"Financial stability and the design of a new rule book"

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Introduction

Good morning, let me start by thanking the European Commission and, in particular, Marco Buti for his kind invitation to participate in the Brussels Economic Forum.

The global economy and financial system continue to face very important challenges, and this provokes the natural question of whether we need to throw out the old rule books for financial sector regulation and supervision, or whether it is sufficient simply to change a few pages and add new chapters. In other words, do we need a revolution or reform of our regulatory model?

Last month, in the course of the Spring meetings of the IMF and the World Bank in Washington DC, I discussed these very topics with representatives from the Fund's diverse and global membership, and I am glad to be able to share my thoughts with you on these subjects here today.

In trying to tackle this issue, I will first lay out my view of how the crisis is unfolding, since this helps frame the more medium term debate, then I will turn to the issue of regulatory reform.

I. An Assessment of the Current Situation

I will begin with an assessment of global financial conditions. The global financial system **remains under stress**, although there are some recent tentative **signs of improvement in financial markets**. The acute interbank stress following the Lehman bankruptcy has subsided. Counterparty and liquidity risks have declined, although they remain at elevated levels. As well, asset prices have rebounded from their recent lows. Emerging market equities and spreads have improved, and there are welcome increases in bank equity prices and a narrowing of credit default swap spreads, which had reached extraordinary levels in recent months. We are also seeing tentative signs that equity markets have reopened for banks, which is providing helpful scope for strengthening their capital position.

Like everyone else, I am heartened to see these signs of improvement. But like many, I do worry that the green shoots that have emerged may still be vulnerable to a spring frost. This vulnerability underscores the critical need to avoid complacency and underpin these tentative signs of recovery with sustained policy commitment to healing in the financial sector. This is indispensable to regain and maintain confidence so as to have a sustained recovery.

What do I see as the main risks to these emerging green shoots of recovery? I would point to three in particular:

- First, that uncertainty about the **health of mature market banks** may continue to undermine their funding prospects, and more generally, confidence by markets and the public.
- Second, is the risk that private **capital outflows from emerging markets** continue or accelerate and deprive the world of a much-needed engine of growth.
- And third is the risk that the **medium-term sustainability of public finances** is compromised, including as a result fiscal support to financial sectors.

Looking at the **first risk, the vulnerability of banks' balance sheets**, the concern is that worsening credit quality will continue to weigh on banks' capital positions. Potential writedowns are likely to continue to accrue alongside deteriorating economic activity, and so banks that are already reeling from losses may not have sufficient amounts and quality of capital to perform their intermediation role adequately.

We already expect that the overleveraging that occurred over the last several years needs to be unwound. In the IMF's baseline forecast, we estimate that U.S. and European private sector credit could contract through 2009 and will recover only gradually thereafter. However, we cannot exclude the possibility of a more abrupt cut in credit, and our experience in earlier crises is that the speed with which credit gets

flowing again depends critically on the policy response. A policy response that is rapid, forceful, and effective means that we can leave the crisis behind us sooner. By contrast, a slow response tends to make the process longer and more costly.

Turning now to the **second risk, from emerging market capital outflows**, what is truly different about this episode is how broad and all-encompassing it has been. The epicenter was the United States, but it quickly spread to Europe and now to emerging markets. Cross-border capital inflows to emerging markets are expected to be negative in 2009, with only the possibility of recovery in 2010. Moreover, significant risks remain. A particular concern is the threat of a "sudden stop" of international capital flows to emerging markets, affecting predominantly private rather than sovereign borrowers.

Turning to the **third key risk, of impairing public finances,** we can see that the amount of net sovereign debt that will need to be issued in the short term in mature markets is very large. It is projected to rise from an annual average of about 1.6 trillion dollars over the last eight years to an annual average of about 4 trillion dollars over 2009 and 2010; that is, by a factor of two and a half. Market concerns regarding medium-term fiscal sustainability have notably affected the sovereign CDS spreads of mature market countries. The very narrow spreads before the crisis have given way to much wider spreads, though, very recently, CDS spreads have declined somewhat, perhaps reflecting some fall in uncertainty in markets generally.

