Questions on Post-Crisis Financial Regulation in Developing Countries, with Implications for Financial Access

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Outline

- State of financial sectors
  - Advanced countries
  - Emerging markets
- Finance reform agenda
- Access to finance agenda

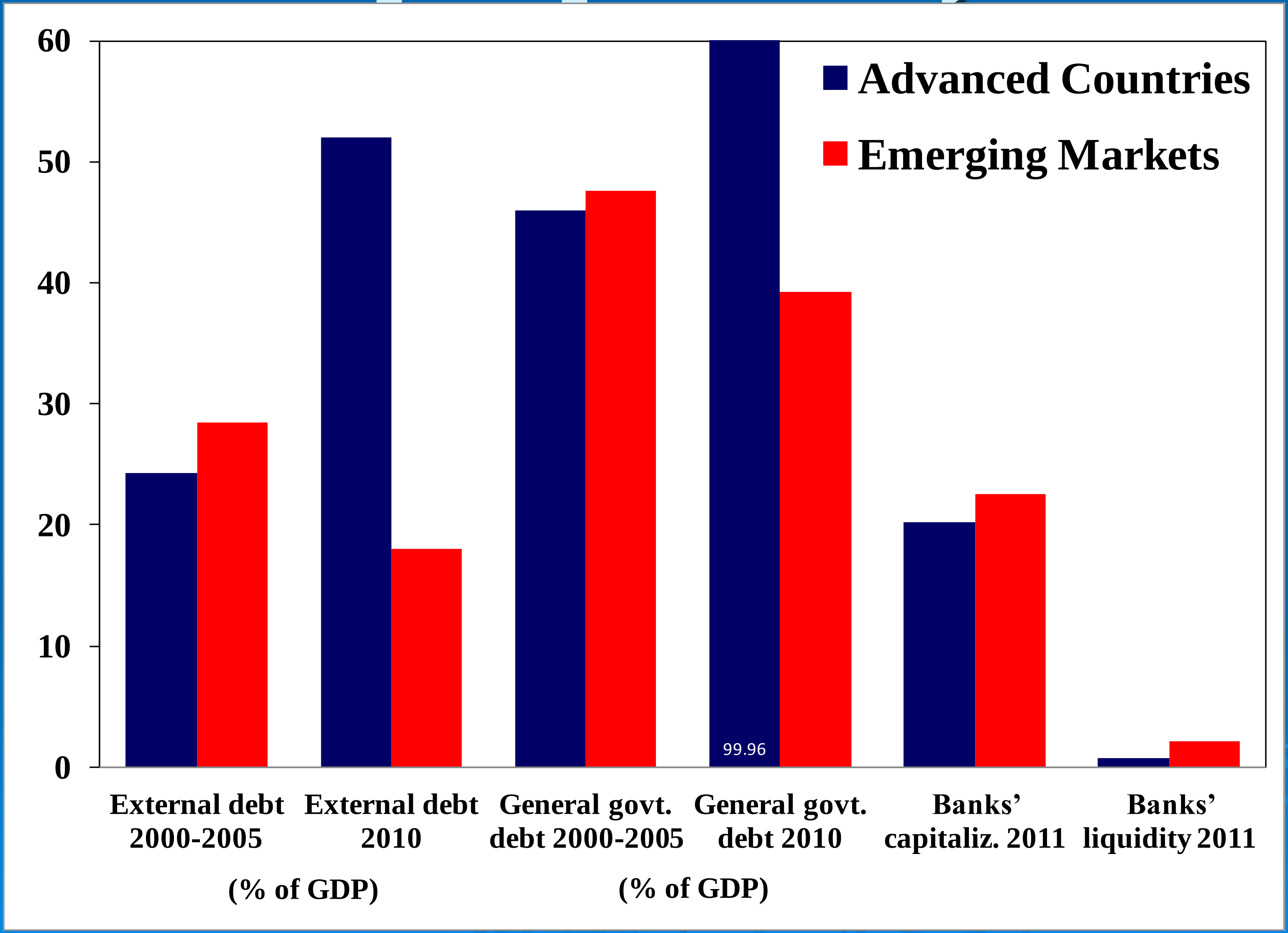
State of financial sectors, in advanced countries

