REFLECTIONS ON THE CRISIS AND THE SUPERVISORY ARCHITECTURE

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Introduction

The basic tenet underpinning the transformation of the global financial system in the last twenty years has been that it would enhance the efficiency of its main economic functions. Public authorities, academics and market analysts were all confident that the new global financial system was channelling savings to investment more efficiently, allowing better risk distribution and management and making the system more stable. The size of rewards to shareholders, directors and senior management seemed to be the logical corollary.

Yet, this belief has been shattered by the crisis of 2007-2008. It is already evident that **the new global financial system has actually been very inefficient from a dynamic perspective.** During the upswing, too many resources were channelled to relatively unproductive investment projects, while risks were poorly priced, ill distributed and insufficiently spread. More worryingly, after the escalation of the crisis during September and October 2008, the system has been on the verge of collapse, jeopardising the continuity of its economic functions. Paralyses in money and credit markets and waning confidence have created the threat that the financial system might cease taking risks and providing funds to businesses and households.

Confronted with this emergency situation, **public authorities have taken unprecedented coordinated actions**. This entailed the massive assumption of banking sector risks by taxpayers in exchange for adequate remuneration, in order to prevent a dangerous downward spiral in asset prices, credit and the real economy. These actions have been widely considered as the appropriate way to lay the foundations for a gradual stabilisation of the financial markets. But they have also been greeted with understandable public outcry: putting billions at risk to prop up an industry, which has been enormously profitable over the last years, is not easy for citizens to understand. The legitimacy of a state of affairs in the financial sphere where private agents reap the rewards and the public purse bears the risks when things turn ugly is clearly questionable.

To reflect on these challenges and their implications for financial supervision, I have organised my comments in the following way:

1. Some quick questions and answers
    a. What has changed in the global financial system?
    b. What went wrong?
    c. What should be done?
2. The architecture of financial supervision

I will end with some conclusions, and I will be happy to take questions, subject to our time limitations ... and particularly to my English.

Obviously I will give you my personal opinions.

I trust that these reflections complement this seminar and satisfy the organizers, who asked me for a keynote under the modest title of "Globalization: Challenges and Responses".

1. Some quick questions and answers

1. a. What has changed in the global financial system?

The world financial system has gone through a major transformation process in the last three decades. The financial system is now:

- **Bigger with respect to the economy**: The ratio between financial assets and GDP has more than tripled between 1990 and 2006, to 346%.
- **Global**: There has been a huge increase of cross-border capital flows and foreign ownership of assets, between developed countries and, increasingly, emerging market economies.
- **More complex and more lightly regulated:** new actors—hedge funds, private equity, SIVs, conduits—and new instruments—notably credit derivatives and ABSs—have appeared, with little public oversight, despite their influence on liquidity, asset prices and leverage.

1.b. What went wrong?

This global and more sophisticated system was thought to be efficient and more stable, but the present financial crisis has proved it to be both inefficient and unstable. So, what went wrong? We can see closely interrelated failures on three fronts:

- **Market failure.** Actors' incentives were badly aligned: those of senior managers of financial institutions (too focused on the short term) and those of financial investors and savers (in their due diligence) and others (rating agencies).
- **Oversight failure:** Regulatory and supervisory frameworks were poorly designed in terms of institutional coverage and instruments, leaving room for the development and worldwide distribution of bad assets (i.e. subprime).
- **Macro policy failure:** The orientation of monetary and exchange rate policies favored excessively loose monetary conditions for too long and enabled them to spread worldwide.

1.c. What should be done?

In the short term, the efforts that we have seen over the past months on the part of most of the major countries in the world economy to stop the negative dynamic and stabilize the financial system through parallel and coordinated actions across the biggest economies should continue. But the extraordinary measures that are being taken to cope with today's problems should not result in lasting financial interventionism. Quite the contrary, the end goal should be to return to an efficient and safe market financial system that is privately managed. Otherwise, the costs to the global economy in terms of lower potential growth and standards of living would be very large.

