FINANCIAL REGULATION, PRUDENTIAL SUPERVISION, AND MARKET DISCIPLINE: STRIKING A BALANCE

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Over the past two decades, we have seen an increased incidence of financial crises, both in industrialized countries and in emerging market economies. These crises have not only disrupted the financial systems in affected countries but also have had severe effects on economic activity. Appropriately, much of the focus of this conference is on understanding the causes of these crises and on developing appropriate public policy responses.

As we discuss these issues, however, we must avoid being caught up in a search for quick fix remedies for financial crises. Rather, I believe that it is essential to maintain a broad perspective on the ongoing changes in the financial system and the scope for effective public policy.

Generally speaking, financial regulatory policy involves choosing an appropriate tradeoff between the objectives of efficiency and financial stability. Our primary tools for achieving these objectives are regulation, prudential supervision, and market discipline. In recent years, changing financial markets along with deregulation and financial liberalization have caused us to rethink our views on the appropriate weights that we attach to our policy objectives. Our principal task, going forward, is to find a new equilibrium.

As part of this task, we need to strike a new balance in the use of regulation, supervision, and market discipline to achieve our policy goals. I think it is clear that we cannot return to, and probably do not want to return to, the highly regulated and segmented financial systems of the past. We do want to give greater scope to the market to guide the evolution of the financial system. At the same time, we recognize that we cannot totally rely on market discipline because of moral hazard and safety net concerns and because the public is likely to have limited tolerance for financial crises in the future.

Moreover, as we proceed, we need to recognize the new realities of the financial landscape. Financial institutions will continue to increase in size, traditional boundaries between intermediaries will continue to disappear, new and more complex financial products will be developed, and cross-border linkages will increase. At the same time, the safety net is likely to expand as deposit insurance protection is extended to a broader range of activities and institutions and as more financial institutions become too big to fail.

In this environment, it is clear that a redesign of regulatory policies will center on two questions: how can we make greater use of market discipline, and how can we adapt regulation and supervisory procedures to the new realities? In the final analysis, the financial system of the future is likely to be more vibrant and efficient but, also, more prone to occasional crises. Realistically, then, our goal will not be to eliminate financial crises but, rather, to limit their impact and to develop principles and procedures for their orderly resolution.

In my remarks, today, I would like to develop these thoughts in somewhat more detail. I will begin with a brief discussion of recent financial crises and the need to strike a new balance among financial regulation, supervision, and market discipline. Then, I will focus more closely on the scope for greater market discipline and on how we might adapt regulation and supervision to ongoing changes in financial markets. Finally, I will explore some of the implications of these changes for the design of public policy to deal with financial crises in the future.

What's Behind Recent Financial Crises?

Over the past two decades, a large number of countries have experienced a serious financial crisis that has weakened the banking system, reduced credit availability, and slowed economic growth. These crises have taken many forms: from the S&L crisis in the U.S., to the real estate and banking crises in some of the Nordic countries and Japan, to the banking and currency crises in Central and Latin America and in Southeast Asia. The social cost of many of these crises has been significant, both in terms of the financial cost of restoring the banking system to health and in terms of lost output and higher unemployment in the affected countries. In addition, many of these crises have spilled over to other countries through currency and asset markets and through disruption of trade.

One possible explanation of the increased incidence of financial crises is that we have experienced larger economic shocks in recent years. While the increased volatility of interest rates and asset prices over the past two decades lends some support to this view, other evidence points toward a more structural explanation. Indeed, as economists and policymakers have looked at these crises more closely, some important stylized facts have emerged. Although each crisis clearly has unique, country-specific features, there is a growing body of evidence pointing toward some common elements. In many instances, a crisis was preceded by a rapid expansion in credit availability that was in turn associated with a prior effort to liberalize the financial system. Moreover, a closer look at the banking system in the aftermath of the crisis has generally revealed a pattern of weak credit review by banks, speculative activities, high leverage, and weak regulatory and supervisory controls. These stylized facts seem to fit a number of diverse situations: from the U.S. S&L crisis, to the Mexican and Japanese banking problems, to the currency and banking crises in Southeast Asia. The presence of these common elements suggests, to me, that the root cause of the recent crises may lie in the design of our financial regulatory system and in the difficulty of adapting this system to ongoing changes in financial markets.

