

BOJ seminar highlights need to reduce financial risk

By KEITH COLLISTER

LAST Friday, the Bank of Jamaica held an important seminar, in conjunction with the DeLisle Worrell-led Caribbean Centre for Money and Finance, on "Strategies to cope with Global Uncertainty — Choices for Caribbean Business and Finance".

Professor Avinash Persaud, a member of the United Nations Special Committee on the Global Financial Crisis, addressed the critical role of regulation in the collapse of global financial markets.

In advice highly relevant to Jamaica, Persaud noted that "If crises keep repeating themselves, it seems reasonable to argue that policymakers need to carefully consider what they are doing and not just 'double-up'. It also means that policymakers should not superficially react to the characters and colours of the current crisis."

Persaud argued that there is a widely held view that the current international financial crisis resulted from an insufficient reach of regulation and that the solution is to take existing regulation and spread it without gaps across institutions and jurisdictions.

"If this were to be the main policy response, it would be a mistake for several reasons, the most important of which is that at the heart of the crisis lay highly regulated institutions in sophisticated jurisdictions—Northern Rock, IKB, Fortis, Royal Bank of Scotland, UBS, Citigroup."

He added, "The solution to the crisis is not more regulation, though more comprehensive regulation may be required in some areas. Instead, it is better regulation—in particular, regulation with a greater macro-prudential orientation, as recommended by numerous recent official reports."

What is macro-prudential regulation?

Persaud noted that financial crises should be prevented given that the costs to society are invariably enormous, something Jamaicans know well, and exceed the private cost to individual financial institutions.

"We regulate to internalise

these externalities in the behaviour of such institutions. One of the main tools regulators use to do this is capital adequacy requirements. But the current approach to capital adequacy is too narrow. Capital adequacy levels are set on the implicit assumption that we can make the system as a whole safe by ensuring that individual banks are safe. This represents a fallacy of composition."

Persaud noted that in trying to make themselves safer, banks and other highly leveraged financial intermediaries can behave in ways that collectively undermine the system.

This is in essence what differentiates macro-prudential from micro-prudential concerns.

In a comment almost tailor-made for what happened in the Jamaican Eurobond market in 2003, and for what could have happened again last year after the collapse of Lehman had the Bank of Jamaica's not provided timely support for JMMB and Capital and Credit, Persaud noted as an example of macro-prudential concerns: "Selling an asset when it appears to be risky may be considered a prudent response for an individual bank and is supported by much current regulation. But if many banks do this, the asset price will collapse, forcing risk-averse institutions to sell more and leading to general declines in asset prices, higher correlations and volatility across markets, spiralling losses, and collapsing liquidity."

Key questions to ask when taking a macro-prudential approach to managing an increase in risk are: who should hold it, and do they have the incentive to do so? If it is liquidity risk, is it in the interests of the system if all institutions, regardless of their liquidity conditions, sell the same asset at the same time?

In short, Persaud argued, macro-prudential regulation concerns itself with the stability of the financial system as a whole. "Risk in a financial system is more than an aggregation of risks in individual institutions; it is also about endogenous risks that arise as a result of the collective behaviour of institutions."

In contrast, micro-prudential regulation, consisting of such

measures as the certification of those working in the financial sector and rules on how financial institutions operate, concerns itself with the stability of individual entities and the protection of individuals.

Critically, it also ignores the systemic importance of individual institutions resulting from such factors as size, degree of leverage, and interconnectedness with the rest of the system.

In his presentation at the same seminar, World Bank representative for Jamaica, Badrul Haque, noted that for the last two decades, countries with export-led growth strategies have seen higher levels of economic growth.

However, he noted that in the recent global economic crisis, the economies of countries that were more open and trade dependent, suffered most.

Encouragingly, with the exception of a few isolated cases, the Caribbean financial sector has been intact. So far, the main negative impact has been from the second round real sector transmission.

Risk management as corporate culture

One of the more interesting presentations, made by Reuters executive Philippe Carrel, who asked the critical question, "Is the crisis over yet", to which he replied "No, as long as regulators were prescribing twice the dose of what didn't work before". He noted that if financial firms are now short of capital, asking them to take less

risk would be bad for the international economy.

Carrel argued, somewhat counter intuitively, that "risk has never been managed before" in the international financial markets, as opposed to being "estimated" and "measured". In his view, the three main pillars of international banking accord Basel II had failed.

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by Switzerland-based Basel Committee on Banking Supervision. The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against their financial and operational risks.

According to Carrel, the first minimum capital "pillar" had failed to ensure business sustainability by underestimating systematic risk. The second supervisory review process "pillar" had failed to create sound risk management procedures and overlooked systemic risks, meanwhile, while the third "pillar" of disclosure policies had failed to bring market discipline and transparency.

The combination of an over-emphasis on models, had led bank CEO's to ignore the critical shareholder question "How much can you lose", and bet the company. As an example of this misalignment between risk and return, he noted the disconnect between the typical Swiss shareholder of the Union Bank of Switzerland (UBS), who expected his bank to be prudent and conservative, and UBS's management, which wanted to take over Wall Street.

Turning to the local situation in Jamaica of First Global Bank, Carrel argued that "you don't lose US\$19 million overnight", and that there was clearly a problem of "information flow" similar to that of French "rogue trader" Jerome Kerviel.