

Global Banking: Paradigm Shift Regulatory Issues

ISHRAT HUSAIN¹

Distinguished Guests,
Ladies and Gentlemen:

Good Morning. I am honoured to chair this session on Regulatory Issues for which I am grateful to conference organizers.

New Regulatory issues can arise either from the changing nature of domestic financial system or due to the challenges arising from globalization and financial integration across borders. In Pakistan, for example, there has been a major shift in the ownership and management of the banking sector from a predominantly public sector to the private sector. As a result of restructuring and privatization, 80 per cent of the assets of the banking system are at present in the hands of the private sector. There has also been a simultaneous shift from a direct and administered system to market determined and market based interest rates, exchange rates and other key price variables. This change in the landscape domestically has imposed new burden on the regulators. As the new private owners and managers of the banks have limited stakes of their own, they can take excessive risks with depositors' money. The upside potential from this excessive risk taking will be appropriated solely by the owners and the managers in form of higher than average returns and performance bonuses, but, the downside risks will fall upon the shoulders of the depositors. The regulator has thus to remain vigilant all the time to ensure that the private owners and management of the banks do operate within the defined risk parameters, observe the standards, guidelines and codes diligently, comply with prudential regulations and norms, follow the best corporate governance practices and do not deviate from the instructions given from time to time.

¹ Chairman's Inaugural Address at the Session on "Regulatory Issues" held at the International Conference on "Global Banking: Paradigm Shift" organized by the Federation of Indian Chambers of Commerce and Industry and the Indian Banking Association at Mumbai on October 6, 2005.

The competences and caliber of the staff working in the regulatory institutions, the use of technology to produce an updated management information system on real time basis and the re-engineering of business processes and systems are the tools whereby the regulators can remain on the top of the potential problems.

The globalization and integration of banking across the globe have brought us a number of benefits. It has not only speeded up the process of economic development by infusing competitiveness and efficiency in the financial sector but, at the same time, given rise to new challenges for regulators and have implications for the stability of global financial markets. This trend of financial integration is accompanied by increased complexity arising from sheer increase in size, changes in nature of business processes, products and technologies, and expansion in geographic scope. The regulators have to keep pace with the financial innovations and comprehend the risks involved in these complex products. The content, characteristics, embedded risks and the accounting of the ever growing array of financial instruments particularly derivatives, hedge products and other similar products have to be fully understood. The regulators have to insist that there are common standards for valuation of assets and liabilities and there are common yardsticks for measurement. The transparency and disclosure standards have to be kept under constant watch and suitably upgraded so that the innovators are obligated to provide the full range of information required to evaluate the risks. While the regulators should not stifle financial innovation from flourishing, they should have the capacity to understand the risks involved and disseminate them to the market participants.

A third area besides domestic financial system development and cross-border financial integration pertains to the possible misuse of the banking system by anti social elements.

Globalization and integration across geographical boundaries involve stepping out of a common regulatory regime and chances are there that such depart might

leave behind some loopholes in the supervisory frameworks that unscrupulous elements could exploit for their anti-social activities. The recent years have witnessed examples of misuse of banking system for activities such as terrorist financing, drug trafficking, and money laundering. The lacunas in the existing laws and regulations have allowed unscrupulous elements to circumvent the regulatory framework governing the global banking. Regulators are therefore paying increasing attention to this issue and their policy responses have been quite encouraging. So far they have established different forums to ensure close and continued cooperation, keep abreast of best practices and have developed partnership network. FATF recommendations for tackling the laxity in uniform standards, laws, and limitation in supervisory sphere are a praiseworthy development. The recommendations provide guidelines to strengthen the regulatory regimes to check the misuse of financial system to create appropriate global norms and to attempt the country regulators to converge to best practices. However, the quality of legal environment and institutional framework to counter these misuses in different countries is uneven. On the one hand there are countries with comprehensive legislation, well defined enforcement mechanism with clearly identified responsibilities, and well thought out standards and guidelines. On the other hand, there are countries with regulatory framework at quite rudimentary stage of development. This emphasizes the need for gap analysis and efforts to overcome the shortcomings so as to bring these frameworks near to the international best practices.

Here I would like to share our experiences and developments in Pakistan in countering the terrorist financing and money laundering:

- We have introduced a comprehensive regulatory framework by issuing prudential regulations for banks and DFIs. The regulations cover all the necessary features recommended by FATF. Their implementation is ensured through on-site examination and off-site surveillance. And our inspectors specifically verify the adequacy of KYC policies and other anti-money laundering safeguards.

- Money changers have been replaced with properly regulated exchange companies, formalizing the business of money changers and underlying transactions. These exchange companies are obliged to document and record all transactions beyond a certain minimum threshold level, to submit reports at periodic intervals to the regulators and to subject themselves to on-site examinations. This is a major step in reducing the risks of unregulated money changing business to be misused by undesirable elements.
- Different kinds of bearer instruments that were previously in currency have been gradually phased out. Banks were used to issue Traveler Cheques of exceptionally high denomination that was not in line with the true spirit and purpose of traveler cheque. And the holder of these instruments often used them as mode of settling the undocumented transactions. SBP therefore prohibited the issuance of RTC in denomination exceeding Rs10,000.
- Close collaboration has been established with a number of central banks for exchange of information and expertise inter alia covering anti money laundering and terrorist financing areas.

