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Systemic risk, governance and global financial stability

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ABSTRACT

The paper argues that while attempts have been made to reform four of the five key pillars of banks' operation, (i.e. competition, resolution, supervisory, and auditing and valuation policies), less attention has been paid to the role of bank governance and systemic risk, despite a strong link between governance and risk-taking. The paper offers four solutions to strengthen bank governance. First, the regulatory capital base of banks could be increased. Second, the compensation structure of managers could be reformed. Third, effort could be focussed on creating and implementing resolution regimes which offer the credible prospect of "bailing-in" creditors in the event of stress and fourth solution is to reform the structure of company law– for example, by extending control rights beyond shareholders. Furthermore, the paper argues that given the diversity of the whole financial system, it is expected that the risks individual financial institutions face are also diverse. It cannot be assumed that the appropriate capitalisation is constant across all risks. While leverage ratios are a useful backstop measure and guard against potential gaming of risk-weights, their appropriate role is as a backstop. The diversity within the financial system also supports the fact that a single measure of systemic risk is unlikely to be universally applicable, nor is a single instrument of financial stability policy.

1. Introduction

The recent global financial crisis highlighted the importance of addressing some of the incomplete financial reforms. One of these unaddressed reforms has been the contribution of systemic risk in destabilising financial markets. Recently, as reported by Bisias et al. (2012), international institutions such as the IMF, the BIS and the SFSB stated that systemic risk can be defined as a "risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy." One of the policy issues is how one might operationalize a policy to limit systemic risk given that a risk is inherently unobservable – only outcomes are observable. Unfortunately, there is no single operational definition of systemic risk so far. Bisias et al. (2012) identified 31 different measures of systemic risk, emphasising a range of aspects of systemic risk and potential channels to financial distress. Indeed, as Bisias et al. (2012) point out, it is probably not desirable to have a single measure of systemic risk as the focus of policy, as this may result in a 'Maginot Line' situation where vulnerabilities building in other parts of the financial system are missed.

The recent global financial crisis has encouraged both policy makers and researchers to find ways by which one could mitigate the impact of systemic risk. To this end, a number of attempts have been made to identify policies, including forward-looking policies, that could potentially address systemic risk.

As part of the efforts to address some of the underlying causes of the recent global financial crisis, the Financial Stability Board ('FSB') has been asked to act as the international standard-setter and attempt to address and coordinate issues underlying systemic risk. One of the key tasks of the FSB was to deal with the contributions of large financial institutions to global systemic risk. To this end, the FSB has identified global systemically important financial institutions ('G-SIFIs'), and more recently domestic systemically important banks ('D-SIBs'). These multinational and large national financial institutions have attracted more policy attention, partly due to their size, complexity, interconnectedness and their contributions to national and global financial systems (Moshirian, 2011, 2012). As part of this process and excessive risk taking by some of these institutions, themes related to too-big-to-fail ('TBTF') have also emerged for debate and analysis.

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Another major development in recent years has been a focus on developing macroprudential frameworks to complement the traditional microprudential approach to regulation. There is also a desire on the part of the policy makers and the market participants to see the financial system sharpen its ability to apply effective macroprudential policies without stifling economic growth and innovation. However, the identification and monitoring of systemic risk and optimal macroprudential policies are still in the early stage of development. In search for global financial stability, one area that has received less attention in recent years are the issues related to bank governance. More discussion and analysis of the role of governance within the operation of financial institutions and also the role of governance in contributing to global financial stability would be an essential part of any policy package aiming to address a number of the underlying causes of financial fragility over time. The paper argues that while there have been analyses of banks competition policies, resolution policies, supervisory policies and auditing and valuation policies, less attention has been paid to the role of bank governance and systemic risk, despite a strong link between governance and risk-taking. This is puzzling (Jensen and Meckling, 1976).

Recent empirical evidence suggests this link may be especially strong for financial firms (Beltratti and Stulz, 2009; Ferreira et al., 2012; Laeven and Levine, 2009). Certainly, the global financial crisis unearthed bank governance failures operating at multiple levels: managers failing to control risk-takers, boards failing to control managers and investors failing to discipline either managers or boards.