- Financial sector still weak
  - Weakly/undercapitalized/reduced profitability
  - Large overhang (households/sov) to be resolved
- Sector facing new regulations, risk averse
  - Stricter capital adequacy, etc. requirements
  - Higher general risk aversion
- Yet (systemic) risks not necessarily lowered
  - Migration of risks to outside perimeter
  - Questions on fundamental reforms

Current State of EMs' Financial Systems Better

- Generally higher, better capital, less leverage
- Different concerns about liquidity risks
  - Other deposit and local funding structures
- Lower public debts, more state-owned banks
  - Gives some headroom, flexibility
- Sometimes better rules for bank resolution
  - With less emphasis on deleveraging
- More used to macro-prudential approaches
  - Some rules, general pragmatic approach

EMs' current circumstances and prospects vary



While EMs Today are Doing Better, They Remain Exposed to Risks

- Current performance and situation stronger
  - EMs more independent growth poles
  - Macroeconomic and institutionally stronger
    - Better macroeconomic policies, less foreign finance
  - Current prospects better

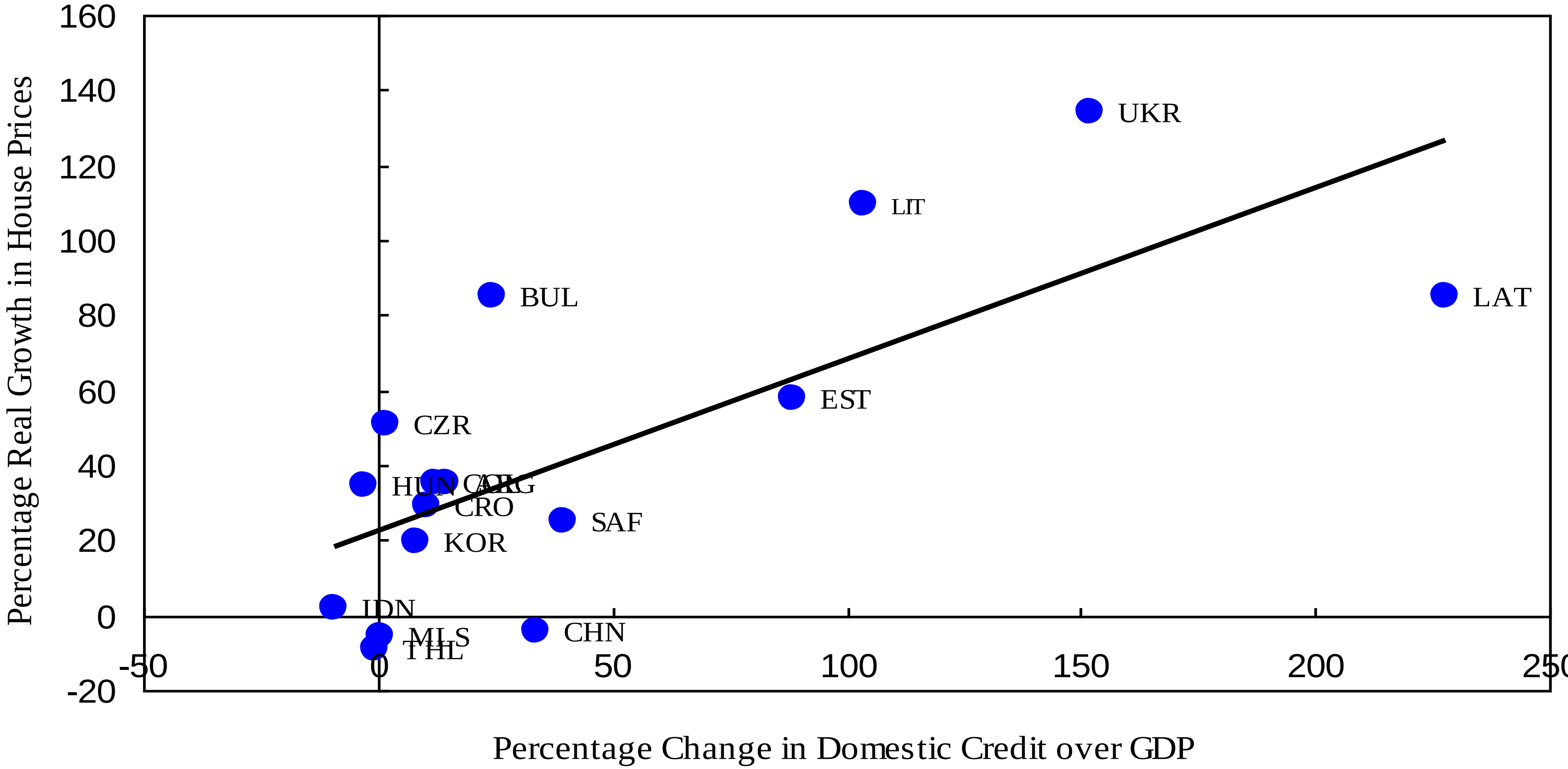
- Yet remain exposed
  - To capital flows volatility
  - External shocks
  - Global slowdown, financial turmoil