In a longer-term perspective, reform should start from a thorough analysis of what has failed in this crisis, starting with market failure itself. At the micro level, information asymmetries, agency problems and difficulties in making the right decisions under uncertainty have been evident. At the aggregate or macro level, the depth of the coordination failures linked to the inherent fragilities of the financial system has been stunning, and this calls for the adoption of a new conceptual approach. Behavioural biases in decision-making and market mechanisms interact to create self-sustaining waves of boom and bust with various associated feedback loops. **Regulation and supervision have to be substantially redesigned to effectively address these failures, some of which have been aggravated by existing rules or wrong-headed public decisions.**

Reform should aim at making the market work for the benefit of all, putting aside any temptations to go back to financial *dirigisme***.** The recent actions to capitalise banks notwithstanding, it should be stressed that decisions about investment, credit and risk must remain in the hands of responsible individuals and companies, within the framework set by regulators and supervisors. The challenge is to seize the welfare-enhancing potential of market-based finance and innovation without repeating the mistakes of the past. To achieve this, action by public authorities should attempt to provide the right incentives in order to align private costs and benefits with social costs and benefits.

The other salient feature of the 2007-2008 crisis has been the scale of contagion. Problems in one (not particularly big) corner of the financial markets have immediately affected markets for all kind of financial instruments in different countries. **This is a real and painful reminder of the global nature of today's financial system.**

If market-based finance is to become a sustainable force for prosperity, it needs a robust institutional framework. The private sector will contribute to it, by changing many of the failed practices and business models of the past. And the public sector has to contribute by substantially improving regulation and supervision. Finally, this new set-up has to be global, so as to capture the relevant dimension of today's financial landscape.

As a consequence of all these elements, in parallel with the short term responses recently put in place, a necessary step is to address the significant shortcomings of the international financial system that the current financial crisis has unveiled, including governance, regulatory and supervisory matters. It is paramount that the scope of the revamped standards is broad, both in geographical and sectorial terms: **all agents performing the same economic activities should be subject to the same standards, and all those who pose a risk for the stability of the system should be closely monitored**. New financial standards need to be developed in six areas:

a. **Transparency and improved financial decision-making.** In spite of a substantial flow of available information in the marketplace, both mandatory and voluntary, the crisis has shown that even the smartest institutional investors lack timely, reliable and easy-to-understand information on which to base efficient decisions. Measures are needed both at the wholesale and issuer levels, as well as the retail customer level. In this regard, work related to:

   i) Ensuring that regulated entities provide information on the basis of their consolidated accounts, including all risks,

   ii) Enhancing disclosure requirements for liquidity risk and credit risk,

   iii) Establishing mandatory disclosure requirements for hedge funds and private equity funds with regard to leverage ratios and liquidity risk, and

   iv) Reinforcing current initiatives to regulate and oversee rating agencies, would be of interest.

   Furthermore, financial education of consumers needs a substantial improvement and work is needed on requirements on the creditworthiness of banks and non-banks to provide potential clients with fair and relevant information on potential risks of the products offered (stressing, for example, the probabilities of increased monthly payments and clearly disclosing the upfront and the early amortisation fees) and identification of deceptive, abusive or risky lending practices should be reinforced.

b. **More resilient market infrastructures.** Uncertainty about valuation and fear of counterparty risk has severely impaired liquidity in a range of OTC markets, including the interbank money market, ultimately bringing them to the verge of paralysis. Transaction costs have soared, overwhelming any trading gains. Even if some re-intermediation is inevitable, the way forward is not to allow direct market finance to wane. On the contrary, we need more and better functioning markets to continue to foster efficiency in capital and risk allocation. In this area, work on central counterparty arrangements for OTC markets, strengthening secondary markets for debt instruments (greater standardisation and post-trade transparency) and rehabilitating the markets in mortgage-related debt instruments as liquid, deep and low risk markets are of major importance.

c. **A stronger and counter-cyclical prudential framework.** The international prudential framework has been overhauled in recent years, with the Basel II capital requirements entering into force in 2008 and fair value accounting for financial instruments being applied in both IFRS and US GAAP. Many fundamental aspects of the current framework are sound. Nonetheless, the fragilities and failures exposed by the crisis call for substantial enhancement in the prudential framework with two main objectives: first, create higher margins of safety in the financial system; second, incorporate counter-cyclical elements in the prudential framework.

d. **Indebtedness must play a more central role**. The degree of leverage of households and firms must be taken into account in the regulation and supervision of financial firms, and must play a more relevant role in the decision-making process of monetary policy authorities.

e. **Corporate governance to support sustainable value creation.** The massive destruction of market value since July 2007 evidences a major failure in the governance of financial institutions in the last few years. Shareholders have tolerated a model of governance focused on the short term, which has benefited mainly directors and senior management and has harmed long-term investors and employees. A change of culture is needed in the governance of financial institutions towards sustainable value creation.

f. And last, it is of paramount importance that the new financial standards described above are **enforced properly** in order for the reforms to be effective.

