

Bank Regulation and Financial Development

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Structure of presentation

- ✚ A tall order for bank regulators
- ✚ The big financial market trends
- ✚ The regulatory tripod – capital, monitoring and exit
- ✚ Dynamic interplay of tripod with big trends
- ✚ Final thoughts

A tall order for EM regulators

- ✚ Rapidly changing financial markets with rising complexity
- ✚ Enduring paradigm so far: *regulated* but *market-based* financial development
 - ✚ Almost everywhere in LAC (threat of reversal in a few places?)
 - ✚ Despite of frequent financial crises, especially in LAC
- ✚ Regulators' vision – quest for the right balance
 - ✚ Enabling financial markets to boost economic wellbeing
 - Lubricating the process of “creative destruction”; mobilizing & administering savings; facilitating payments; allocating risks
 - ✚ Avoiding the maladies of finance
 - Contagious runs; irrational exuberance (undue risk taking); looting

Regulating in the midst of big market trends

✚ Driven by competition, de-regulation, technological change

- ✚ Conglomeration
- ✚ Internationalization
- ✚ Functional de-segmentation
- ✚ Financial innovation
 - Securitization
 - Derivatives-ation

✚ Regulators' main mission

- ✚ Ensure that financial intermediaries understand and know how to measure and manage the risks they take
- ✚ Ensure that they have the incentives to do so
- ✚ *Given high leverage, limited liability, and information asymmetries, such incentives are not naturally in place!*

The regulatory tripod

- ✚ Capital
- ✚ Screening and monitoring
- ✚ Closure and exit

A dynamic view of the regulatory tripod

Capital

- ✚ Towards increasing *risk-sensitivity* & *comprehensiveness* of regulatory capital requirement
- ✚ Conglomeration → capital on a consolidated basis
- ✚ Internationalization → aligning global-local incentives
- ✚ Functional de-segmentation → regulatory capital arbitrage
- ✚ Financial innovation → credit risk transfer issues
 - ✚ From “originate and hold” to “originate and distribute”
 - ✚ “Circularity of risk” – is there enough capital in the system?
 - Something to be said about the good old “leverage ratio”

