisis brought into question the perceived wisdom acquired in the recent decades, that central banks should focus more and more on price stability, to perhaps the exclusion of all other objectives. It has become fairly obvious that, although in normal circumstances central banks could perhaps focus exclusively on price stability, in instances such as this, when the financial system is in crisis, financial system stability becomes as important, if not more so, than price stability.

3. Background to the Crisis

In order to have a better understanding of the impact of the current crisis on governance, regulation and financial system stability, it is important to consider the factors that led to it. Analysts have concluded that the crisis was the result of a number of factors coming together – almost a perfect storm. Given below are some of the main factors.

a. It is argued that one important factor that led to the crisis was the low interest rate regime and excessive market liquidity that had been created to support the US economy to overcome the impact of the 'dot com bubble'. This argument maintains that interest rates were kept too low for too long. Compounding this was the policy to encourage home ownership which, although beneficial in itself, led to excessive credit being granted for home mortgages at unsustainable rates with little attention being paid to basic concerns regarding ability to repay.

b. A second reason was the creation of complex financial products whose risks were not clearly understood by the originators; clearly a classic case of poor risk management and failure in governance.

c. Closely related to this governance issue were the incentive schemes for pay and compensation that encouraged the creation of such complex instruments with no off-setting regard to risk.

d. Evidence has also emerged that inadequate regulation and supervision by the relevant authorities had permitted these financial institutions to engage in such risky behaviour.

e. An additional factor that transformed the sub-prime issue from being a problem in a minor segment of the US financial system into one that affected the entire world was the establishment of global links amongst financial institutions everywhere. Although globalisation of financial services has brought many benefits to the world economy, this particular instance is clearly a case where infection in one part of the system spread to the entire world because of globalisation.

Doubtless there will be more analysis in the future, which will continue to throw further light on the causes of the problem. However, the current understanding provides enough information for action in respect of governance and regulation, in the interests of financial system stability.

4. Governance

Broadly speaking, the main issues relating to governance, arising from this crisis, are as follows.

a. The boards of directors and top management of many of the financial institutions that engaged in these sub-prime transactions appear not to have understood the ramifications of the transactions into which they entered. Or worse still, appear not to have cared, so long as profits were generated.

b. There appears to have been a basic lack of accountability. The model "originate to distribute" has an inherent weakness in that the usual due care exercised, in the case of "originate to hold", does not appear to be applicable, because once risk is distributed, there seemed to be no accountability on the part of the originators.

c. The transactions themselves were often highly complex. It is sometime alleged that the complexity was deliberately designed to create opacity so that regulators would not be able to regulate and supervise.

d. In many instances, it appears that there has been a conflict of interest on the part of Credit Rating Agencies in the matter of rating these instruments. This has been aggravated by the over reliance on these ratings by investors, thereby failing to carry out their own due diligence studies.

There is little doubt that there were serious governance issues that contributed to this crisis. Hence, any proposals to avoid a repetition of the crisis would need to bring about improved governance.

5. Regulation

An important consequence of the current crisis is that it has brought into question some fundamental aspects of regulation that have evolved in the past decades. The crisis clearly demonstrated that markets do not necessarily correct themselves. Even as diehard a believer in the efficiency of markets as Alan Greenspan was forced to concede this. It also exposed the weaknesses of having multiple regulators for the financial system. The numerous regulators in the US system were woefully inadequate in preventing the crisis. Similarly, it is argued that in the UK, the creation of the FSA, with the supervisory and regulatory functions being removed from the Bank of England, was a significant contributory factor to the Northern Rock debacle. This latter was an eye opener to many regimes, as the UK system had been regarded as a model to follow, since the introduction of this separation. It also became apparent that the operations of entities such as hedge funds, about whose activities very little information was available, and which were not under the purview of any regulatory authority, vastly magnified the problem. The realisation of the adverse impact of such unchecked operations is reflected in the fact that even

financial centres such as London and New York, which had strongly resisted imposing any constraints on the operations of such entities, are now much more amenable to the prospect of regulation. Finally, perhaps one of the most ironic outcomes of the crisis is the suggestion by the G20 that Credit Rating Agencies should also be brought under regulatory oversight. Ironic, because these Rating Agencies were expected to bring discipline to the market.

