# TOWARDS A SAFER GLOBAL FINANCIAL SYSTEM

**November 9–11, 2010 – London School of Economics**

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## 1. Introduction

I want to start by thanking the LSE for the invitation to speak to you today. In my talk I will examine where we stand in our quest to address the issues that arose in the crisis so as to enhance global financial stability and put the financial system on a new course to facilitate strong and sustained economic growth. I will pay special attention to the issues surrounding the policies oriented to preserve the stability of the financial system as a whole: the so-called macro-prudential policies.

## 2. The Crisis: its Causes and Effects

Having just entered into the fourth year of what has been termed the "Great Financial Crisis," it is now widely recognized that in the run-up to the crisis there was a significant under appreciation of systemic risk, so much so that many viewed policymakers as having established an era of sustained and stable expansion—labeled the "Great Moderation."

In retrospect it is striking how resilient the financial system appeared at the time as it survived a number of shocks, such as the terrorist attack of September eleventh, the bursting of the dot.com bubble, and the Enron-Worldcom accounting scandals. Nonetheless, under the surface, deep down, the financial system was building up large vulnerabilities that ended up provoking a major crisis, putting the world on the verge of another Great Depression.

The results have been devastating. An estimated 210 million people are unemployed across the globe, an increase of 30 million since 2007. So far, the cumulative output loss relative to trend in those G-20 countries that experienced a systemic crisis is about 26 percent of GDP. The debt-to-GDP ratio of the advanced G-20 countries will likely increase, on average, by some 35 percentage points from 75 percent in 2007 to a projected 110 percent by 2014. In short, we went from the Great Moderation to the Great Financial Crisis and the Great Recession.

## 3. The Four "Must Haves" of Reform

As you are in the heart of London, many of you have already recognized many of the characteristics that led to the crisis, so I will not review them now. The more pertinent question is where are we on our long quest for a safer and more stable financial system? Certainly, much has already been done to stabilize the global financial system. The crisis has been and is being met by an unprecedented global policy response, including the creation of the G-20 Leaders Summit process, which has elevated the discussions to the highest policy level and kept international attention focused on the financial reform effort.

The ultimate goal of the reform process is to have a safer global financial system that remains sufficiently dynamic and innovative to finance strong and sustained economic growth.

From my perspective, this process should be underpinned by four "must-haves."

1. First, we “must have” strong microprudential regulation that is globally coordinated. It should strengthen the resilience of individual financial institutions and ensure as much as possible a level regulatory playing field in order to limit the scope for cross-sector and cross-border regulatory arbitrage, which could be damaging to global financial stability.

2. Second, we “must have” effective supervision. Good rules are not enough. They have to be enforced. Good supervision requires both the ability and the will to act—both of which had often been sorely missing in the run-up to the crisis. Supervisory bodies must have adequate authority, resources, and the right incentives in place for them to effectively execute their job.

3. Third, we “must have” coherent resolution mechanisms at both the national level and for cross-border financial institutions. At the national level, it is critical to have effective policies and procedures for resolving financial institutions in a prompt and orderly manner. Given the global reach of financial institutions, there must be an enhanced cross-border coordination framework for resolution to eliminate moral hazard while preserving financial stability and the IMF has proposed a pragmatic approach as a starting point

4. The fourth “must have” is an overarching policy framework to address the stability of the financial system as a whole, dealing with the system-wide interactions of institutions and markets and their role vis-à-vis the macroeconomy. This is the so-called macro-prudential policy framework.

## 4. The Macroprudential Framework.

Let me now spend some time developing my thoughts on this last “must have,” as it is still somewhat controversial and the outlines of what constitutes a “macroprudential framework” are still in the formative stages. Indeed, not everyone is convinced that such an approach is even warranted.

Nonetheless, I believe that the crisis has shown that looking to ensure the safety and soundness of individual institutions is not enough—the financial system as a whole is greater than the sum of the individual parts. The first three “must haves”—microprudential regulation, supervision, and resolution—are necessary, but as the crisis has made clear, they are not sufficient to rein in systemic risks. They must be complemented by an overarching macroprudential framework and a set of new tools to complete the toolkit to address systemic risks.

However, while we "must have" such an overlay to our existing set of policies; we will need to be humble about what it can deliver. We need to recognize that even with a well-developed macroprudential approach we will not eliminate crises. It is no panacea, but it can help make crises less likely to occur and less costly when they do. It is important that we do not overpromise, in part because we are still developing the objectives, tools, and institutional framework that will be part of the approach, and in part because we will also need the support of the public to accomplish this.

Despite the daunting tasks ahead, let me proceed to describe some of the key attributes of the desirable macroprudential framework. The framework will need to identify the risks to be mitigated, the tools to do so, and the body that will be implementing the policies and have contingency plans ready to be used when necessary.

4.a Objectives

First, the framework will need to address two different types of risks.