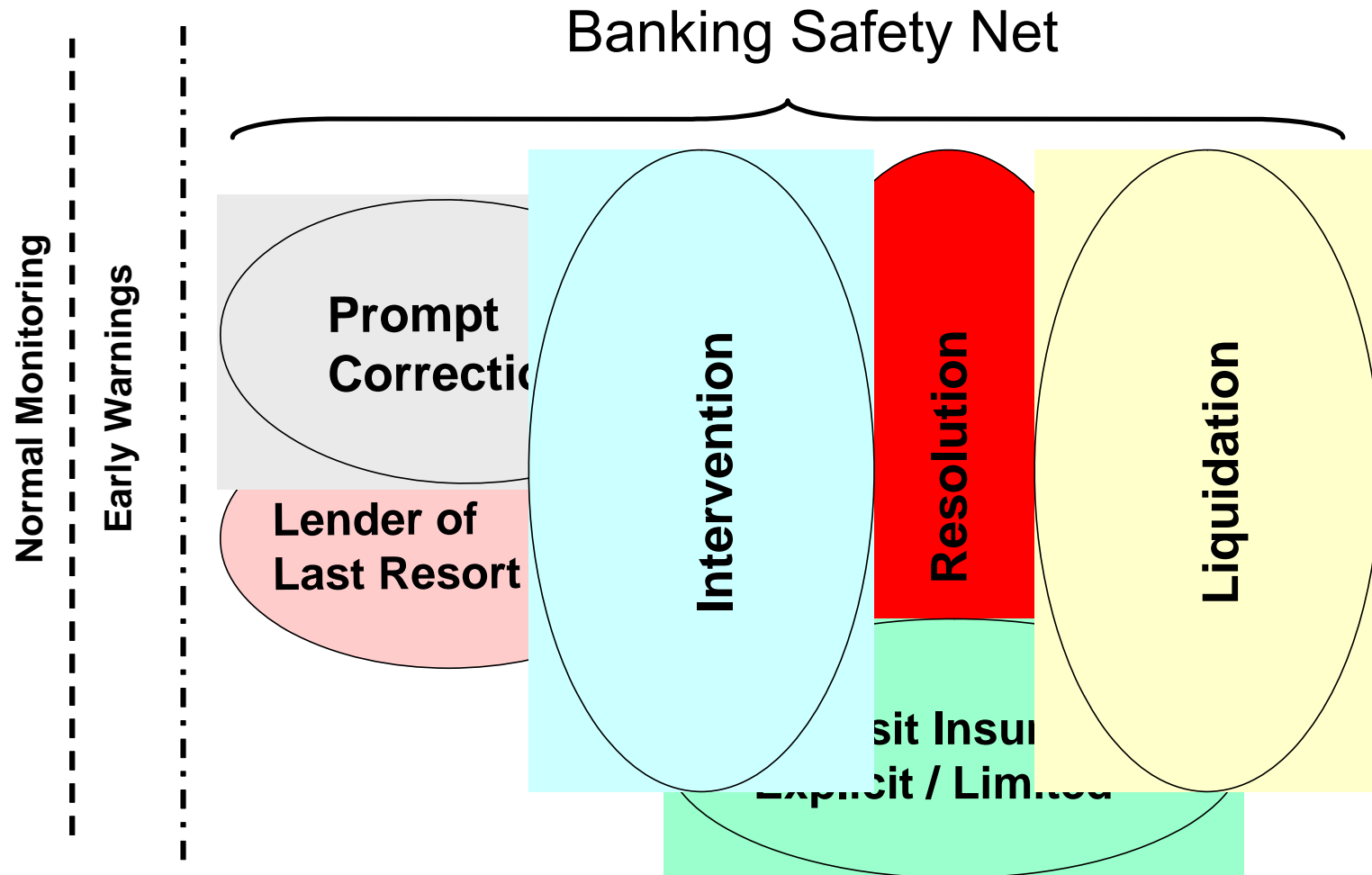
A dynamic view of the regulatory tripod

Screening & Monitoring

- ✚ Toward setting up sound lines of defense, in the right order
 - ✚ Fit & proper screening of managers and owners
 - ✚ Boards of directors
 - ✚ Internal and external auditors
 - ✚ Rating agencies
 - ✚ Large depositors/investors
 - ✚ *Official supervision*
- ✚ ... based on sound accounting & disclosure practices and reliable contract enforcement systems
- ✚ Securitization and “derivatives-ation”
 - ✚ From “originate and hold” to “originate and distribute”
 - ✚ Complexity and opacity – what is the risk and where is it?
 - ✚ Warping of incentives – origination and monitoring failures
 - ✚ From monitoring of banks to monitoring of markets!

A dynamic view of the regulatory tripod Closure & Exit

Towards a very complex, institutional-intensive architecture



A dynamic view of the regulatory tripod

Closure & Exit (cont.)

- ✚ Conglomeration → how to deal with the failure of a financial group?
- ✚ Internationalization → how to deal with the failure of an international financial group?
- ✚ Financial innovation → how far to stretch the safety net?
 - ✚ From run on the bank to run on the markets
 - ✚ LOLR – whither Bagehot's rule?

Final thoughts

- ✚ Regulators can hardly keep up with market developments
 - ✚ Complexity of risk measurement & management systems
 - ✚ Risks that outpace risk measurement/management capacity of market participants
 - ✚ Rising premium on market discipline – but how feasible?
- ✚ International standards help but...
 - ✚ Need to adapt regulatory policy to stage of financial development
 - ✚ Historically, standards came late in financial development
- ✚ Market liberalization challenge
 - ✚ It spurs reform and not destabilizing *in the long run*
 - ✚ Caution is needed regarding speed and timing – but how feasible?

END

