Beyond surveillance: reducing the risk of financial crises

Comment on "The Limits of Surveillance and Financial Market Failure: Some Fundamental Issues Arising from the Euro Area Crisis" by Kumiharu Shigehara

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Kumi Shigehara's issues paper reviewing the failure of both financial markets and governments to anticipate and prevent the euro crisis points to the limits of surveillance by international organizations, even when the surveillance is well done. The paper calls attention, in particular, to three forces which will be at work regardless of however much the institutions improve their own analysis and oversight[2]:

- Limits governments impose on surveillance by international institutions in their "shareholding" capacity, as well as self-restraint by the institutions ("sanitization", self-censorship);
- The reluctance of elected governments to face up to implications of warnings and alerts if this would be politically unattractive.
- Failure of markets to discipline policies that permit macroeconomic, fiscal or financial imbalances due, at least in part, to poor assessments of available information, including "sanitized" surveillance reports.

The issues paper also refers to[3]:

- Difficulty in designing effective micro- and macro-prudential policies, their mixes and their coordination with monetary policies;
- The "herd instinct" of financial institutions, moral hazard and the problem of regulatory and supervisory "capture" by large financial institutions.

These considerations lead him to ask whether we are just condemned to have more crises.

Surveillance and financial markets

Hopefully this is too pessimistic. Early post-war surveillance within the framework of international inter-government institutions activities was carried out against a background of weak and repressed financial markets and institutions. Its context was the need for oversight of

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[2] For discussion, see Chapter 4 of K. Shigehara and P. Atkinson, "Surveillance by International Institutions: Lessons from the Global Financial Crisis", OECD Economics Department Working Paper, No. 860, May 2011, www.oecd.org/economics.

[3] See in particular the references in endnote 24 of the issues paper.

the use of public money: multilaterally at the forerunner of the OECD in the context of distribution of Marshall Aid; and bilaterally at the International Monetary Fund in the context of the its oversight of the fixed exchange rate system and its readiness to provide financial support to countries managing balance of payments disequilibria. Over the years surveillance has contributed to better policy design in individual countries, at least in part due to better understanding of the forces at work in the international economy as a whole. But it was never designed to influence banks and it cannot impose policy adjustments needed to avoid financial crises. It can only propose them to member governments.

The world has moved on and reliance on controls and directed lending to influence investment has diminished in OECD countries[4] as financial institutions have become larger and (at least until recently) "stronger" and financial markets have assumed a dominant role in the allocation of investible resources. This role has increasingly involved financial institutions and markets heavily in the surveillance of both government policies and economic developments. "Market discipline" has increasingly supplemented "peer pressure" emerging from surveillance at the institutions as a force working to influence policies. Indeed, at least for large countries not looking for financial support, market discipline may be the only effective pressure that can be applied to enforce policy adjustment.

While improved surveillance would always be helpful, these considerations point to the need for alternatives or complementary arrangements to minimize the likelihood of financial crises. These must involve some combination of strengthening supervisory arrangements, i.e. official oversight of financial institutions that goes beyond what can be embedded in regulations, and relying more on effective market processes and discipline.

Supervisory arrangements

Strengthening supervisory arrangements may have a role to play but, like surveillance by the institutions, it will have its limits. Supervisors face too many constraints on what they can achieve, some similar to the forces working to limit the effectiveness of surveillance by the institutions:

- Supervisors operate subject to political constraints which may discourage calling attention to and addressing problems (for more, see below);
- Supervisors are detached observers rather than profit-oriented participants in the markets where financial institutions operate.

[4] Perhaps the most important motivation for financial repression and foreign exchange controls disappeared with the end of the global fixed exchange rate regime in 1973. The OECD Codes of Liberalization of International Capital Flows, from 1961, and the EU Single Market Program, from the late 1980s, have served to guide this process.

- Resources available to supervisors are usually limited, especially in comparison to the institutions they are supervising. While supervisors can obtain any information they ask for, they often do not know what to ask for.
- Supervisors are paid a fraction of what senior bankers they are supervising earn. The best people may avoid being supervisors except as stepping stones to better jobs. Capture can be a problem.

Notwithstanding these limits, in response to the sub-prime and euro crises considerable effort is being devoted to making improvements in two major areas. First, arrangements to ensure "macro-prudential" oversight are being developed, in the United States as well as in Europe, to reinforce "micro-prudential" supervision that has to date not been focused on stability of the financial system as a whole. Second, the EU is moving toward creating a banking union which, among other things, will involve giving the ECB direct supervisory authority over all euro area banks.

These initiatives are motivated by the need to address clear weaknesses in existing frameworks and one can applaud the efforts and hope for success. But this will not be easy to achieve.