The Need for a New Balance

In the United States and many other countries, policymakers have traditionally placed heavy emphasis on financial stability as a goal of public policy. Thus, historically, they have tended to rely on regulation and prudential supervision rather than on market discipline to ensure the safety and soundness of the banking system. While this approach worked well in periods where financial market change was slow and evolutionary, it proved inadequate in the face of rapid technological change in financial services, increased competition between regulated and unregulated institutions, and the breakdown of geographic barriers to the provision of financial services.

Policymakers responded to these changes in a variety of ways. In some cases, deregulation and financial liberalization were seen as necessary to allow market forces to play a greater role in shaping the evolution of the financial system. This was done both to ensure the continued health of financial institutions exposed to increased competition and to take better advantage of the benefits promised by new financial services. In addition, policymakers recognized the need to modernize and adapt regulation and supervision to better reflect developments in financial markets.

Unfortunately, in many countries, the combination of changing financial markets and an altered regulatory structure created a disequilibrium in the financial system. Market discipline and its necessary ingredients did not develop quickly enough to contain the risk taking of institutions no longer adequately constrained by the traditional regulatory and supervisory framework. Moreover, it proved more difficult than originally anticipated to adapt regulation and prudential supervision to the changing financial marketplace. Such an environment, I suggest, has made financial systems more vulnerable to the development of financial crises such as those experienced in recent years.

Going forward, the main tasks for policymakers are to rethink what is an acceptable tradeoff between efficiency and financial stability and to strike a new balance in the use of regulation, supervision, and market discipline to achieve these goals. These are by no means easy tasks. We recognize that there is no going back to a framework of segmented financial markets and tight regulatory control over deposit rates, bank expansion, and banking activities. And, we acknowledge the need to give greater scope to market forces in guiding the evolution of the financial system.

The difficulty with all this, however, is that we now operate in an environment with larger and more complex financial institutions whose potential failure threatens the solvency of existing insurance funds and may pose risks to the payments system. Moreover, in today's freewheeling financial markets, herd mentality may apply market discipline abruptly and at inconvenient times, punishing institutions and individual consumers rather than controlling their risk taking. Thus, while we wish to enjoy the benefits of a market-driven financial system, we may not be comfortable with the consequences when markets are disrupted or when financial institutions seem likely to fail. Few supervisory authorities will want to be responsible for the type of economic disruption recently seen in Southeast Asia and even fewer will want to risk starting a global financial crisis.

Consequently, another reality of the operating environment is that we will be forced to rely more on public safety nets and "too big to fail" policies than most of us would prefer. Unfortunately, this also means that we will still be faced with significant moral hazard issues within our financial system. Bank creditors and others that are protected by safety nets will not have sufficient incentives to thoroughly select institutions, and consequently, there will be limits as to how far market discipline can work in controlling risk taking.

How, then, should we proceed? Let me turn next to a more detailed discussion of the scope for greater use of market discipline as well as some of the practical difficulties of adapting regulation and supervision to these new realities. I should note at the outset that, while much of my discussion of specific policies and procedures is most relevant to the U.S. financial system, the underlying principles have more general application.

How Can We Make Greater Use of Market Discipline?

In general, I am very sympathetic to the view that policymakers must place increased reliance on market discipline. Market discipline is clearly necessary if our financial system is to have the appropriate incentives, and disincentives, guiding its evolution and development.

We should also recognize, though, that our continued reliance on public safety nets and "too big to fail" policies will necessarily temper the use of market discipline. In fact, it will be difficult to escape these limitations, given the externalities that exist in banking. Public protection may also be needed because of the learning curve that market participants and regulators will face in our rapidly changing financial environment. Therefore, the critical question is not whether we should move toward greater market discipline, to which the answer is yes. Instead, we must ask ourselves how we can make market discipline more effective within the context of public safety nets.

Undoubtedly, the most important step we can take toward enhancing market discipline is to encourage more accurate and detailed disclosures of financial information. I regard full financial disclosure as the prerequisite or the underpinning for an effective system of market discipline, since it is the key factor that guides the decisions of bank stockholders, debtholders, depositors, and other customers.