II. The Immediate Policy Response

To deal with these important risks, the Fund has emphasized the need for immediate, forceful, and effective policy responses, which focus on restoring confidence in the financial system, and, particularly, in the banking system. We have advocated a three-pronged approach for achieving this important goal:

- First, continue to support bank intermediation through the provision of liquidity and funding guarantees, and take measures to restart securitization markets;

- Second, assess the soundness of banks' balance sheets, based on a careful analysis of the quality of each bank's assets; and

- Third, viable banks must be recapitalized and restructured where necessary, while nonviable banks must be promptly resolved. When bank recapitalization is needed, funds should be raised preferably in the market, and, only when this is not possible, should public funds be used.

Certainly, experience clearly teaches us that there is not a single approach for all countries. Indeed, countries are taking different approaches to implement these principles, and here I would cite the welcome steps recently taken by the U.S. and European countries to stress test banks and address their asset quality problems and capital shortfalls.

While these steps are welcome, it is important that all affected countries continue to make progress along these lines. However, I would offer two cautionary notes. While there is no one-size-fits all solution, care must be taken to avoid endangering cross-border competition and falling into financial protectionism. Second, meeting these principles over the short term should be consistent with the improvements required in the regulatory and supervisory framework over the medium-term.

Against this background, let me take up again the question I posed at the beginning of whether we need to throw out the old rule book, or rather re-write a few pages or add some new chapters.

III. Improving the Regulatory Framework

As we look to reform the regulatory framework for global finance, there are four issues that stand out:

- **First: do we need to expand the perimeter** of financial sector regulation and oversight, given the role played in the present crisis by the less regulated parts of the financial system?

- **Second, how should regulation deal with the excessive procyclicality in the financial system**, given that current market practices have exacerbated the earlier lending boom and subsequent crisis?

- **Third, do we need more and better disclosure**, given that a hallmark of the present crisis has been uncertainty over the quality of bank balance sheets?

- **Fourth, how do we ensure more effective cross-border regulation, supervision, and resolution** of internationally active financial institutions, something that is critical, as highlighted by the problems created by the failure of several such institutions in this crisis?

Let me look at each in turn.

Regarding the first question, the expansion of the perimeter of financial sector regulation and oversight, there were clearly instances in which nonbanks created problems in addition to banks. Reliance on market discipline proved to be ineffective in constraining risk taking outside the banking sector, and the failure of several nonbank financial institutions, which disrupted key financial markets, had systemic repercussions. So here I would suggest we need to add a chapter to the rulebook, with the aim of increasing the likelihood that the systemic risks posed by unregulated or less-regulated financial sector segments are identified and addressed alongside risks in the regulated sector.

Now, how should we do this? I have to admit that thinking along these lines is still at an early stage. But the key objective would be that financial activities that pose systemic risks are appropriately overseen, regardless of their legal form. Institutions that fall into such an expanded perimeter would be subject to increased disclosure

obligations, so that authorities can monitor activities and exposures to determine potential systemic risk. Institutions deemed to be of systemic importance would then be subject to higher levels of prudential oversight. Of course, I would expect that prudential requirements themselves should differ based on the type of institution or activity. It is important that such regulations include authority for supervisors to take rapid corrective action in order to contain an unacceptable build-up in systemic risk, and appropriate resolution tools to resolve failing institutions.

We should also acknowledge that there were clearly many instances in which the supervision of regulated financial institutions like banks was inadequate. Therefore, as we expand the perimeter of regulation, this must be accompanied by more effective implementation of rules.

The second area for reform is addressing elements of excess procyclicality in the financial system. Such procyclicality has aggravated the current crisis by both promoting rapid credit growth when the economies are booming and then restricting credit when economies turn down. Reducing this procyclicality is an important element of the new rule book.

