General Discussion:
How Should Financial Market Regulators Respond to the New Challenges of Global Economic Integration?

Chair: Gordon Thiessen

Mr. Thiessen: I think we've got some controversial things that we can talk about this morning. Let's start off.

Ms. Malmgren: I'd like to go back to a point that Howard Davies raised when he talked about at the end of the day after codes and capital adequacy transparency and other regulatory initiatives have been put in place, fund managers and investors must understand how to manage risks. Fund managers seem to have a tendency to go after the same kinds of investments at the same time. They do this partly because they're competing for shareholder funds and they're competing for investor funds. Anyone who takes a non-consensus view has to see profitability rise within, let's say, one quarter, otherwise they're punished by investors who withdraw funds. When you see this tendency in financial markets, it is exaggerated by something that Andrew Crockett mentioned, which is the fact that value at risk completely collapses in times of stress. You can hedge against a two standard deviation move but not against a four standard deviation move. So, the question is, does regulation have a role to play in trying to prevent fund managers from all moving in the same direction at the same time? One thing we know for sure is when they move in a consensus direction, the consensus is always wrong, and that's where losses begin to rise. So, this happens all the time, but it's particularly an issue when crises emerge.

Mr. Thiessen: Thank you. Don Johnston.

Mr. Johnston: My question is perhaps more practical. The regulatory frameworks, of course, are critical and the work that's going on in this area is terribly important. But Andrew mentioned, for example, the quality of the supervisors and the people. In other words, especially in emerging markets, are we satisfied that we are going to build regulatory frameworks? Fine, but what about the implementation that we speak of? Where are the credit officers going to be trained? I know that work is being done in that direction now. And I'm wondering whether that does not have to be enhanced and very quickly. But, Andrew, I would be interested in knowing at the moment—because I think you are involved in programs of that kind—whether sufficient effort is being made to develop a capacity, especially in the emerging market economies, to administer the kind of regulatory frameworks that may well emerge in the coming years.

Mr. Thiessen: Next question is from David Hale.

Mr. Hale: I just want to follow up on a recent comment by Mr. Johnston. One very important detail of the institutional nature of capital flows has not been talked about at all this morning but I think is worthy of discussion by this panel, has been the significant changes in the last ten years in the composition of the ownership of banking systems in developing countries. If we focus on this, we can see why Latin America, for example, performed well in recent years, whereas Asia collapsed.

In the last five or six years, the foreign investment in Latin America's banking system has gone so far that today foreign institutions control 60 percent of Latin America's domestic banking assets. Argentina, Chile, and Peru have gone the farthest. But in recent months, Mexico has also been catching up by permitting a major change in the ownership of that country's leading banks.

If we look at Asia, by contrast, we'll see one of the major contributing factors to the crises in Korea, Indonesia, and Taiwan was the fact that as recently as three or four years ago, it was illegal for foreign banks to operate directly in those countries. And, hence, all capital flows had to go through local intermediaries, which often had poor management, poor supervision, and a variety of institutional defects that led to inefficient and very sub-optimal allocation of capital.

The question up here, I think, for the panel is, can we do more to promote the growth of financial integration through ownership of banking systems across national boundaries? I would also add that Eastern Europe now is following in the footsteps of Latin America. In the case of Hungary, 75 percent of the banking system is foreign owned. Poland is about 60 percent. Estonia is 80 or 90 percent. It looks like Eastern Europeans have decided, again based partly on the Latin American experience, that this kind of change in ownership is a major asset. And I would add the only reason Argentina still has the Currency Board is because the change in bank ownership has now created new lenders of last resort for their banks in London, Madrid, Frankfurt, and Washington, they wouldn't have had just five or six years ago. They would not, in my opinion, be able to withstand the current strains on the economy if there hadn't been this dramatic transformation here in the mid- and late 1990s.

Mr. Thiessen: Scott Pardee.

Mr. Pardee: I think I heard Howard Davies right when he was talking about maybe the central banks might get involved in the regulation of insurance. And that worries me in terms of a mission creep, that the central banks moving outside of the normal areas of monetary policy and banking.