There are a number of areas where financial institutions could look to improve their disclosures. The traditionally opaque nature of many bank loans has prevented investors and creditors of financial institutions from accurately assessing their risk exposures. The increasing complexity of financial instruments and the wider range of activities conducted by banks and other financial institutions have also complicated disclosures.

I believe market participants might benefit most from more detailed disclosures on asset quality, either in the form of estimated market values, internal credit ratings, other credit assessments, or assessments of loan loss reserve adequacy. Also, institutions should be disclosing their levels of concentration within particular industries and countries and with regard to individual customers. Other steps toward improving information disclosure might include descriptions of a bank's risk management policies and their comprehensiveness, the bank's business objectives and oversight of the resulting activities, and the implications of internal risk models and management's confidence in such information.

While financial disclosure has a long way to go, many institutions are now making notable progress in reaching out to investors and other market participants and providing them with greater information. It is certainly true that, with the spread of public safety nets, increased disclosure may not be of substantial benefit to many depositors and others likely to be protected in financial rescues. However, I think better information will still be of significant importance to bank investors in helping them achieve appropriate risk/return tradeoffs.

Besides improved disclosure, there are a number of other proposals that show promise in increasing market discipline. These include subordinated debt and various proposals to reform deposit insurance through coinsurance, private insurance, or changes in insurance coverage. These proposals could help shift more responsibility to bank creditors for monitoring and controlling risk, thus increasing overall market discipline.

At the same time, though, I think we must realize that there will be some limitations with these approaches in a "too big to fail" environment. For instance, policymakers could be forced to back away from such policies when the outcomes are viewed as too harsh for the economy to tolerate. Also, if creditors and their banks believe that they are likely to receive protection in a crisis, much of the anticipated market discipline could be left unrealized. Thus, while these proposals have merit, we should be cautious in expecting them to forestall serious banking problems.

How Can We Adapt Supervision and Regulation to the New Realities?

While increased market discipline is important, supervision and regulation must also be rebalanced in light of the new realties of the financial system. In the past, rules and regulations were of major importance in establishing the guidelines under which institutions operated. These restrictions addressed the assets, liabilities, and activities that were permissible for particular institutions; interest rates that could be paid on deposits; where and how institutions could expand; and many other operating constraints. In recent years, many of these rules and regulations were relaxed or eliminated as they were found to limit the services that institutions could offer customers and to hinder firms in adapting to a changing marketplace. As a result, banks and other financial institutions now find themselves competing directly in a much broader and less structured marketplace.

For financial supervision and regulation, I see several important implications arising from this changing financial environment. First, with depository institutions competing with less regulated firms and on a worldwide basis, regulators will no longer be able to limit risk taking through highly restrictive and, in some instances, burdensome regulations. Too many restrictions would place regulated institutions at a serious competitive disadvantage, which could threaten their continued viability. Second, supervisors will have to be concerned about a much wider range of risks. In fact, many institutions are not only expanding into new activities, but are also increasing their linkages and exposure to other institutions. A third consideration is that markets have become larger and more liquid, and institutions can now change their risk profile, both on and off balance sheet, much more quickly than before.

What can financial supervisors do as they attempt to adapt to this new environment? One step, which we have already begun, is to use a risk-focused approach to supervision and regulation. Through risk-focused examination procedures, examiners are now directing more attention to the major risks within an institution and to the institution's ability to measure and control its own risk exposure. For larger institutions, bank internal risk models, credit rating systems, and risk-management practices are becoming important aspects of this process. On the regulatory side, proposals to reform risk-based capital are aimed at providing more refined measures of risk and therefore may help relate a bank's capital needs more closely to its risk profile. A number of other regulatory changes would provide well-capitalized and well-managed banks more latitude in their operations.

The move toward risk-focused supervision and regulation is still in its infancy, and I believe it should be regarded as a promising, rather than a proven, approach. Measuring and managing risk remain extremely difficult tasks, and the results are highly sensitive to the underlying assumptions and a variety of other factors. Also, risk-focused supervision and risk modeling will require a greater level of expertise, both at the bank and the supervisory level.