First, the strength of the macro-prudential approach is that it introduces the macro-environment, i.e. both policies and the risks associated with developments, into the process of financial sector oversight. But:

- The main parameters influencing the macro-environment are the responsibility of the official sector, not the banks being supervised. The single currency is much like the 19th century gold standard: an admirable monetary arrangement, certainly more coherent than the EMS that preceded it, but one that requires participants to respect certain rules of the game. If euro area governments ignore their own fiscal agreements or fail to make any serious effort to integrate their labor markets, it is not obvious why macro-prudential authorities would be more successful than the international institutions in persuading political authorities to confront problems they understand but do not wish to confront.
- While new arrangements may create new superstructures they seem to add little, beyond whatever emerges from the mandate to have a "macro-prudential" focus, in terms of new people or institutions to the policy and oversight process. The European Systemic Risk Board (ESRB) is dominated by the European System of Central Banks (ESCB). It is chaired by the president of the ECB, 29 of its Governing Board's voting members are from the ECSB, the ECB hosts the ESRB's secretariat and the ECB and national central banks provide analytical, statistical, administrative and logistical support. While the ESRB also includes someone from the EC and chairs of the three supervisory authorities, the only sources of new blood appear to be two advisory

committees. The Financial Policy Committee (FPC) in the United Kingdom similarly appears to be dominated by the Bank of England[5].

- It is unclear how new macro-prudential mandates will affect who does what, how and when. Definition of instruments, allocation of authority to use them and identification of circumstances in which they are to be used remain on the agenda[6]. The ESRB's authority is so far limited, like the international institutions engaged in surveillance, to issuing warnings and non-binding recommendations. The UK's FPC, on the other hand, has authority to issue directives to micro-prudential supervisors. Much progress has been made since the 1980s with strengthening management of public policy by separating functions, clarifying roles, defining responsibilities and looking for ways to ensure accountability. It would be unfortunate if progress in this domain were threatened by mixing monetary, supervisory and regulatory activities in ways that are unclear to achieve diverse objectives[7].
- Thinking about these issues seems to be at an early stage, with many available discussions about them too abstract to provide operational guidance for some of the questions posed above[8].

Second, the transfer of supervisory and regulatory oversight to the EU level in the context of creating a banking union seems like a definite advance, given the integration of the European banking system. This assumes that it will replace national arrangements with European ones and not just add a new layer to existing arrangements. It also assumes successful demarcation of respective roles and responsibilities of the ECB and the EBA.

However, the choice of the ECB, rather than a civil service-based arrangement attached to the EC, to take over the key supervisory role raises some questions. The ECB was established with a clear role, in the form of its price-stability mandate, and it enjoys an unusually high degree of

[5] In the United States the Financial Stability Oversight Council is to be chaired by the Secretary of the Treasury but broadly just brings existing agencies together under an arrangement likely to be dominated by the Federal Reserve and the Treasury.

[6] On 4 April, 2013, the ESRB sent requests to national macro-prudential authorities and Member States asking them to (i) define and pursue intermediate objectives; (ii) assess, identify and, where necessary, define macro-prudential instruments; and (iii) define a policy strategy to link these to ultimate objectives of macro-prudential policy in a way that fosters transparency and accountability. Reports about actions taken or justifying inaction are only requested by end-2014 and end-2015. See ESRB/2013/1.

[7] Jorgen Stark of the ECB Executive Board has stressed that the ECB's role with the ESRB has no implications for its price stability mandate (Dinner speech, Berlin, 8 November 2011). ECB Vice-President Vitor Constancio has similarly stated that "Price stability comes first." See his testimony on "Reform of the EU Banking Sector" before the Select Committee on EU Economic and Financial Affairs of the House of Lords, London, 22 October 2012.

[8] See, for example, see C.A. E. Goodhart, A. Kayshap, D. Tsomocos and A. Vardoulakis, "An Integrated Framework for Multiple Financial Regulations", presented at the Federal Reserve System and Journal of Central Banking conference on "Central Banking: Before, During and After the Crisis", 23-24 March 2012; and A. Large, "What framework is best for systemic (macroprudential) policy?" Chapter 7 in *The Future of Finance And the Theory that Underpins it*, Centre for Economic Performance, London School of Economics.

autonomy from political oversight in order to allow it to focus on this mandate. Its success, or lack of it, is highly transparent which provides at least some degree of accountability for its performance. Since the euro crisis began the ECB has tread a fine line between liquefying the system when needed, a core central bank responsibility, and engaging in quasi-fiscal support for governments, which would go beyond its mandate. Now, with its assumption of supervisory responsibilities, the ECB is moving into core government territory. This will raise issues of political oversight and accountability for both substantive supervisory performance and its resource costs, which seem likely to escape the normal parliamentary scrutiny that is part of budgetary processes. Care will be needed to ensure that the mixing of roles, functions and mandates does not lead to erratic and confused policy formulation and implementation.