When you're talking about Lloyd's of London, I'm sure that for his organization, it's a good idea to oversee insurance regulation and particularly in connection with the global reinsurance market that he commented on. But much of insurance is local—in New York, thieves steal cars in Queens and ship them to the Dominican Republic and Puerto Rico. I'd hate to see the Federal Reserve Bank in New York get involved in that. In New Jersey, exaggerated claims are a big political issue. Every time a bus crashes, even if there are only three of four people on it, all of a sudden it has fifty people claiming to be passengers, all with bad neck injuries. This is outside the Fed's area of expertise. The Federal Reserve Bank of Atlanta may face requests for funds from the State of Florida, which is seeking to get more insurance money to cover hurricane damage. In San Francisco, does that Federal Reserve Bank want to get involved in earthquake insurance? And, indeed, between the Federal Reserve Bank of St. Louis and the Federal Reserve Bank of Kansas City, do you have to worry about the New Madrid Fault, which every 200 years has an 8 point earthquake? So these are things that are very specialized, very local, and are certainly outside of the purview of the Federal Reserve.

There's another issue, also, as far as Lloyd's is concerned. This is the long tale, forty years—asbestosis. This is what has damaged Lloyd's so much. So, you're going to have really specialized institutions dealing with insurance.

Mr. Thiessen: Okay. Any other questions? One right there.

Ms. Phillips: My question is addressed to Andrew Crockett. One of the points that he made toward the end had to do with whether or not central banks should be involved in regulation generally. He was making the point that perhaps regulation should be outside of central banks, but that central banks should be somehow associated particularly with respect to responsibility for stability in financial markets. And my question is: how can central banks be effective if they come late to the party for a financial crisis? I would just appreciate a bit more expansion on how this might work.

Mr. Thiessen: Any other questions? Yes?

Mr. Heller: Little was said about the role of private entities in the regulatory arena, and yet we have a lot of examples of successful self-regulation by industries. If you look at the stock exchanges in this country, if you look at the payment systems in this country and so on, there are a lot of examples like that. So, I would argue that not all regulation has to be done by government, but self-regulation can play a useful role.

Mr. Thiessen: Okay. Well, let's give our panelists a chance to respond. Andrew, let's begin with you.

Mr. Crockett: Thanks very much, Gordon. Don Johnston asked about the quality of supervision and programs to improve human capacity. This is very important because we are asking supervisors of financial institutions to do a much more sophisticated job than in the past. They are being required not just to understand the risks taken by an institution but to put that in the context of its business plan, the managerial structure, and so on. This is not a question of sending in a group of people to tick boxes on numerical ratios. You need to have a different category of expertise. I would argue that the basic background and training has to be somewhat different, and it has to be to a higher level. And the fact is that this capacity doesn't exist at the moment in emerging markets. The process of strengthening financial systems is not just a matter of adopting domestic laws covering the twenty-five Basel principles. You have to look to a program that's probably five or ten years in length to effectively implement these principles.

Susan Phillips asked about the remarks I made on central banks and supervision, which were, I think, rather brief. I would agree that central banks, if they're going to be asked to come in at the stage of crisis, have to be aware of more than simply the outline of the problem. My preferred model—others may have a different view—is that central banks should be involved in some sense in broad supervisory policy, though not necessarily in the specifics of individual institutional supervision. In Germany, for example, supervisory and regulatory policies cannot be adopted unless the Bundesbank has agreed to them, even though the Bundesbank does not have specific responsibility for supervision.

I also believe, and this is common ground, that there needs to be well-established principles for information exchange that can be activated not only in crises but also in non-crisis situations other than crisis so that the central bank has the information it needs to fulfill its mission.

I don't think I want to comment at length on the other questions. Pippa Malmgren seemed to argue can we regulate against herd instinct? I don't think you can do that, but I do believe there is something that you can to make market participants more aware than they have been until now of the risks. Perhaps it is also possible to facilitate the introduction of new capital into market making. If there is overshooting in prices, there ought to be a profit opportunity, and, therefore, capital ought to be attracted in. If you wanted institutions to come into the business of market-making and take positions, but you didn't want it to sound too threatening, you could find an attractive name for that activity. Hedge funds?

Mr. Thiessen: Howard?

Mr. Davies: Taking the questions very quickly in turn. Pippa Malmgren's question is an interesting one. I would just make a couple of observations about it. One, I don't think that this is something that regulators can really take on directly, though we have begun to put together comparative information tables targeted at retail investors of the costs and charges of different collective investment opportunities. And we even put out a consultation paper that suggested that there was absolutely no case for including past performance in these tables since there was no predictive information in those figures. This has irritated the fund management industry in huge amounts, and I regard it as one of the most positive things I've done.