Another step that must be taken is to limit concentrations and linkages among institutions that could lead to systemic problems. To the extent we can reduce interbank exposures and prevent serious problems from spreading from one institution to another, we will be better able to isolate financial problems and prevent a systemic crisis. Moreover, by isolating and reducing the consequences of one institution's problems, I am hopeful that we can create more room for market discipline to work. In recent years, we have made substantial progress in reducing the vulnerability of the payments system to the failures of individual institutions. We have also taken steps to limit interbank deposit and credit exposures. There is no question, however, that further progress must be made, particularly as institutions continue to become larger and more of a systemic threat and as financial linkages expand on a worldwide basis.

I believe we must also try to limit the financial activities that are to be protected by the safety net and by "too big to fail" policies. I should make clear this does not mean unduly restricting the financial activities that any one organization can conduct. Instead, holding company or financial service company subsidiaries could be used to divide activities into those that receive safety net protection and those that can be regulated more appropriately through market discipline. If we could adequately separate banking and nonbanking activities, we would greatly reduce the implications nonbanking activities might have for the safety net and financial stability. Another major benefit is that the market could continue to be the principal force regulating securities, insurance, and nonbank lending activities, subject to the usual customer protection requirements regarding disclosure, prevention of fraudulent practices, and maintenance of insurance policy reserves. Although it may be difficult to fully isolate activities in financial organizations, I view this option as giving us the best opportunity to expand market discipline and to foster efficient and innovative markets.

One other step I strongly recommend is for supervisors to become a greater force in ensuring that banks accurately disclose their condition to the markets. In bank examinations, supervisory personnel collect extensive information on the quality of a bank's assets, as well as other indicators of its condition and risk-management practices. While supervisors may not want to disclose this information themselves, they are in a position to encourage more accurate disclosures by banks. For example, examiners could ascertain whether all uncollectible assets have been charged off, loan loss reserves are reflective of a bank's credit exposure, and other aspects of a bank's condition are accurately depicted on its balance sheet and in its public disclosures. I might even suggest that bank management be required to comment regarding its assessment of supervisory examinations and to accurately disclose any material findings of the examiners. Through this process, examiners could play a leading role in making market discipline a more effective tool in controlling risk taking and allocating capital across financial institutions.

Summary: Coping with Future Financial Crises

Let me conclude my remarks by drawing some implications from this discussion about how we might approach financial crises in the future. As I indicated earlier, I believe the increase in financial crises in recent years is partly a function of the regulatory disequilibrium that has arisen as policymakers have struggled to adapt to ongoing changes in financial markets and institutions. As we reestablish this equilibrium, the number of crises should diminish. However, since the new equilibrium will likely place more emphasis on allowing market forces to guide the development of the financial system, realistically, we are likely to experience somewhat more crises than the historical norm. This is simply the result of allowing markets to play a larger role in the financial system. In this environment, I believe that it is important that we ask what steps can be taken to minimize the severity of future crises or, when crises do occur, to improve crisis management and resolution procedures.

Some of the changes that I discussed earlier should help prevent crises as well as reduce their severity. For example, improved internal risk control procedures by financial institutions and better supervisory practices may reduce the likelihood that institutions will get into serious difficulty. Similarly, to the extent that market discipline is effective, ex ante, in altering the incentives for institutions to take excessive risks, failures, ex post, may be less likely or less severe. And, to the extent that systemic effects across institutions can be reduced, crises may be less severe in the future.

Despite these efforts, however, some crises will occur and so we must also be concerned about how to manage and resolve them with as low a cost as possible. Realistically, this is an area in which there is still considerable disagreement both within the academic community and among policymakers. One view is that we need formal resolution procedures such as explicit policies for domestic and international facilities to provide lender-of-last-resort support in times of crisis. Another view is that less explicit procedures and constructive ambiguity are a better approach. The underlying issue in this debate is which approach minimizes the moral hazard distortions that accompany explicit or implicit government guarantees.

My own view is that we are better served by explicit and transparent crisis management and resolution procedures. It is also important that these procedures be credible in the financial markets, which means that we need to adhere to these procedures even in periods of financial stress. Otherwise, neither market discipline nor regulatory restrictions are likely to be effective in controlling risk taking, and we may find that resolving the current crisis sets the stage for a vicious cycle of more severe crises in the future.