It is worth noting that from today's perspective (mid-August, 2013), progress towards making a EU banking union a reality has been slow. A framework for a single supervisory mechanism has been agreed but core financial aspects relating to the design of deposit insurance, bank resolution and support for the system remain bogged down in dispute. The erratic handling of recent haircuts-plus-support packages for Greece and Cyprus, notably the Troika's apparent willingness to sign off on losses for even small insured depositors at Cypriot banks, raise questions about commitments to respect even existing obligations, let alone to accept the sharing of sovereignty that a full banking union will imply.

Relying on market processes

Given that the limits to supervision appear at least as serious as those to surveillance, the most promising way to avoid crises will involve greater reliance on market processes. The key to this is obviously strengthening the regulatory framework in which financial institutions operate. Much has been written about this and, since I am on record with Adrian Blundell-Wignall about our views as to what is needed,[9] I will not develop this here beyond summarizing the main points:

- The current Basel framework should be scrapped in favor of something vastly simpler[10];
- Banks should be required to have meaningful amounts of capital to (i) absorb losses so that local shocks do not become systemic; (ii) ensure a significant weight in bank

[9] See A. Blundell-Wignall and P. Atkinson, "The Sub-prime Crisis: Causal Distortions and Regulatory Reform", in Bloxham, P. and C. Kent, *Lessons from the Financial Turmoil of 2007 and 2008*, Reserve Bank of Australia, Sydney, 2008; "What will Basel III Achieve?", German Marshall Fund of the United States and Groupe d'Economie Mondiale de Sciences Po, 2010; "Global SIFIs, Derivatives and Financial Stability", *Financial Market Trends*, OECD, Paris, 2011 No. 1; "The Business Models of Large Interconnected Banks and the Lessons of the Financial Crisis", *National Institute Economic Review* No. 221, NIESR, London, July 2012. An important related paper is A. Blundell-Wignall and C. Roulet, "Business Models of Banks, Leverage and the Distance-to-Default", *Financial Market Trends*, OECD, Paris, 2012 No.2.

[10] The recent relaxation and delay of the liquidity rules of Basel III are encouraging in this regard.

decision-making for principals, i.e. owners, who face the consequences of their decisions rather than hired agents who can leave problems to taxpayers; and (iii) ensure the trust of creditors and counterparties which is required for financial institutions to fund themselves. A leverage ratio requiring core tier 1 capital of 5% of assets measured on an IFRS basis would seem to be a minimum, although more might be desirable -- especially for poorly diversified banks[11].

- The implicit guarantee that encourages banks to become too-big-to-fail needs to be limited. Separation of investment banking, notably activities involving large portfolios of derivatives, from commercial banking with each set of activities being separately capitalized to end cross-subsidization is a key element here.
- Corporate governance of banks should be strengthened to encourage a more prudent balance between risk and search for return, notably by separating the roles of the CEO and Chairman of the Board and by ensuring that the CEO has no role in Board nominations.

Two points can usefully be added. First, better diffusion of information to the market and better analysis of it might assist the markets to make more effective use of the information available to it, including but not limited to that provided by surveillance. Two important areas which have been implicated in financial market disruptions since the beginning of the millennium, and where improvement is needed, are audit and the rating agencies. In both cases a core problem is the way services are funded. Audits and ratings provided to the market are both paid for and overseen by the business being audited or rated. They are not paid for by the users, i.e. investors in the market. This creates a skewed set of incentives which affects the integrity of what is provided to the market. Until this funding model is changed it seems doubtful that any reforms designed to improve matters will achieve much. A promising avenue would be to move to a funding model in which the businesses in question cover the necessary costs, as now, but that they do so by paying the exchanges on which they are quoted. The exchanges, on behalf of investors, would use the funds to commission the actual work and oversee the providers of the services in question.

Second, the key to avoiding crisis situations is to force adjustment at an early stage, while problems are still of a local nature and do not threaten to become systemic. In this regard, considerable energy has been invested in obliging banks to develop "living wills" and "recovery

[11] There have been some recent encouraging statements from senior policymakers about some of these issues although they have so far not been reflected in significant modifications of the current framework. See, for example, A. Haldane (Executive Director, Financial Stability, Bank of England), "Constraining discretion in bank regulation", paper presented to the Federal Reserve Bank of Atlanta conference *Maintaining financial stability: holding a tiger by the tail(s)*, 9 April 2013; and T. Hoenig (FDIC Vice Chairman), "Statement on the use of International Financial Reporting Standards in computing the leverage ratio for systemically important financial institutions", FDIC, 23 July 2013.

plans" while strengthening resolution mechanisms. Unfortunately, it seems hopeful to expect that recovery plans designed in stable conditions will be readily applicable in circumstances when they are most needed. And while better resolution mechanisms will provide authorities with better options than a choice between bankruptcy (Lehman Brothers-style) and simply bailing everyone out, the central problem is not one of process but of being able to live with the consequences of using it. Something must activate the process at an early stage.