The purpose of this paper is to discuss some of the issues related to systemic risk, governance and financial stability. To this end, Section 2 of the paper discusses issues related to systemic risk, the identification of G-SFIS and D-SIBs and the recent policies related to macroprudential policies and the importance of implementing globally a number of regulatory policies that have been proposed by various international institutions; Section 3 analyses issues related to measurement of systemic risk. It argues that the diversity within the financial system also supports the fact that a single measure of systemic risk is unlikely to be universally applicable. Furthermore, this section discusses how, due to the diversity of the whole financial system, the risks individual financial institutions face are also diverse. The section also discusses why one may not assume that the appropriate capitalisation is constant across all risks. Section 4 discusses bank governance, including how this important aspect of global financial stability has been overlooked for vigorous debate and analysis in recent times and the importance of having specific policies to address the current structural weaknesses of bank governance. This section offers solutions regarding how to strengthen bank governance, including the regulatory capital base of banks, could be increased, the compensation structure of managers could be reformed and efforts could be made by putting resolution regimes which offer the credible prospect of "bailing-in" creditors in the event of stress, into place and Section 5 concludes.

2. Large financial institutions and propagation of systemic risk

2.1. Identification of systemically important financial institution

According to Financial Stability Board, a financial institution could be defined as a G-SIFI, if its failure or fragility could impact other financial institutions, the wider financial system and the domestic and international economies (FSB, 2011a, 2011b). Given the size and complex nature of these large financial institutions with other institutions, their failure or fragility could negatively impact the overall global financial system. A number of attributes have been identified by the FSB that could qualify certain financial institutions to be part of G-SIFIS. These attributes include: size, lack of substitutability and interconnectedness. In addition, the Basel Committee for Banking Supervision (Basel Committee) identified cross-jurisdictional activity and complexity as other attributes of financial institutions which could fall into the category of G-SIFIs (see BIS, 2013).

As of November 2013, there are 29 designated G-SIFIs by the FSB. As part of an overall strategy to ensure more stable G-SIFs, these institutions are now required to maintain greater loss absorbency capabilities under Basel III. As highlighted by the FSB's various publications, this additional requirement, which applies in addition to the Basel III capital requirements, is intended to reduce the "cross-border negative externalities" of the global financial system and to reduce systemic risk. Some regional and domestic banks could also pose systemic risk to the national and regional financial systems and national economies, (over and above those institutions identified as G-SIFIs). To this end, the Basel Committee has developed a framework and asked local authorities to identify whether a large domestic bank is systemically important from a domestic perspective (domestic systemically important bank (D-SIB). A number of national authorities have already identified their D-SIBs. One should also note that there are also some regional systemically important banks that could be operating in different continents whose operations could pose systemic risk. As part of an overall strategy to increase global financial stability, international institutions such as the FSB now have a strategy in place to ensure that national and international policy makers work together and ensure that the G-SIFIs and D-SIBs are better supervised and these institutions, as state above, are required to put aside more capital as part of their operation. This is because the current strategy is to insulate the global financial system from systemic shocks on top of the Basel III capital and liquidity requirements.[1] As Moshirian (2012) stated, the Great Depression in the 1930s created incentive for authorities to collect national economic data so policy makers could measure the magnitude of economic downturn in the economy accurately. This attempt in the 1930s led to the emergence of relevant data that are used to generate what is now referred to as Gross Domestic Products (GDP). Similarly the recent global financial crisis has created a new impetus to policy makers and market participants to improve and also share some financial data, particularly when the financial market is becoming increasingly interconnected. The attempt by the FSB, in collaboration with central banks and supervisors, to create a mechanism that could facilitate the international sharing of firm-level data on systemically important financial institutions, is yet another step in the process of facilitating globalisation and another attempt to enhance the capacity of the global financial system to be more informed about the overall state of large financial institutions and the nature of their aggregate risk taking and business models.

2.2. Macroprudential policies and a global approach to financial stability

The FSB has been working on issues related to macroprudential policies over the last few years. While a number of proposals have emerged as part of the tools available to enhance the effectiveness of policy recommendations with respect to macroprudential strategies, this area of policy development is still in its infancy and requires more work (Arnold et al., 2012). Nevertheless, some good progress has been made in recent times including the work of the FSB itself. At the present time, there are four main areas of

[1] This section of the paper benefited from a number of information and issues that can be found in the FSB publications and website.