As I have said earlier, primary focus of the regulators remains the stability of their respective financial markets. Our task in the face of rapidly changing circumstances and ensuring complexities has become even more challenging. The increased complexity that transpires in fast changes in business processes, practices and technologies and emergence of novel products at quite rapid pace puts ever rising demand on us to improve our effectiveness and bring the banking system around the globe to best practice standards. I propose two-pronged policy response to effectively meet the objective:

1. Shift to proactive supervision, and
2. Increased role of market discipline and self regulation

Proactive Supervision:

The traditional approach of regulation that is mainly compliance oriented and reaction-oriented in nature has lost its effectiveness in the present dynamic scenario. The imperatives of market dynamism demand depart from the trite approach towards a more proactive approach that forces banks to recognize the problems when occur or, preferably, even ensure that the probability of their occurrence is contained. This approach puts more emphasis on examining the bank's risk measurement and management processes instead of just reviewing its assets portfolio and demands that a bank's risk management processes should be scaled up to reflect its risk appetite and the complexity of its operations. Specifically, the bank which engages in more complex nature of businesses should be expected to have in place credible internal risk measurement models and should assess and maintain economic capital adequate to cover the underlying business risks.

The adequate capital coverage could, though not essentially all the times, ensure solvency and stability of the financial system. The prevailing capital accord commonly known as Basel-I, was a first initiative towards this end. However, this has some inherent rigidity and does not cover all the risks that banks assume in their businesses. That's why it has been becoming less meaningful and undermined as a result of regulatory capital arbitrage emerging from its rigidity. New Capital Accord is expected to take care of these anomalies. The new accord covers more comprehensive range of risks, better align regulatory capital to underlying risks, and integrate capital requirement to larger framework and provide for the role of supervisors and market discipline. Since it provides options to banks, it encourages improvements in the risk management processes. Policy makers have already realized the importance of this new accord, and presently it is in different stages of implementation across the globe. However, its implementation in itself demands even more concentrated efforts and capacity building both with regulators and concerned stakeholders.

The importance of best practices and principles cannot be ruled out. These best practices and standards essentially are not strictly confined to supervisory regime, but cover broad environmental factors in the economy. Convergence to best standards and practices in supervisory regime alone cannot ensure stability of the financial system. This objective demands an all-embracing approach that takes into account the economic, legal, and political aspects also. The BCBS's Core Principles on Banking Supervision provide a good insight into what an enabling supervisory framework ought to be. The policy makers will be well advised to take account of their supervisory frameworks in the light of these broad guidelines and bring them at par with the international standards.

Increased Role of Market Discipline:

The recent developments in banking have made the regulatory standards less effective and rendered them laggard in adapting to the fast developing markets. This phenomenon has made the supervision more challenging and demands that all the stakeholders should share the task. In simple words, the role of market should be enhanced to discipline the businesses indulging in excessive risk taking. But this is not going to be an easy task, especially in the economies that have built-in safety nets which offer negative incentives and hamper the market discipline on one hand and in turn encourage the excessive risk taking by banks on the other. Anyhow, the utility of the market discipline in augmenting the supervisory roles cannot be overlooked. Since some of these safety nets are indispensable, we could find ways to reduce associated moral hazards and perfect the market discipline framework to complement the supervisory practices.

Market discipline basically centres on provision of adequate information to the market and incentive for the market participants to act thereon. We need to identify the information that could enhance market discipline. The banks that are entering the global arena must meet the international standards with respect to transparency and disclosure. The adoption of International Financial Reporting Standards (IFRS) that aim to achieve a uniform understanding on the financial

statements across the globe and recommendation of the BCBS's group on transparency could prove effective guiding stones in this regard.

Improved disclosure about risk profile, risk management practices and performances and related matters facilitates market discipline by enabling the market participants as well as supervisors to assess the soundness of a bank given the level of risks it assumes. The market assessment of the bank's soundness as reflected in the pricing of its products by the market could be used as an indicator for devising effective policy responses.

Closely related with market discipline is corporate governance which focuses on ensuring sound and prudent business practices on the part of banks by infusing transparency, responsibility, and accountability in the organizational culture. Corporate governance is basically about setting clear line of authority and responsibility in the organization, ensuring that each participant in the organization has clearly defined objectives, strive to accomplish them, and stands responsible for her/his job.

In conclusion, I would like to stress that the regulatory issues associated with global banking and the realization of our objectives - safeguarding the financial system against misuses and ensuring the stability of the system - demand a continuous efforts towards achieving effectiveness in our supervisory frameworks. We should strive to achieve best practice standards which, in the rapidly evolving scenario, are no more static and demands equal dynamism in supervisory practices so as to realize the maximum benefits of globalization while containing its downside effects to the minimum.

In the end, I would also like to express my hopes that this session would carefully analyze the critical issues relating to regulation of global banking and help us in ascertaining the ways to draw effective policy responses.