- The first set of risks is related to the amplification of normal interactions across institutions and across markets—a sort of cross-sectional component. Hence, one objective is to put in place policies that aim at making sure that institutions do not all fail together, or do not all need funding simultaneously, or do not all try to exit the same markets at the same time. In short, the objective is to short-circuit the systemic cross-institution or cross-market knock-on effects that amplify an initial shock.
- The second set of risks is associated with swings in credit and financial cycles that leave the system vulnerable to a destabilizing unwinding that in turn can have real economy effects—a sort of time-series component. Hence, this objective is to remove excessive procyclicality by dampening its root causes, reducing the amplitude of such cycles.

In developing this framework, we will need to connect the objectives with the means to address them. That is, we will need to identify and monitor the risks, filling the information gaps that we have identified so far.

### 4.b Tools

For a start, we will need to decide on how many tools are needed and what they are. Here, it is worth recognizing that we do not start with an empty toolkit. In fact, we already have some tools to address the first set of cross-section type risks by increasing the required capital and liquidity buffers of individual institutions through the new Basel Committee on Banking Supervision's release of Basel III and some infrastructure improvements to certain over-the-counter markets to help to lower counterparty risks and potential spillovers. Yet, while important, these proposals will not be enough.

Apart from this, we will also need to deal with risks posed by institutions and market infrastructures that are systemic, in the sense that their distress or failure would impose large costs on the financial system and on the economy.

We have made some progress in identifying those institutions that we believe contribute in some way to systemic risk. A workable set of criteria to identify systemically important financial institutions (or SIFIs) and how much systemic risk they embody is currently being developed.

Once we define them, we will need to address the systemic risks that they collectively generate—both in terms of solvency and liquidity—by using not just one but potentially several tools. The prospective tools can be “price-based,” giving these institutions incentives, perhaps by using some combination of capital or liquidity surcharges, contingent capital instruments or levies, to avoid contributing to these risks. Alternatively, they can be “quantity-based,” by limiting or removing positions or business activities deemed to contribute to systemic risk. These potential tools are still under construction and there is so far little agreement about which tool is most effective, mainly because they haven’t been tested yet in real situations. Still, the idea would be for these tools to be applied in such a way that those institutions that contribute most to systemic risks also carry the largest burden.

As regards procyclicality, here the tools will need to be multidimensional. The current discussion surrounds the use of countercyclical capital charges and through-the-cycle provisioning, which apply to banks. However, there are a number of other areas where procyclicality influences the financial sector that will not be cured by these two tools. Hence it is fundamental that we adjust fair value accounting rules to allow institutions to build up reserves on securities (rather than just provisions for loans) and that we make credit ratings and the compensation structures of financial professionals less procyclical. These too need attention and, to date, we have only begun to address them.

The private sector must also play a fundamental role in combating systemic risks but has lately been left on the sidelines. We are spending a lot of time on the redesign of regulation, both micro- and macroprudential, but the best–designed regulation in the world will still be problematic if we do not align the incentives of the private sector with its goals. We have made some progress in the area of compensation. But there is still work to be done as incentives to produce and sell products without due attention to their long-term risks and appropriateness for the client remain with us. To the extent the reforms can incentivize the private sector to “do the right thing” for the system as a whole, we will certainly all be better off.

### 4.c Organizational structures

As important as the toolkit is, there is also the additional question about who should use the tools and where should the body that is responsible for financial stability and the macroprudential policies be located—that is, what is the appropriate organizational structure? What about the independence of this body? And which tools should it have at its disposal?

This is new ground and there is likely to be a lot of experimentation with different models in different countries and areas. A “one-size-fits-all” approach will not do as it could unduly suppress important individual country attributes that might make one model work better than another. Indeed, there are already several variations of organizational models that follow from the particular circumstances arising in these countries—the United States, the United Kingdom and the EU have all taken different approaches.

Many have taken the view that the central bank should be in charge of macroprudential policies. There are several arguments for and against such a view. In most countries, the central bank has excellent staff, a solid reputation, and significant expertise in monetary policy and financial markets, which is closely linked to macroprudential policy. Also, central banks play the role of lender-of-last-resort and many of them take a keen interest in financial stability as exemplified by the publication of financial stability reports. Placing macroprudential policy at the central bank should facilitate communication and coordination of both policies.

Still, there are concerns about whether the central bank could safeguard its hard-won monetary policy independence from political interference if it also assumed the role of the macroprudential overseer. Additionally, in such cases where the central bank is the macroprudential policymaker, there would be a need to address important communication challenges and even the impression of conflicts of interest between the monetary policy and the financial stability goals, for instance when monetary policy requires low interest rates and macroprudential policies would thus need to tighten to deal with the consequences for financial stability. This is an important challenge that would need to be addressed through adequate institutional design.

Lastly, there could be concerns regarding setting up a brand-new independent agency to run macroprudential policy, with no experience or track record. It could take time to build credibility in this field.