And as Risks Become More Like ACs', Need To Adapt

- Financial cycles have become more similar
  - Now also concerns about domestic credit booms
- Exposures, shocks, institutional environment, policies and head-room still differ
  - Notably twists: capital flows, euro/dollarization
- So need to adapt policies and tools
  - Likely more basic tools and approaches
  - Macro-prudential policies, e.g., to include more foreign exchange risk, capital flows management

Credit Growth and Asset (House) Price Increases Also Tend to Go Together in EMs

Credit Growth and House Price Inflation 2004-07



State of financial regulatory agenda

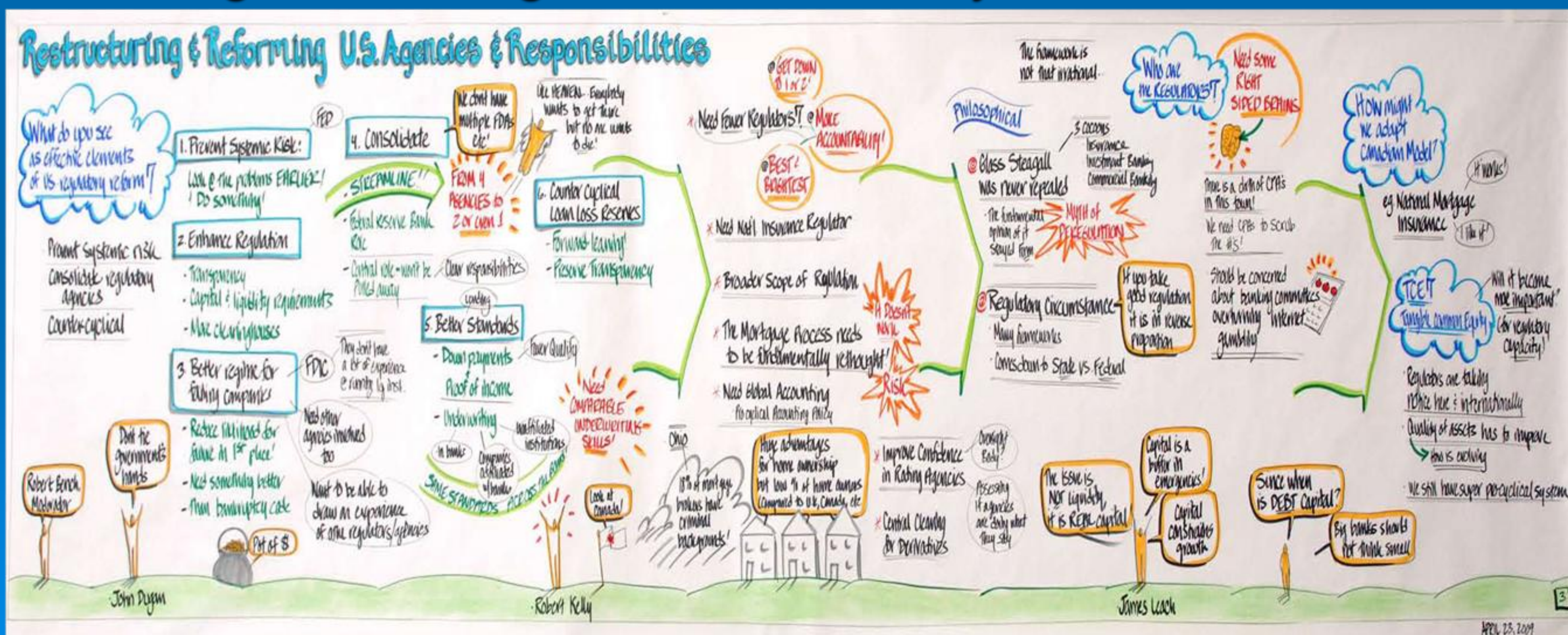
- Progress on some, but “easier” elements
  - Higher/better capital adequacy, some buffers
  - Limits on leverage
  - Better coverage of risks
  - Some progress on derivatives/CCPs/OTC
- At the same time, because of interventions
  - Moral hazard increased
  - Market structures largely similar (same top SIFIs)
  - Concentration greater