All of this was covered at the recent G-20 meeting in Washington. But there is a central issue upon which the financial sector, and particularly the regulators, should reflect in order to achieve these goals: what is the most appropriate financial supervisory architecture in complex global markets? That is the subject of the second part of my talk.

2. The architecture of financial supervision

Financial stability, as a goal of public policy, should be construed in a broad sense to include not only the safety and soundness of financial institutions but also the proper assignment of resources in the various markets.

In fact, the subprime crisis has put global financial stability in jeopardy principally through objective deficiencies in market functioning, such as a lack of transparency about issuers, products and the terms of the transactions, and deficient performance by the rating agencies. But the crisis has also brought out problems on the part of the authorities and market actors in comprehending and assessing the complexity and size of the financial markets, and the risks that they produce.

Accordingly, in order for any supervisory approach to be effective, it must devote sufficient attention not just to institutions' solvency but also to the behavior of market participants and to market functioning. On this depends the efficiency with which markets are able to operate and, consequently, facilitate stable and sustainable economic growth.

What models of supervision are available to address these challenges?

In the developed world, we observe a range of models of financial supervision, which can be divided basically into three types (note [1]):

i. The traditional model of institutional supervisors.

Under this model, there is a separate body in charge of full supervision of each of the main financial sectors: lending, insurance and securities. Banking supervision is normally assigned to the central bank. I consider this model to be outdated since the borders between these three areas of financial activity are becoming increasingly complex and diffuse. Efficient functioning requires good coordination, which is not always easy to achieve. Moreover, each supervisor maintains its own list of priorities with regard to prudential matters and conduct of business within its sector, which may result in either area receiving insufficient attention. It is quite a common approach, but there is general agreement that it is suboptimal; consequently, many countries that currently use it are considering the adoption of the twin peaks approach or the integrated approach.

Brazil, France, Italy and Spain have this type of supervisory architecture. So do China and Mexico, with some variations.

ii. The integrated approach to financial supervision.

In this model, a single institution—which is not the central bank—is in charge of soundness oversight and conduct-of-business regulation for all financial institutions. This approach should lead to an efficient use of supervisory resources by taking advantage of synergy in overseeing the various activities of a given entity. However, some recent cases in countries with a single supervisor illustrate the difficulties that may arise in the coordination between the central bank, which manages the system's liquidity, and the supervisor. Finally, as in the institutional approach, this approach leads to the establishment of a hierarchy between the prudential function and the conduct-of-business function, which may not always coincide with what is desirable from a social standpoint.

Canada, Germany, Japan, Qatar, Singapore, Switzerland and the United Kingdom have adopted the integrated approach.

iii. The twin peaks approach.

This approach is based on regulation by objective. The supervisory functions are assigned to two separate but appropriately coordinated institutions. One of them is in charge of conduct-of-business oversight of the participants in all the financial markets; the other, which is normally the central bank, oversees the safety and soundness of all relevant financial institutions, regardless of whether or not they have a bank charter. This approach guarantees proper coordination between liquidity management and prudential supervision since both functions are handled by the central bank. Moreover, and this may be its

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[1]An excellent description of the supervisory approaches that exist in the most financially-developed countries can be found in *The structure of financial supervision. Approches and challenges in a global market place* by the Group of Thirty –chaired by Paul A. Volker, which was published recently.It can be found at: www.group30.org

main virtue, the twin peaks model ensures that proper attention is given to the two matters that are vital to the preservation of the financial system's stability: namely, financial institutions' safety and soundness, and the proper functioning of the markets in financial products and services.

This is the approach adopted by The Netherlands and Australia, but such countries as Italy, Spain and France are considering it, as is the United States, according to the current Administration's plans.