The foregoing amply shows both that regulatory weaknesses contributed to the origins of the crisis, and that far reaching reforms in regulatory regimes are inevitable, as countries seek to avoid repetition of such failures.

6. Financial System Stability

The crisis brought the world's financial system to its knees. Achievements that had occurred over decades were set aside, if not destroyed, in a matter of a few weeks. Perhaps even today, we are not quite aware of how close the world was to a global financial meltdown. It demonstrated that despite all the sophistication of modern markets, all the built in safeguards, the entire edifice rested on confidence. Once this confidence was lost, the system simply froze. And confidence was a very fragile thing. Financial houses that had stood for decades, that were considered rock solid, were unable to withstand the erosion of confidence, and hence collapsed. Consequently, underlying all the frenzied efforts of the governments of large market economies, lay a basic effort to restore confidence. The enormous stimulus packages, the government guarantees on deposits, the effective nationalisation of private banks and financial institutions, were all fundamentally designed to restore confidence.

The focus of political and economic authorities was on financial system stability. Even central banks, which in the last few decades had moved away from everything but price stability, were forced to confront the reality that in a crisis of this magnitude, price stability was effectively of secondary importance. This has led to much soul searching among central bankers who were convinced of the primacy of price stability as an objective of central banks, and a reluctant acceptance that perhaps financial system stability too merits close attention.

7. The Aftermath

At the height of the crisis, some strident and triumphant voices proclaimed the death of the free market economic system. A year has elapsed since the collapse of Lehmann Brothers. Financial markets, although severely battered, have survived. The global economy is showing signs of recovery from the recession. Thus, the obituary for the free market system appears to be rather premature. It is also evident that neither globalisation nor the evolution of financial markets and instruments can be suppressed or reversed. However, the international economy, in particular financial markets, has been badly shaken. This will undoubtedly call forth strong action from those responsible for overseeing major economies. As succinctly noted by one author, "The most

serious financial crisis since the 1930s Great Depression will elicit the most comprehensive and robust international regulatory response.....'[3]. This was echoed by the UK's Chancellor of the Exchequer Alistair Darling, who was quoted by AFP as saying 'there should be no let up in the reform of the financial sector'[4].

As expected, governments, academics and regulators have studied the events and their outcomes, and made recommendations for the reform of regulation of financial markets. Although there is no uniformity of view on what measures are appropriate, and certainly no finality on practical decisions, there is broad agreement on the areas that should be addressed. These can best be summarised by examining the recommendations of two extremely influential groups.

a. The Group of Thirty (G30), an international body consisting of some of the world's leading financiers and academics, launched a project on financial reform under the leadership of a Steering Committee chaired by Paul A. Volcker, a former Chairman of the US Fed. The result, published in January 2009[5], yielded 18 major recommendations under five main areas or principles. The five principles were:
   a. The public sector role in safeguarding financial stability
   b. Fair and effective competition
   c. Official oversight and crisis response
   d. International consistency and coordination
   e. Governance and risk management

Based on these, four core recommendations (which were expanded to 18 recommendations) were put forward.

i. Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated.
ii. The quality and effectiveness of prudential regulation and supervision must be improved.
iii. Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity.
iv. Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.

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[3] Clarke, Thomas (2009), *Regulatory responses to the global crisis – the next cycle of corporate governance reform?* Keeping Good Companies, June 2009, Vol.61, No.2.
[4] AFP (31 August 2009).
[5] G30 (2009) – *Financial Reform – A Framework for Financial Stability*

b. Similar ideas were expressed by the Group of Twenty (G20) in their Declaration on Strengthening the Financial System[6]. As the G20 comprises finance ministers and central bank governors of the 19 economically most important countries and the EU/ECB, the communiqué gives strong signals on the directions of future reform in the international financial sector. In summary, the Declaration envisages:

i. The Financial Stability Board (successor to the Financial Stability Forum) being given a broadened mandate to promote financial stability;
ii. Strengthening international co-operation;
iii. Strengthening international frameworks for prudential regulation;
iv. Subjecting all systemically important financial institutions, markets and instruments to an appropriate degree of regulation and oversight;
v. Ensuring that pay and compensation in significant financial institutions are consistent with firms' long-term goals and prudent risk taking;
vi. Taking action against tax havens and non-co-operative jurisdictions;
vii. Improving accounting standards, particularly with regard to the valuation of financial holdings;
viii. More effective oversight of the activities of Credit Rating Agencies.