How to do this? Very few individual players have an incentive to force adjustment. Bank managers themselves do not want to acknowledge problems that arise on their watch and are likely to keep them hidden unless something forces them into the open. One of the functions of external audit is to do just that, hence the importance of ensuring its integrity. But audit is more art than science and it cannot be relied upon.

Ideally, supervisors or regulators should make timely interventions. But supervisors and regulators are civil servants who operate, as noted above, subject to political oversight. This oversight is too often captured by vested interests, especially from the financial sector itself, or biased toward easy credit. Even where capture and bias are not embedded in laws or politically appointed officials who direct key competent agencies[12], an emerging problem with a financial institution will be seen as someone's failure and no supervisor or regulator wants to acknowledge that this has occurred under his oversight. Similarly, no one at the political level, e.g. the Minister of Finance, wants to hear about an emerging problem with financial institutions that might require support. So there is often a quiet conspiracy not to face up to problems so long as that can be avoided.

This leaves the market. Unfortunately, the market's method of forcing adjustment in a financial institution is too often to withdraw its funding in bulk. If this leads to a liquidity drain that threatens the institution's ability to operate even those creditors not withdrawing funds will quickly feel exposed. And if this takes place in panic conditions it can easily lead to contagion. In practice these often occur together and reinforce each other. But either on its own can threaten a systemic crisis. What is needed is a trigger mechanism which:

- Bypasses supervisory forbearance;
- Becomes effective before funding withdrawals make it impossible to operate;

[12] It is difficult, when reviewing the origin and evolution of the US sub-prime and euro crises and subsequent reform efforts, to avoid being impressed by the apparent influence of financial sector interests and beneficiaries of easy credit .At the level of legislation the Commodity Futures Modernization Act of 2000 and the American Dream Down-payment Act of 2003 stand out as benefiting vested interests in the short term while limiting the scope for officials to influence developments on behalf of taxpayers who would face the ultimate costs of excesses. At the level of implementation the most egregious case was the failure by the Securities and Exchange Commission to pursue evidence that Bernard Madoff's operation was fraudulent. Pressure from large banks to relax Basel III proposals has been intense and has had considerable success.

- Facilitates restructuring while the institution is still solvent.

There is no perfect solution here but suggestions by Goodhart[13] and Carmassi and Micossi[14] offer useful starting points which should receive more attention than they have. Key elements include:

- Use of market-based indicators, such as the value of equity, as at least part of the mechanism to trigger intervention;
- A "Prompt Corrective Action" framework envisaging early recourse to an "intervention ladder" of rising intrusiveness and intensity as successive thresholds involving more stringent capital standards are breached;
- A process in which intervention moves quickly from measures to strengthen the balance sheet, e.g. dividend restraint, to ousting management to restructuring and coherent resolution of the institution at shareholders' expense.

Many criticisms can be directed toward these ideas, which need further development. Market-based indicators can move erratically for many reasons that do not warrant intervention. And Prompt Corrective Action in the United States, which has been envisaged for weakly capitalized banks since 1991, has rarely, if ever, been successfully applied to a GSIFI. Nevertheless, the general approach of allowing bank management maximum freedom to manage so long as the bank is financially strong but intervening early, while a bank is still viable, to restructure and replace management if these conditions fail to hold seems like the right way to go.

Concluding remarks

So long as the future is uncertain and a core role of the financial system is to allocate credit to investments that will pay the highest future returns, mistakes leading to balance sheet problems seem inevitable. But putting systems in place to identify emerging problems at an early stage and to resolve them quickly should reduce both the likelihood that they cumulate to crisis level and their severity.

What does this imply for the role of surveillance by international institutions? Relatively little. Opportunities for policymakers to exchange views and perspectives with their counterparts in other countries will always have a useful role to play. So will good analysis and an independent overview of developments from a global perspective. But it is important not to hold unrealistic

[13] See for example, "If banks should act as utilities, why not treat them as such?", www.voxeu.org, 30 August 2011 and Charles A.E. Goodhart and Enrico Perotti, "Preventative macro-prudential policy", www.voxeu.org, 29 February 2012.

[14] See J. Carmassi and S. Micossi, "Time to set banking regulation right", Centre for European Policy Studies, Brussels, 2012, especially section 6.2. See also S. Micossi, "A viable alternative to Basel III prudential rules", www.voxeu.org, 9 June 2013.

expectations since these are usually disappointed. Policymakers face democratic accountability to their electorates, not to the institutions. In the end debates about economic policies that influence the economic and financial environment and that determine the institutional and legal framework in which financial markets operate must be won with electorates.