Current Challenges in Financial Regulation

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Structure of Presentation

1. Knowledge to date
2. Current challenges in finance
3. Issues facing emerging markets
4. Conclusions
1. Knowledge to date

Financial development depends on:

A. Macro-economic and fiscal stability
B. Real sector
C. Legal and judicial system
D. Proper regulation and supervision
E. Access to credible information
F. Competitive & contestable markets
A. Macro-economic, fiscal stability

- Stable macro-economic environment
  - Moderate, positive real interest rates
  - Appropriate exchange rate regime

- Stable fiscal environment
  - Low fiscal deficits to avoid crowding out
  - Limited direct role of the government in financial intermediation
  - Low financial sector taxation
B. Real sector

- Finance input for real sector and vice-versa
  - Vicious and virtuous relationships
  - Development and effectiveness of financial and real sector depend on many similar factors

- Yet still separate finance reform agenda
  - Additional positive effect of finance on growth
  - Financial sector represent allocation of control rights, link to general political economy of reform
C. Legal and judicial system

• Good property rights, laws
  – Effective legal system very important for financial markets, financial intermediation
  – How equity and creditor rights affect financial development, external financing, dividend patterns, growth, firm valuation, etc. is well documented
  – Includes a well-functioning judicial system that enforce these rights
D. Regulation and supervision

- Regulation and supervision of intermediaries, markets
  - Financial sector is highly regulation dependent
  - Regulation differs from supervision. Regulation needs to balance market discipline and government supervision
  - Without checks and balances, too much power in the hand of supervisors/regulators retards financial development and creates risks
E. Access to credible information

- Information is essential for risk management, access to finance, efficiency of intermediation
  - Information to be available on borrowers, consumers and financial intermediaries
  - Quality of accounting & auditing, rating agencies, credit bureaus, key components of informational infrastructure
  - Information infrastructure has to be contestable
F. Competitive & contestable markets

• Contestability of financial system key
  – Entry (including of foreign institutions) helps stability, efficiency, access while state-owned institutions hinder
  – Structure (bank versus markets) matters less than having right fundamentals and open systems
    • Banks complement securities markets—in financing, corporate governance—and vice-versa
    • Most financing depends on similar determinants
    • Balanced development can, however, provide a spare wheel
2. Current challenges in finance

A. Triggers and changes
B. Overall approach
C. Changing special nature of banks
D. Competition policy
E. Consumer protection
F. Costs of regulation
G. Harmonization
A. Triggers and changes

- Financial services are changing rapidly
  - **Deregulation**: within markets and products, across markets, geographic, including cross-border
  - **Technology**: advances in information, particularly internet and increased remote delivery

- Factors are changing financial services industries structures and altering forms of provision
  - Banks and finance becoming less special; increasingly more substitutes available; more remote delivery possible; local markets less relevant; lines between products and financial institutions blurring
  - Globalization accelerating: increased (gross) capital flows, cross-border financial services, foreign bank entry, listing in financial centers
Changing real world has implications also for financial intermediation

• Nature of the firm altering
  – Intangibles, new economy, network-type assets more important for production and productivity

• Investments to be financed changing
  – Investors invest in “ideas”, rather than fixed assets
  – Ideas need more protection for investors
  – Yet often not suited for organized/formal markets

• Implications for financial sector
  – Fewer fixed assets: makes debt more difficult
  – Higher risk: requires other financing structures
  – Greater importance of corporate governance
  – More VC-type, more equity markets for VC to exit
B. Overall approach

• Overall approach: reaffirming fundamentals
  – New evidence confirms crucial role of fundamentals
  – Yet need to revisit continuously fundamentals

• Greater emphasis on enabling environment
  – Property rights, information infrastructure, etc.

• Reduced, but more focused role of government
  – Do not expect government to solve all problems
  – But neither will market always
  – Focus on core role of government, with some market-friendly interventions
C. Special nature of banks

• Greater substitutes for bank liquidity available
  – Reducing specialness of banks

• New roles for banks and increased conglomerates
  – More risk managers, as within financial conglomerates
  – Introducing new risks and oversight challenges, e.g., LCFI

• Revisit prudential and institutional-oriented approaches
  – Revisit tools/approaches used for managing risks → Basel II
  – Higher transparency, better corporate governance → Pillar III ↑
  – Protect more core elements (payments system) against spillovers
  – Less cylinder approaches, stress more common elements
  – Reduced special nature of banks implies less need for public safety net and requires adjustment of standards
D. Competition policy

- Competition proven to be effective, yet more active competition policy both possible and needed
  - Finance and banks particularly less special
  - Global and across types of institutions providing financial services
- New paradigm to be developed and applied
  - To go beyond institutional and functional approaches; more input based; and to be global, horizontal and sector-specific
  - Approaches to resemble other network industries
  - Tools to adjust, e.g., less market structure, more conduct
- For countries to benefit from competition policy
  - Competition policy to be separate from supervision
  - International agreements can play a useful role to commit/enforce
  - Active role of government can be needed given externalities and coordination issues, e.g., payments system
E. Consumer protection

• Assuring proper business conduct
  – Long-standing issue, but recent events show that small “distortions” hurt consumers and negatively affect integrity
  – Limit conflict of interests, increase oversight, especially in capital markets, of key issues (e.g., A&A), take strong actions (e.g., NY SEC)

• Protecting individual consumers
  – Can no longer assure “fairness” of products and markets
  – “Buyer beware” to be matched by increased “truth in advertising” requirements, liability and means of users to take legal actions

• Assuring consumers obtain the greatest benefits
  – Increased choices and complexity not (yet) matched by knowledge
  – Requires more financial education, starting at an early age
F. Costs of regulation