In addressing procyclicality in the norms governing capital, provisions, liquidity, and incentives in general, regulators will need to balance carefully the trade-offs between rules and discretion. For instance, in the area of capital and provisions, coming up with the appropriate approach will be difficult and controversial, but I

would lean towards introducing a more “rules-based” approach. There is work underway in the standard-setting bodies to develop appropriate countercyclical standards, such as capital requirements and through-the-cycle provisioning, and we hope to continue to work with them in reflecting on appropriate standards and measures to determine prudential buffers.

Promoting more effective disclosure is a third area for reform. Disclosure is important for market discipline, but we also need to ensure that disclosed information is both accurate and informative. Requiring financial institutions to provide massive amounts of information can be just as ineffective as too little. Therefore, a concerted and consistent approach to disclosure on a global basis would be a substantial benefit to strengthening market discipline, as would be the development of a common database of comparable financial statistics for all globally active banks. An important example of this gap in information is the wide difference between the frequency and availability of basic bank data across countries.

This crisis has been unique in modern times in terms of its cross-border dimension, and so this is the fourth area of the rule book needing reform, or perhaps a new (and thick!) chapter. The need for consistent cross-border resolution and deposit insurance frameworks has been recognized for many years, well before the current events unfolded. The reason is that differences in approaches can make supervision of a cross-border institution more complex and resolution more costly. So with this crisis, the time has come for concrete action.

I recognize that such frameworks are integral parts of national regulatory and legal traditions, so advancing in this area will require strong political will. We should commend the recent progress that has been made to develop colleges of supervisors involving the authorities of the countries responsible for the supervision of each of the globally active banks, but more is needed. Let me say in connection to this that Europe has the opportunity to be a model for the rest of the world, given its shared institutions and commitment to a regional approach. If anyone can make progress on this issue, surely it can be in Europe. So I look forward to the steps that will be taken as a result of the discussions triggered by the De Larosière Report.

All of these suggestions I have made are clearly in the nature of reforms to the existing rule book, some of them significant, rather than re-writing it in its entirety. Encouragingly, the G-20, the Financial Stability Board, and standard setters have already begun work on these improvements. In some cases, new regulations will have to be introduced. In other cases, existing regulations will be enhanced, as is being done by the Basel Committee on Banking Supervision in the case of the Basel II framework.

But while we reform the rule book, we must also consider its implementation. One of the key lessons of the crisis is that supervisors and regulators were not as effective as they should have been in identifying risks and acting on them: that is, the implementation of existing standards was as much of a problem as what was not captured by the rule book.

Let me offer a few examples of implementation issues that we should be mindful of.

The crisis has illustrated the importance that supervision and regulation adapt in response to financial market developments and innovation, as experience shows that regulation typically lags behind market developments. This is not surprising. Innovations take place and then develop into market-wide practices. But regulators must keep a watchful eye on market developments to understand emerging risks, and as these evolve into market-wide practices, regulators need to respond.

Another issue relates to the Basel II framework. This approach aims to adapt regulatory and supervisory practices to market developments. The Fund supports the implementation of Basel II, given its significant focus on strengthening bank risk management. At the same time, we must take into account national specifics when determining the speed of Basel II introduction, particularly in emerging markets. Their banks and supervisory systems must have first adequately implemented the Basel I capital rule before the countries advance to the more sophisticated Basel II guidelines. This is consistent with the fact that the G-20 has called for the framework to be adopted over time across its membership.

