The Reform Agenda and the Balance between Stability and Efficiency

José Viñals
Financial Counsellor

IMF High Level Seminar on Reforms in Financial Sector Regulations
July 12, 2010
Outline

- Key challenges and objectives
- The reform agenda
- Potential impact
- How to get the balance right
Key challenges and objectives

The reform agenda

Potential impact

How to get the balance right
Key Challenge:
How to balance competing goals?

- Improving resilience of global financial system
- Supporting economic recovery and financing sustained growth
Key Challenge and objectives

- Finalize reforms
- Implement
  - timely
  - effective
  - consistent

- Credible fiscal consolidation
- Prudent public debt management
- Mitigate financial transmission

- Macro/prudential tools
- Preserve benefits of globalization

- Rebuild capital
- Secure stable funding
- Restart “safe” securitization
- Resolve/restructure weak banks
- Careful monetary, financial exits

Advance Financial Reform
Reduce Sovereign Risk
Address Challenges of Capital Inflows
Support Credit
Key challenges and objectives

The reform agenda

Potential impact

How to get the balance right
How to view the reform agenda

**Sector**
- Reform agenda is so far largely **bank centric**
- Need to advance on **non-banks**

**Focus**
- **Micro-prudential** – basic agreement on bank level regulation
- **Macro-prudential** – many systemic issues still unresolved

**Time**
- **Short-term** – decisions by year-end
- **Medium-term** – to be implemented by end 2012
The reform Agenda

- **Micro-prudential**
  - Basel 2R: Capital / Risk Capture / Leverage
    - Higher and better capital
    - Higher capital charges for certain risks
    - Leverage ratio

- **Macro-prudential**
  - Basel 2R: New minimum quantitative liquidity standards
    - Liquidity Coverage Ratio: to survive a 1 month stress
    - Net Stable Funding Ratio: requires longer term funding sources
  - Systemic risk:
    - SIFIs “TBTF”: supervision; COCOs; Volker Rule; surcharges; Levy OTC derivatives and central clearing; non-bank financial institutions
    - Countercyclical provisioning and capitalization; accounting; compensation; CRA; resolution
What has been proposed

Capital

Better quality, consistency and transparency of capital

- Predominance of Tier I capital
- Phasing out of Hydrides
- Phasing out of Tier III
- Harmonization of deductions

Limit leverage

- Leverage ratio

Forward looking and counter cyclical capital

- Capital conservation measures
- Forward looking provisioning
- Counter cyclical capital
What has been proposed

Liquidity

Liquidity coverage ratio

High quality unencumbered liquid assets > net cumulative outflows

30 day period Stress scenario

Net stable funding ratio

Available funding > Required funding

One year period Risk factor approach
Why it matters for the Middle East and Central Asia Region

- Some banks have to make adjustments
- Islamic banks may be challenged by liquidity requirements
- Consistency between regional and global reform agendas needed for enhanced efficiency
Why it matters for the Middle East and Central Asia Region

Contagion/spillover effect

- Impact on growth and stability in advanced economies
- Capital outflow/inflows
- Regionally and globally active banks
  - Regulatory competition
  - Cross-border supervision
  - Cross-border resolution
Why it matters for the Middle East and Central Asia Region

Macroprudential tools are very relevant

- Lack of independent monetary policy under pegged exchange rate regimes => importance of macroprudential tools

- Counter cyclical capitalization and provisioning policies relevant to commodity exporters to mitigate lending procyclicality and asset price bubbles with commodity price cycles
The objective: less volatile growth

Avoid Lehman-Brothers type crisis
The danger: over-reaction by policymakers

Growth

Time

Before reforms

After reforms
Reform agenda and impact on growth

**Potential impact**
- Higher lending cost
- Lower supply of credit
- Larger impact on risky sectors (speculative--positive / SMEs--negative)

**Potential mitigations**
- Monetary policy response
- Lower risk premium for safer banks (funding)
- Financial stability lowers risk premium (lending)
- Banks cost cuts
- Non-bank financial sector supports lending
However, we should not forget the costs of financial crises

- **Output losses** of systemic banking crises averaged **about 20 percent of GDP** during the first four years of the crisis.

- **Fiscal costs**, net of recoveries, associated with crisis management averaged **about 13.3 percent of GDP**.

- These costs do not include the **contagion cost** to other economies and the **loss of fiscal revenues**.
### Financial stability

<table>
<thead>
<tr>
<th>... it is in the interest of ...</th>
<th>... as its absence could result in</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>loss of equity</td>
</tr>
<tr>
<td>Bank managers/employees</td>
<td>loss of jobs and income</td>
</tr>
<tr>
<td>Depositors (investors)</td>
<td>loss of deposits or investments</td>
</tr>
<tr>
<td>Borrowers</td>
<td>credit squeeze</td>
</tr>
<tr>
<td>Tax payers and public sector</td>
<td>bail out cost and loss of revenues</td>
</tr>
<tr>
<td>Central banks</td>
<td>monetary policy impediments</td>
</tr>
<tr>
<td>The overall economy</td>
<td>welfare losses ➔ social costs</td>
</tr>
<tr>
<td>Global economy</td>
<td>contagion/spillover cost</td>
</tr>
</tbody>
</table>
Outline

- Key challenges and objectives
- The reform agenda
- Potential impact
- How to get the balance right
How to get the balance right

- Assessment of the potential impact to guide the size and timing of reforms
- Clear transition timeframe to reduce uncertainty
- International coordination to avoid regulatory arbitrage
- Expand the regulatory perimeter to avoid shifting the risk to the shadow banking system
How to get the balance right

- Develop government securities (including sukuk) to facilitate banks’ liquidity management

- Active participation in the global debate about the reform agenda to reflect the region’s interest

- Avoid substituting higher capital and liquidity requirements for quality of supervision
The Fund identifies that good supervision has to be

- **Intrusive**: intimate knowledge of the supervised entity
- **Proactive**: always question, even in good times, the industry's direction or actions
- **Comprehensive**: being especially vigilant about what's going on the edge of the regulatory perimeter
- **Adaptive**: keeping abreast of new products, new markets, new services, and new risks
- **Conclusive**: don't just identify problems, follow up too
Thank you