The foregoing are evidence of the desire on the part of international opinion makers and leaders to reform the financial system to ensure that there is no recurrence of the stupendous financial crisis just faced. The extent to which these policies and principles can and will be implemented remains to be seen. Nevertheless, tightening of regulation and supervision is inevitable.

The major challenge faced by these policy makers is to ensure adequate regulation that would engender stability and activity in the financial system, while avoiding the excesses of over-regulation which would nullify the beneficial influences of a vibrant and dynamic financial sector.

A basic question that needs to be asked is whether even the implementation of all these policies would ensure that financial crises would be eliminated. The answer is probably, sadly, no. The history of regulation in the past century or so is that increased and improved regulation has been introduced after every crisis. Nevertheless, modern history is also replete with incidents to show that crises were not eliminated. They appeared in different forms and in different places. Perhaps the best that one can hope for is that the frequency and magnitude of crises would be dampened.

8. The Sri Lankan Context

By and large, the initial international financial crisis had very little direct impact on the financial sector in Sri Lanka, although the consequent world recession most certainly did have

[6] G20 (2009) – *Declaration on Strengthening the Financial System* – Communiqué, 2 April 2009.

noticeable ill-effects on the entire economy. This resilience of the financial sector was not accidental or fortuitous. The strong regulatory framework and the conservative culture of the banking sector, although derided in some circles in the past, were found to be of solid worth. The exposure of banks operating in Sri Lanka to the so called 'toxic' assets was practically nil. The fundamentally sound banking practices adopted enabled the avoidance of 'sub-prime issues'. The regulatory requirements ensured that adequate capital and liquidity were available. At a more macro level, the tight monetary policies adopted in late 2007 and early 2008 created sufficient space for some relaxation of policy, to offset the negative effects of the world recession. This was of significant importance as the Government's ability to put in place a fiscal stimulus package, as done by some other countries, was limited.

However, there is no cause or room for complacency. In as much as there is likely to be greater regulation internationally, Sri Lanka's own regulatory framework would need to be strengthened. A sound regulatory framework is one that is not static, but evolves continuously to meet changing conditions.

9. Conclusion

It is no exaggeration to say that in the past year or two, the world teetered on the brink of an economic catastrophe not seen since the disastrous days of the Great Depression. A multitude of reasons are adduced to explain this. Although analysts will continue to debate, there is general consensus that fraud, excessively loose monetary policy, over complex financial instruments, bad risk management, ill designed compensation schemes and lax regulation all played their part in creating the disaster. The crisis also clearly brought to the fore the negative effects of globalisation, while highlighting that substantial weakness existed not only in the financial systems of emerging and less developed countries, but also in countries with highly developed economies. The world learned that modern financial markets are based on confidence, and that if this confidence is lost, then all is lost. Moreover, it became apparent that emerging markets were still not decoupled from developed markets, and also chaos in the financial sector would damage the real sector.

Fortunately, by the exercise of pragmatism rather than ideology in many developed markets, and the injection of unbelievably large amounts of funds by governments and central banks, the danger of a second and perhaps more destructive Great Depression appears to have been avoided. Events, however, have not yet played out their course, and the effects of these injections into the markets will only be seen over time. The crisis alerted policymakers to the many weaknesses in the international financial sector. Alarmed leaders, both financial and political, are now engaged in efforts to revamp regulatory frameworks worldwide. Although the exact forms and practical applications of these reforms are not yet known with certainty, there will unquestionably be tightening of regulations. The world has learnt, to its cost, that complacency is a recipe for disaster, and that constant vigilance is essential to maintain stability.