Ongoing agenda, in various stages

- Market discipline
  - Accounting (note MtM was waived): underway
  - Rules on rating agencies, role of CoCos: TBD
  - Better corporate governance of FIS: TBD
- Regulatory governance
  - Some, but some moving of boxes (FSA/BOE)
  - Or more new agencies (US 7 new, only 1 out)
  - Little progress on independence (less perhaps), accountability, integrity, transparency

U.S.: 1 less, 7 (?) more agencies

- <u>Gone</u>: Office of Thrift Supervision
- <u>New</u>: Consumer Financial Protection Bureau, Financial Stability Oversight Council, Office of Financial Research, Federal Insurance Office, Investor Advisory Committee, Office of Housing Counseling, Office of Minority and Women Inclusion



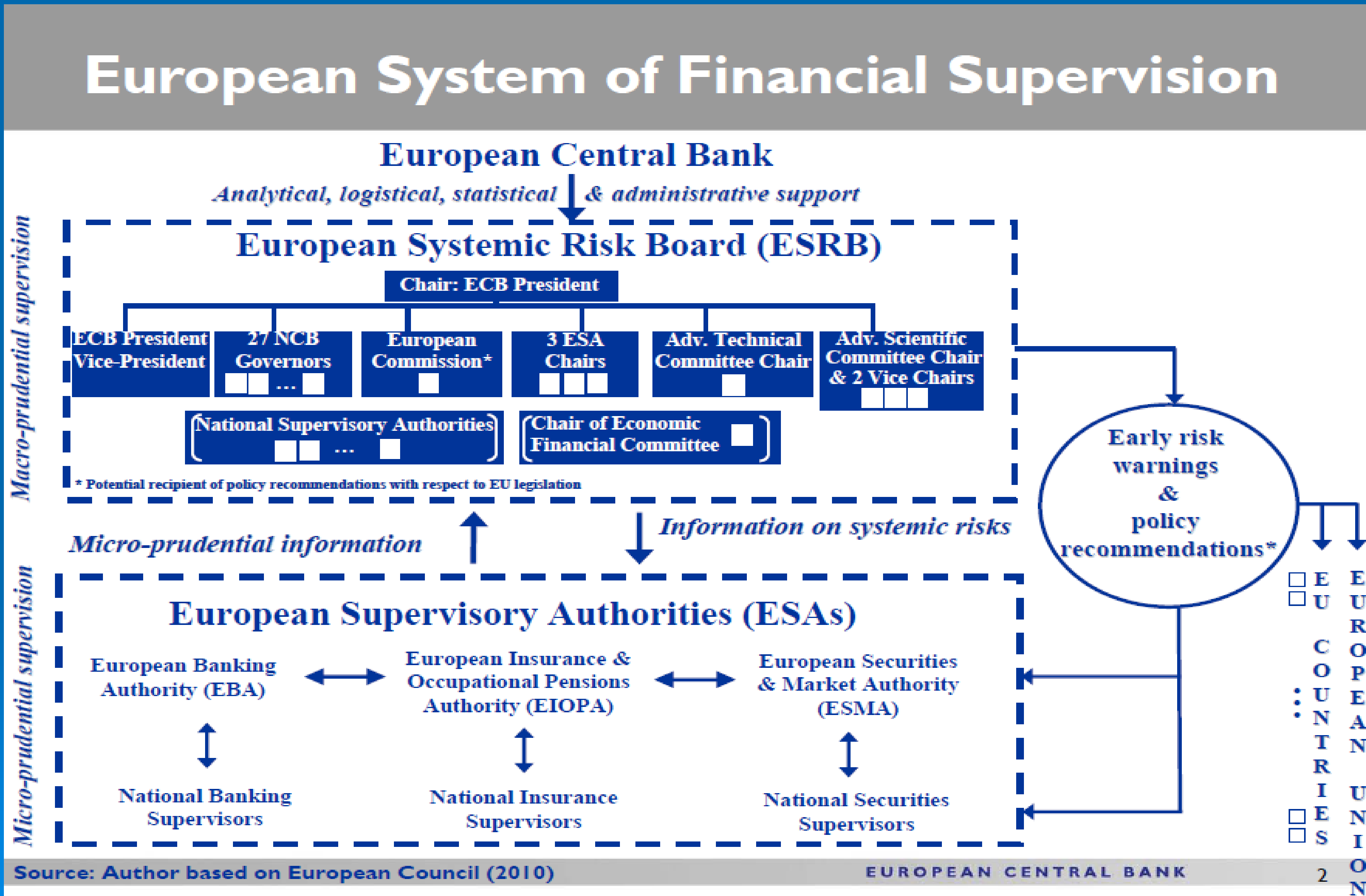
Problems still to be addressed

- Limited progress in fixing deeper "causes"
  - Resolution: few countries finalized so far
  - Liquidity: requirements still TBD
  - Cross-border: little so far (some implicit in EU)
  - Procyclicality: hard, but much to be done
    - Only some limits on activities
    - Little on incentives/compensation
    - Dynamic provisioning, through the cycle TBD

Long-standing issues (still or even more so) to be addressed

- Shadow banking system
  - Approach and perimeter: much remains TBD
- Macro-prudential policy
  - Concepts: some progress. Operational: TBD
- Surveillance (national, regional, global)
  - Mandates, powers, institutional structures: TBD
    - e.g., ESRB, FSOC, IMF/FSB
  - Data, analyses: to be set up/done
    - e.g., OFR, BIS, G-SIFIs, data on interconnections

Surveillance in EU: quite complex



Costs have risen for provision, while risks may remain

- Finance facing higher (compliance) costs, reflected in prices and quantity
  - Spreads up/higher, access less (some good)
  - Drag on growth (MAG: 0.3% GDP loss MT)
- Emerging /developing markets affected in MT
  - Costs of cross-border/capital flows up (like Basel II)
  - Foreign banks: less eager to expand in local markets
- Short-run, as deeper causes not addressed, AC' "2nd best policies" create some externalities
  - QE2, low interest rate → capital flows ↑
  - Asset prices bubbles, credit booms (and busts?)