Effective application of rules also requires a **strengthening of the ability and accountability of regulatory and supervisory agencies** to undertake timely and credible action. As mentioned already, all of the effort that is going into updating the prudential rule book will be unsuccessful if equal attention is not paid to enforcing the rule book. The supervisory response to the vulnerabilities that emerged ahead of the present crisis varied widely. In some countries—and I know we did this in Spain—

supervisors used existing regulations to require banks to hold capital against a range of risks (like off-balance sheet structures such as SIVs or conduits), effectively reining in the build-up of risky exposures. But in many jurisdictions, supervisors may have faced impediments to enforcing fully all supervisory regulations. So, an issue that requires more examination is whether we can identify factors that inhibited supervisors from taking more timely action. In this respect, the Fund's work on assessing the effectiveness of supervisory regimes suggests that operational independence, the ability to hire and retain skilled supervisors, and the capacity to take corrective actions are most important.

Finally, a basis for assessing and acting upon macro-prudential risks is also essential for effective implementation of the rule book. Regulators and supervisors, as well as central bankers, must develop frameworks for working better together, sharing critical information and analysis. Of particular importance is that central banks take adequately and fully into account financial considerations when taking monetary policy decisions in the pursuit of their ultimate policy goals (such as, in the European Central Bank case, price stability). Likewise, regulators and supervisors need to adequately and fully take into account the systemic repercussions for the financial sector resulting from monetary policy and other macroeconomic developments. In short, they should also incorporate a macro-prudential dimension in the regulatory and supervisory framework.

IV. The Fund's Role in the Reform Agenda

Let me say a few words about the role of the IMF. The Fund has been asked to play a role in helping to design the new rule book, and ensuring its implementation. While we are not directly involved in setting standards, we participate in standards discussions to provide feedback on gaps in the design and implementation of standards based on our work with member countries. We are also contributing to international efforts to develop better surveillance and crisis management tools, and supporting member countries in enhancing their central bank operational frameworks. In November, the Fund entered into an agreement with the FSF (now FSB) aimed at improving cooperation and collaboration.

The Fund has also been an active participant in the G-20 process, which took on sharper focus following the November meeting of the leaders. In their April London declaration, the G-20 leadership assigned several tasks to the Fund in keeping with its mandate of financial stability. Briefly, the Fund has begun work toward:

- Expanding our program of assessing the **quality and effectiveness of a country's financial sector infrastructure** to encompass: macroprudential oversight, the scope of regulation, and supervisory approach to overseeing the influence of the structure of compensation schemes at financial institutions on risk taking.

- Producing guidelines (with the FSB) for national authorities to assess whether a **financial institution, market, or an instrument is systemically important**, with a focus on what institutions do rather than their legal form; and to review and adapt the boundaries of the regulatory framework to keep pace with developments in the financial system and promote good practices and consistent approaches at the international level.

- Developing an international framework for **cross-border bank resolution** arrangements with the FSB, World Bank, and the Basel Committee on Banking Supervision and continuing its work on exit strategies

- Providing an assessment, with the FSB and standard setters, of implementation of prudential regulations by **relevant jurisdictions**, and building on existing Financial Sector Assessment Program (FSAPs) where they exist.

- Assessing the progress with international convergence in the provision of **deposit insurance** to identify gaps and highlight best practices in terms of regulatory cooperation.

We have also started work with the FSB on another key agenda item—to provide **early warning** on macroeconomic and financial risks and the possible actions that would need to be taken to reduce these risks. This work is being further developed at present.

V. Conclusion

To conclude, revising the rule book and making progress in regulatory reform are critical to preventing future financial crises and minimizing their severity. In examining the lessons from the crisis, expanding the regulatory perimeter, effectively addressing excess procyclicality, closing information gaps, and improving cross border cooperation should be high priorities. At the same time, the effectiveness of new rules requires a strengthening of supervisory enforcement.

Let me end with a note of caution. While implementation of many of the suggested reforms will be a medium-term exercise, the appetite for reform may wane as we emerge from the crisis, and this would be detrimental for future financial stability. It is now or never. Consequently, keeping these topics on the policy agenda will be an important task, and discussions such as the one taking place today at the Brussels Economic Forum, have a major role to play in this regard.

Thank you