And as far as the herd instinct is concerned, I think there is an issue related to the types of solvency requirements which, in fact, in the UK are not ones imposed by us but typically imposed by the Social Security system on pension funds. And the government has actually set up an inquiry regarding that specific case at the moment—as to whether there is almost a kind of monopolistic and herding behavior by consulting actuaries and advisors to pension funds which promotes what we typically call reckless conservatism. You may want to look at the outcome of that. It's being carried out by someone called Paul Myners who runs a fund management company called Gartmore. He's a very sensible fellow.

And, Don Johnston, I absolutely agree on the capability point in emerging markets. Andrew and the Financial Stability Institute that John Heimann runs are doing a lot. I do hope, however, that they do not train battalions of credit officers since I don't have any of those. We don't regard looking at individual credits in bank as a particularly useful thing for regulators to do.

David Hale, I think, is absolutely right about the importance of international ownership of banking systems, and certainly we are very conscious of that in regulating HSBC. We have to take quite a healthy interest in Argentina and in Mexico and Chile and Brazil.

Professor Pardee, frankly, I couldn't disagree with you more. And so I can't think of a polite response to your question. Clearly I was not suggesting that the Federal Reserve get involved in motor theft in Queens. You can't seriously have thought that I did. But let me give you an example of the kind of thing that I think is a financial stability issue that may be of interest to central banks where they have that responsibility. And even in our system where we have taken over all of the responsibility for insurance regulation, we work very closely with the Bank of England in our financial stability committee. This is part of the answer to Susan Phillips' point, I think. And what is going on in the insurance industry is of enormous interest to us. Let me give you a specific example. A number of our life companies thought it was a bright idea, in the 1970s and 1980s particularly, to sell guaranteed annuity products. Of course, that was rather an attractive marketing gambit. And they sold them on the basis that the actuarial advice told them that long-term rates in the UK could never fall below 7 percent because they never had, or they hadn't since 1945. This was entirely consistent with regulations in force at the time, and it was entirely consistent with actuarial advice. What these companies were doing was selling uncovered interest rate options. And I cannot help thinking that if they had been regulated by the FSA as it is now constituted, with quite a lot of economists and a very close link with the Bank of England, we would never have allowed that. The consequence of it has been that the Equitable Life, for example, one of our best life insurance companies, has gone bust and has had to basically offer itself for sale because the House of Lords ruled that they couldn't get out of these guaranteed annuity contracts as they sought to do.

It is absolutely crucial that there is some kind of economic analysis brought to bear on insurance regulation. So, your assertion that there needs to be a specialized agency dealing with this, I think, is about as wrong as it could be. And our experience in the UK, I think, provides huge argumentation to the effect that you need to look at the risks being run by big insurance companies, and particularly big reinsurers, which is the point that I was really making in an economic way and looking at it in a broad financial stability context, as well as just looking at whether they are meeting the precise regulations in force. So, I am totally unrepentant on that point.

And as for Susan's point, the way we have structured it in the UK, following the velvet divorce of supervision from the bank, is to have a tripartite standing committee between the Bank and the treasury and the FSA, which looks at financial stability issues broadly. And I think I would speak for the Bank of England as well when I say that the broadening out of that has actually, in some ways, given the Bank a better view of the overall financial system than it had when it was responsible directly for regulating one part of it but had no kind of structural relationship with any of the other supervisors. And, therefore, the breadth of the Bank's financial stability interests has in many ways grown as it lost responsibility for the specific implementation of supervision in individual institutions. That's the structural framework, and we find it's working reasonably well.

Lastly, regarding Mr. Heller's point, yes, I agree on self-regulation to some degree. I think the issue that we faced, however, in the UK, and the reason why we moved away from self-regulation to statutory regulation in a number of areas of financial services or securities regulation, was that our previous self-regulatory structures had been built on almost guild structures, where the investment management regulatory organization, for example, was built on a community of fund managers in Edinburgh and London, all of whom knew each other and who knew that their individual reputations depended on the collective reputation of that extremely tightly defined group.

What has happened now, is that that is not the case, and there is obviously foreign ownership of our investment managers. But there are also other people. Richard Branson, for example, with his Virgin Group, whose whole marketing initiative is that he is not one of those people. I mean, that is how he sells himself, that he is not part of the old fund manager consensus. And, therefore, the basis for that kind of self-regulatory structure really started to fade away, as he didn't think that his reputation depended on the probity of Equitable Life. In fact, he thought it was significantly improved if Equitable Life went belly up, as, indeed, it has done.