Finally, there is a notable exception: the United States. Given the size and importance of the US in the financial markets, this difference is very significant. The current supervisory structure in the US is quite complex and it has been questioned,, particularly as a result of the recent crisis (note [2]). Basically, the US applies an institutional approach but with very peculiar characteristics and the added complexity of a large number of state-level agencies with supervisory powers. The current Administration apparently wants to move towards a twin peaks approach.

What conclusions can be drawn from this situation in the light of the current crisis? There are many. I will focus on just two, which I consider to be very clear, in connection with financial stability.

The first is that, if we accept the reality of complex globalised financial markets where the traditional borders between banking, insurance and securities are blurred, then, regardless of their regulatory approach, countries must pursue intense and effective cooperation between the supervisory agencies, the central bank and the Finance Ministry in order to preserve financial stability. Evidently, the more complex the supervisory architecture, the more difficult it will be both to coordinate and to assess the type and scale of the risks that the financial system is taking on. Also, the more complex the supervisory approach, the greater the risk of regulatory arbitrage and of information asymmetries in the market.

The second conclusion refers to international coordination. In the same vein as the previous comment, there have been many expressions of concern that the current supervisory architecture for international coordination and exchange of information is inadequate for complex global financial markets. The problems describe at national level are replicated at international level. And there is an aggravating factor. Multilateral institutions, which seek to develop international standards and information exchange between supervisors, cannot be expected to act in unison to address an international crisis such as the present one, although they can and should provide very relevant ex-post analysis.

In short, the design of the supervisory architecture at national and international level is a key factor in preserving financial stability. Standardization, which is positive and sought on many fronts (such as in accounting and auditing standards, capital requirements, etc.) in order to improve the global financial markets, should also be applied to the supervisory architecture.

There are too many approaches at present, and the debate is open. I believe the twin peaks approach is superior to the integrated approach, although the latter may be a reasonable solution for countries whose financial markets are not very large. In any

[2] Blueprint for a Modernized Regulatory Structure, presented by Treasury Secretary Paulson to the US Congress in March this year.

case, the classic institutional model should be abandoned, which would contribute to the standardization and simplification of supervisory approaches that is so necessary to preserve financial stability.

Conclusión

The financial history of the last 20 years has a number of clear characteristics: growing globalisation and sophistication in the financial markets. These features have led to changes in the behaviour patterns of issuers, intermediaries and investors, and have substantially altered the range of products on offer. Particularly notable is the growth, perhaps excessive, of financial derivatives. At the same time, the development of the markets has made the work of financial supervisors more complex. Consequently, although markets have become more efficient, the successive episodes of turbulence and crisis throughout the world in recent years have brought to light a number of notable deficiencies. Those episodes, though differing in nature, reveal a common pattern: for example, their impact is increasingly felt throughout the world, affecting a growing number of regions and markets and often significantly impairing economic growth and employment.

In this context, the relatively recent concept of financial stability has been modified gradually to reflect the growing complexity of the financial system by adding the concept of proper market functioning to the traditional component of bank safety and soundness. At the same time, the goal of financial stability so defined has been gaining in importance in the framework of public policy. Regrettably, the current crisis has provided a harsh reminder that much work remains to be done in order to preserve financial stability in the modern world.

The supervisory architecture would appear to be vital to successfully maintaining financial stability. Without a supervisory approach that is responsive to the current financial system, which is more complex and global, we will depart from that public goal and will fail to take full advantage of the positive effects of a more competitive, efficient financial system. Since the old functional approach to supervision (which separates banking, insurance and securities) has become obsolete, an integrated approach and the twin peaks approach are the two options around which countries are adapting their structures. Spain is moving towards the twin peaks option, which I consider to be the one best suited to our situation.

In any case, regardless of the supervisory approach that a country chooses, the current turbulence has shown that financial stability can only be maintained with determined international cooperation. In my opinion, this will enable the multilateral agencies to gain in importance in the immediate future. It is also advisable for countries to converge their systems of organising supervision in order to better align their objectives and practices and thus improve coordination. The role of the IMF, the Financial Stability Forum, IOSCO and the Basel Committee should be enhanced with determination in order to ensure that the financial markets unleash their positive potential to facilitate solid, stable economic growth.

Those multilateral bodies have a key role to play in preserving financial stability in a global world.

Thank you very much for your patience and attencion