But, regardless of where the macroprudential overseer will be situated—which, as I mentioned, may vary across countries depending on specific characteristics and experiences—, in my view the following six principles would need to be fulfilled:

1. One, there needs to be just one single macroprudential overseer or dedicated body;

2. Two, this body will need access to all information necessary to perform its duties and to fully be able to identify the "macroprudential transmission mechanism;" that is, it will need to understand how the different tools translate into financial stability; this, in turn, will require a solid understanding of the macro-financial linkages.

3. Three, the body needs to have the ability and the will to act. That is, it must have control over the toolkit, a well-formulated mandate, sufficient authority and resources, and professional independence, all while being fully accountable for its actions. Macroprudential policies might be politically unpopular as they might affect various interest groups or industries at times, and there will therefore also be a need to build "social legitimacy" for its role. It will need to make the case that its decisions are as important as macroeconomic policy decisions.

4. Four, given the various aspects of systemic risks, there will be a need for a holistic approach when deciding on which tools to use and when. The body should consider the entire toolkit and decide whether to use a fixed tool, one that varies in a prescribed way over the cycle, or one that is discretionary. An issue is whether it should only use truly macroprudential tools or consider other microprudential ones.

Furthermore, there may be unintended consequences and a need to take into account potential market distortions and migration of activities to less regulated areas. Also, as the problems facing advanced countries might differ from those facing emerging economies, there might also be differences in the tools needed. Indeed, some emerging economies have already started experimenting with various macroprudential policies, with some success.

5. Five, regardless of where the macroprudential overseer is to be situated, the central bank will always need to play a role, given its mandate and expertise. In particular, central banks can provide important insights into the identification of systemic risks based on their extensive knowledge of macro-financial linkages, as well as inputs into the design, calibration, and use of macroprudential tools.

6. Six, and lastly, the importance of communication and cooperation should not be underestimated. This is relevant both among the various public sector bodies, but also between the public and the private sector. For instance, communication, information sharing, and cooperation between the micro- and macroprudential policymakers will be essential. Communication with those in charge of monetary and fiscal policy will

also be important. In particular, it will be key to maintain two-way communication between monetary policy and macroprudential policy. For instance, interest rate movements will likely have a macroprudential impact, and, similarly, macroprudential policies may well affect the monetary policy transmission mechanism.

The communication with the public will also be key as social support is critical for the effective conduct of macro-prudential policy. Moreover, there will need to be a delicate balance between being transparent about financial risks and vulnerabilities to encourage market discipline that can help self-correct those risks to the extent possible, while at times not providing so much information as to cause the financial instability one is trying to prevent.

In addition to these principles, to be applied at the national level, is there also a need for international cooperation of macroprudential policymaking? Do we need a global structure? Just as the health of domestic individual institutions does not add up to overall domestic financial system stability, the financial health of individual countries does not add up to global financial stability. There will certainly be a need for international consistency of macroprudential policies as regulatory arbitrage could otherwise ensue. Is there also a need for global coordination? In my view, yes. Given its all but universal membership, surveillance mandate, and financial sector expertise, the IMF can be helpful in facilitating this task similarly to what it is already doing in the macroeconomic policy dimension within the G20 coordination process.

## 5. The Future Contours of the Financial System

So what will the financial system of the future look like once we have implemented these financial sector regulatory reforms?

- Banks are likely to return to their more traditional function as stricter regulations in a number of dimensions will limit the risks and activities they can undertake.

- Meanwhile, the nonbanking sector will likely have a greater competitive advantage—both in supplying credit and providing investors with nonbank services—and will thus grow.

- As a result, the perimeter of regulation is bound to expand to better account for the increase in risks in the nonbank sector. To keep the nonbanks from making the financial system more vulnerable, more regulatory attention will need to be focused on this larger class of institutions. There will be the challenge, however, of coping with the proliferation of new institutions and activities that will try to escape the broader regulatory perimeter—the well-kown “boundary problem.”

- Furthermore, markets will become safer. Specifically, market infrastructure, including more exchange trading of previously over-the-counter instruments and robust netting and clearing systems, will be reinforced.

- To conclude, the financial system might well become smaller, less levered, and less dynamic than in the recent past. Nevertheless, a less risky system that has safer institutions and markets but is less profitable and employs less people isworth the price paid if crises such as the one we just experienced become less likely and less damaging. Achieving a safer financial system that remains sufficiently efficient and innovative to finance strong and sustained growth must be the main goal when designing the regulatory reforms.

Let me end with a word of caution. We are entering unchartered territory. While progress on macroprudential regulations will be key for moving forward, lots of work is still needed in this area. We will need to be humble—there are not only several “known unknowns” but most likely also a number of “unknown unknowns.”

What is clear is that prior to the crisis we were not able to see the forest for the trees and in some cases we did not even see the trees clearly. Going forward we need to be much better gardeners. We need to see the trees, their bark, and the root systems that interconnect them. And we need to take a good look at the forest as a whole. And not just the national but also the global forest. For this we do not just need good gardeners at the national level but also adequate collaboration among them at the international level.

The financial system has become global and as the present crisis has clearly shown, global problems need global responses. International collaboration is therefore a must if we really want to succeed in moving towards a better global financial system.

Thank you.