Access raises challenges in general and special for developing countries

1. Access to credible information
2. Competitive and contestable markets
3. Good consumer protection
4. Moderate costs of regulation
5. Harmonized rules/practices
6. Supportive international standards
7. Regulatory governance

1. Access to credible information

- Information is essential for risk management, efficiency of intermediation <u>and</u> for access
  - 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 to be contestable

2. Competitive & contestable markets

- Contestability is key for access, structure less so
  - Entry (including foreign) 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
    - Balance, however, provides spare wheel

Calls for better competition policy

- More active competition policy possible and needed
  - Finance and banks particularly less special
  - Global and across all types of financial institutions
- New paradigm to be developed and applied
  - To go beyond institutional and functional approaches; more input based; and global, horizontal, sector-specific
  - Approaches to resemble other network industries
  - Tools to adjust, e.g., less market structure, more conduct
- Institutional changes
  - Competition policy to be separate from supervision
  - International agreements to commit/enforce
  - Active role of government, given externalities/coordination

3. 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 of key issues
- Protecting individual consumers
  - Can no longer assure “fairness” of products and markets
  - “Buyer beware” to be matched by increased “truth in advertising”, liability, means of users to take legal actions
- Assuring consumers obtain greatest benefits
  - Increased choices/complexity not matched by knowledge
  - Requires more financial education, starting at early age

4. Costs of regulation

- Deregulation first, now reregulation: how much?
  - Direct and indirect (compliance) costs increase
  - With possible adverse effects on access
    - e.g., higher capital adequacy requirements raise cost
    - e.g., AML/CFT can affect access of households
  - Markets and governments balance this with risks
- Proper policy responses
  - More formal cost-benefit analysis
  - Transparency & consultation to balance tradeoffs
    - Without inviting capture, need to have broad(-er) representation of producers and consumers in processes

5. Harmonization

- Big barriers removed, but many remain
- Further harmonize across markets, sectors and products, by functions, so 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 price and cost
  - Competition—between markets, sectors, products and regulators—key to force more effective harmonization

6. Supportive international standards

- Countries less freedom to pursue own approaches
  - Good, since state has often not been productive
  - Yet many successful economies had some interventions
- Countries can combine, but only to some extent
  - Commit to pro-competitive framework through international agreements, especially when credibility, competition authorities weaker, politics adverse
  - Pursue some national (access) objectives, through lending requirements, development institutions, etc.
  - Balance precarious: deter entry, raise costs, distort

Application of international standards

- Standards (Core 25, Basle III, IOSCO, etc) help, but:
- May not be 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

Adaptation of international standards

- Adapt standards and assessment over time
  - Standards to adapt to country circumstances, changing world and lessons learned
  - Need to consider assessor/methodologies consistencies
- Include all relevant parties in review
  - Increase stake of emerging markets in international standard setting forums (BCBS, CPSS, FSB, etc.) and IFIs (IMF, WB)
  - Consider legitimacy, which may mean raising stakes even more
  - Help with negotiations in FTAs, GATS, etc to level playing field
  - Balance private sector/producers' interests with consumers'

6. Regulatory Governance

- In developing countries: Long standing issue
  - Many political economy factors, lack of resources
- Developed countries: no longer examples (?)
  - Little progress.
    - Mandates, powers, structures (ESRB, FSOC, IMF/FSB): TBD
  - Data, analyses: to be set up/done (e.g., OFR, BIS, G-SIFIs)
- What is to be done? Templates to be designed
  - How to emulate central bank with monetary policy?
  - Independence, accountability, integrity, transparency

Conclusions

- Crisis raises new issues
  - Macroeconomic, and many regulatory policies
- While many fundamentals confirmed
  - Although changing emphasis and adaptation needed
- Developing countries have own agenda
  - Level playing field: harmonization, with competition
  - Competition policy: often missing, but more needed
  - Consumer protection: more emphasis, tools, education
  - Role of standards: to a point, to evolve, require inputs
- Developing countries’ challenges
  - Fast financial integration: can require specific responses
  - Better representation in rules/int’nal forums/policy making