So, there was no basic consensus any more. If you look to self-regulation, you have to be sure that there is a genuine commonality of interest among the people who are organizing in that self-regulation. Where there is, then I am entirely happy to have it perhaps with some kind of loose statutory umbrella. But we had found that the old SRO structures that we had in place no longer represented a coherent commonality of interest and were not, therefore, terribly effective at raising and promoting standards and they had lost public confidence as a result.

Mr. Thiessen: Thanks, Howard. I don't know whether the Federal Reserve Bank of Kansas City recognizes the famous international rules of two-handed interventions, but I know Andrew wants to have another go.

Mr. Crockett: I had forgotten to make a point on the insurance question raised by Scott Pardee. I hope he won't regard this as "piling on" after Howard's response. The point is that a lot of insurance companies are now marketing risk mitigation products to banks. For example, in operational risk, the BIS was offered coverage up to $2 billion against operational risk by a major insurance company. Were we to take that on, then we would be greatly interested in the security that the insurance company was offering. I assume our supervisor (were we to have one, which we don't) ought to be interested in that too. I just want to mention that the solvency of banks is becoming increasingly bound up with the way in which they assess the solvency of those who insure some of the major risks they lay off.

Mr. Thiessen: Thank you. Randall?

Mr. Kroszner: One of the issues I'm thinking about is not only the quality of supervisors, which is an important issue, it is also the incentives the supervisors have to enforce the appropriate regulations. Sometimes it is very difficult even in the U.S., like during the savings and loan crisis, when the problems were developing. There were a lot of very competent regulators who really didn't have an opportunity to enforce the regulations as they would have wished. They were often reassigned or given disincentives to do so. So, I think that's an extremely important part of thinking about the implementation mechanism—not just having quality supervisors, which is certainly necessary, but I think having the proper incentives in place is also necessary.

On the point about foreign ownership, I think that also fits nicely into the political economy framework because I think that creates a virtuous circle. Once you get foreign ownership in, often it comes in crisis situations, as in a private sector bail out. Typically, there isn't as close a relationship between the local regulators and the foreign institutions, and so you end up getting a more open, more equitable system than you might otherwise have gotten if you just had the same old players together working with the same old regulators.

On the point about mission creep, that's, in some sense, the point that I was trying to bring up—not with respect to insurance but with respect to electricity, telecom, and natural gas. We have financial services providers in very different areas, and not the traditional structures that we would have thought about, but potentially Microsoft, Yahoo, and AOL providing these kinds of things. Is this going to be an excuse for mission creep, or should I not characterize it as an excuse? Should this be something that we should seriously think about? But it's something that doesn't seem to be in the debate, and I think it is very, very important to think about. But certainly there are important bureaucratic forces toward increasing the mission.

And, finally, on the point about SROs and competition, clearly I was trying to promote the idea that historically there have been very strong successes prior to any sort of regulatory system besides basic contract enforcement where we had in the futures markets and derivatives markets, as well as in bank clearing and payments markets. The private sector is coming up and providing very good, not perfect, but very good provision of these kinds of services.

On the SRO point, it's sort of an interesting trade-off that in some sense what Howard was talking about was that there are fewer rents to be had because there's more competition. But when there were more rents, the people who were part of the group that was concerned about its reputation, saw a lot on the line. If there's a lot more competition, there are fewer rents to be had and, perhaps, the structure wouldn't provide the same kind of incentives as under a system where there was less competition. However, there is also the cost in terms of monopoly rents. And so there's a trade-off again between efficiency and the stability kinds of issues, which are ones that I think are the core of what we have to face going forward.

Mr. Thiessen: Thanks very much, Randall. I must say, as coming from a central bank that has never done supervision, it hasn't been a question, in our case, of finding ourselves coming late to the party, as Susan Phillips was suggesting. You really do have to have a very close relationship between the central bank and the supervisor if you're not going to do supervision. But Andrew, I wouldn't agree that you somehow need to have some sort of broad responsibility for the broad policy of supervision. I really do think that fouls up the whole accountability arrangements. And as those lines between financial institutions increasingly blur, and there are interactions between various categories of financial institutions, as Andrew was mentioning, having supervision in central banks really does get increasingly awkward. So, the sorts of arrangements that we've had and a number of other countries are moving to—where you have a separate supervisor but you've got these kind of close arrangements—really does deal as best you can with these circumstances, taking all the points, however, of needing to avoid this whole issue of safety net creep because I think that, indeed, is a very dangerous one.