

Governance Challenges for Ensuring Global Financial Stability

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Disclaimer

The views expressed are personal.

Road Map

- Existing policy framework for safeguarding global financial stability
- How/Why did this architecture fail?
- Options for reforming governance over global finance

Road Map

- Existing policy framework for safeguarding global financial stability

Sources of cross-border systemic risk

- Financial Institutions – primarily large, international banks/groups.
- Global Financial Markets – FX, bond, and over-the-counter derivatives markets.
- Unregulated Financial Activities – Institutional investors (insurance, pensions, hedge funds)
- Financial Infrastructures – such as clearance, settlement, and payments systems (not discussed here)

Lines of defense against cross-border financial problems

- Private risk management and governance
- Market discipline – adequate disclosure via financial reporting and market transparency
- Appropriate regulations, oversight of financial institutions and markets, and legal enforcement
- Crisis management and resolution (more detail later)

Oversight Regimes for Systemic Risk Management

Sources of Global Financial Systemic Risk

Lines of Defense	Global Financial Institutions	Global Money and OTC Derivatives Markets	Unregulated Activities
Pvt. Risk Mgt & Market Discipline	Partial	Primarily	Exclusively
Market and Banking Regulation	National with cooperation	Not really; over-the-counter transactions	No
Prudential Supervision	National and Home/Host Issues	n.a.	No
Market Surveillance	Indirect, as participant	Direct; National and International	Indirect, as participant

Source: Adapted from Tables in Schinasi (2007), 'Remarks on Causes and Conditions for Cross-Border Threats to Financial Stability,' chapter in FRB Chicago Conference Volume.

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Global Crisis: What went wrong?

Failures in all lines of defence.

- Markets dysfunctioned because of
 - Imperfect information
 - Opaque instruments and exposures
 - Poor incentive structures; excessive leverage
 - Inadequate governance/control by top management
 - Insufficient 'ex ante' market discipline
 - Loss of trust
- Official supervision failed to promote safety and soundness of major institutions
- Market surveillance failed to identify build up of imbalances
- Central bank and treasury tools proved to be too limited to address liquidity/solvency issues in restoring market trust and confidence

Why did existing architecture fail?

- National orientation of supervision/surveillance
 - Can existing national focus anticipate or prevent problems in cross-border institutions?
 - Can international groupings and committee structures provide sufficient early warnings?
- Central banks addressed immediacy of liquidity problems. But, underlying problem was credit/counterparty concerns?
 - CBs do not supervise all systemic institutions
 - CBs lack comprehensive authority to obtain necessary supervisory information – e.g., credit exposures – and intervene all systemic institutions.

Why did existing architecture fail?

(continued)

- Absence of regional and global financing mechanisms to recapitalize systemic cross-border institutions when deemed appropriate and necessary.
- Coordinated government efforts to recapitalize cross-border institutions (for example, Lehman Brothers and Fortis) reverted immediately to national ring-fencing and solutions.

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Options for reforming systemic risk assessment and management

- Centralized/coordinated surveillance of global 'interbank' markets to monitor systemic risk
- Two-tier banking supervision
 - Centralized supervision for cross-border/wholesale finance – the big players in OTC derivatives market
 - National/Local supervision for domestic/retail finance
- Regional/Global pre-committed financing for recapitalizing global/systemic institutions when deemed appropriate and necessary
- Uniform market regulation (one rule book) – designed/coordinated across major international financial centres.

Other essential reforms

- Bank capital requirements on off-balance-sheet and structured-product credit exposures
- Regulatory limits on bank leverage
- ‘Intelligent’ disclosure and market transparency
- Re-align compensation incentives with long-term stakeholder interests
- Hold bank executives, prudential supervisors, market regulators, and market monitors accountable for performance

Global Governance Issues

- What is the appropriate political level of leadership versus enforcement and implementation: Heads of State; Finance Ministers and Central Bank Governors; other authorities?
- What is appropriate geographic representation: can't have 185 countries making global financial risk assessments?
- How to communicate risk assessment without triggering market disturbances?

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