• Deregulation followed by reregulation: now too much regulation and too intense oversight?
  – Direct and indirect (compliance) costs have increased
  – With possible adverse effects, e.g.,
    • SOX may lead to migration of US IPOs to UK; fewer new listed firms
    • AML/CFT can affect access of households
  – Markets players and governments have recognized this
    • e.g., EU Action Plan streamline regulations, US competitiveness reports

• Proper policy responses
  – More formal cost-benefit analysis needed
  – More transparency and greater consultation to balance tradeoffs
    • Without inviting capture, need to have broad(-er) representation of producers and consumers in processes
G. Harmonization

- Big barriers have been removed, but many small remain
- Further harmonize across markets, sectors and products, by functions, so that labels no longer matter. Complex as:
  - Costs of regulation hard to assign to specific functions/products
  - Path dependency, e.g., tax differences
  - Subtle distortions/benefits, e.g., safety net, LLR

- Policy responses:
  - More consolidated/single supervisory authorities may help
  - Standards help globally, but country differentiation unavoidable
  - Better data and more transparency on prices and costs
  - Competition—between markets, sectors, products and regulators—key to force more effective harmonization
3. Issues facing emerging markets

A. International financial integration
   a) Stability and volatility
   b) Cross-border activities
   c) Access concerns

B. Development strategies
   a) Application of international standards
   b) Adaptation of international standards

C. Political economy
A. International financial integration
   a) stability and volatility

- Developing countries, emerging markets especially, subject to rapid financial integration
  - Large capital flows, foreign bank entry, capital market migration
- Forcing adjustment faster than in current developed’ past
  - Need for more rapid institutional development
  - Intermediate level of (financial) development/openness most risky
- Integration → more stability, but at times also volatility ↑
  - Greater emphasis on measurement and management of risks
  - May need to keep toolkit to intervene (e.g., capital account controls, circuit breakers, tighter restrictions)
b) Cross-border activities

- Increased foreign bank presence, foreign capital markets activities on- and offshore, raising specific questions
  - Costs of regulation and supervision increase with (multiple) coordination with home countries
  - Yet capacity of emerging markets lower and effects of banking failure and financial crisis higher
  - Foreign investors/financial institutions not internalize all issues
- Lack of paradigm more costly for emerging markets
  - Rule for cross-border bank resolution, capital markets oversight ambiguous in some respects
  - Inefficient responses, e.g. subsidiaries, create additional costs/risks
c) Access concerns

- Large foreign bank entry → more access generally, but:
  - Access to information-intensive firms may suffer when hard-information banks come in
  - Local information production: when foreign banks list abroad, less information, less market discipline, more complex monetary policy

- Large migration in capital markets → benefits but:
  - While larger firms gain, local liquidity can decline, making it harder for other (small) firms to raise financing locally
  - Local capital markets activities in general decline as business is reduced, hindering development

- Policy responses
  - Specific corporate governance and listing requirements for local subsidiaries?
  - More harmonization and more specialization in capital markets?
B. Development strategies

- Countries have less freedom to pursue own approaches
  - Good on one hand, since state has mostly not been productive
  - Yet many now successful economies have had some interventions
- Countries can combine, but only to some extent
  - Can benefit from committing to pro-competitive framework through international agreements. Especially useful for countries whose credibility more at a premium, competition policy authorities weaker, political economy more adverse
  - While pursuing some national objectives, through lending requirements, development financial institutions, etc.
  - Balance can be precarious: deter entry, raise costs, distort
a. Application of international standards

- Standards (Core 25, Basle II, IOSCO, etc) help, but:
  - Many not applicable, too sophisticated and sometimes even wrong given issues facing developing countries
    - Markets missing, capacity to implement lacking, enforcement, etc
    - Special nature of banks and safety net: can be perverse
- Many country-specific requirements and tradeoffs
  - E.g., degree of competition and access to financing relate differently when information more obscure. Size of market matters
- Yet signal of poor compliance a problem. Implications:
  - Regulations to be applied to vary. Focus on key, priority elements: regulatory governance, corporate governance, transparency
  - Consider multiple enforcement approaches, not just public
b. Adaptation of international standards

- Adapt standards and assessment over time
  - Standards to be adapted to changing world and lessons learned
  - Need to consider assessor/methodologies consistencies

- Need to include all relevant parties in review
  - Increase stake of emerging markets in international standard setting forums (BCBS, CPSS, etc.) and IFIs (IMF, WB)
  - Consider legitimacy, which may mean raising stakes even more
  - Provide technical assistance in negotiations in FTAs, GATS, etc to level playing field
  - Balance private sector/producers’ interests with consumers’
C. Political economy

• Finance in emerging markets: same principles and industry undergoing similar changes as ROW. However:
  – While countries generally benefit from reform and lib., not clear what pre-conditions are for successful reform
  – And some failures. Regulator/supervisor capture major constraint
    • Government poor regulator, e.g., more power does harm if checks and balances missing; minimally paid supervisors unlikely to resist corruption; securities markets: private better than public oversight

• Often deeper causes: political economy, corruption, etc.
  – Limits to what government/regulation can achieve. Rebalance role of government relative to private sector
  – Consider quantity restrictions, to avoid risks, preserve incentives, but need to avoid negative signals
4. Conclusions

- Fundamentals confirmed
  - Yet, changing emphasis and adaptation needed
- Level playing field
  - More harmonization with increased competition
- Competition policy
  - Often missing so far, but more needed and possible
- Consumer protection
  - Increased emphasis, more tools and more education
- Role of standards
  - Useful to a point, need to evolve, require proper inputs
- Emerging markets challenges
  - Fast financial integration requires specific responses
  - Better representation in int’nal forums/policy making