The Reform Agenda and the Balance between Stability and Efficiency

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Outline

- Key challenges and objectives
- The reform agenda
- Potential impact
- How to get the balance right

Key challenges and objectives

The reform agenda

Potential impact

How to get the balance right

Key Challenge:
How to balance competing goals ?

- Improving resilience of global financial system
- Supporting economic recovery and financing sustained growth

Key Challenge and objectives

Advance Financial Reform

- Finalize reforms
- Implement
  - timely
  - effective
  - consistent

Reduce Sovereign Risk

- Credible fiscal consolidation
- Prudent public debt management
- Mitigate financial transmission

Address Challenges of Capital Inflows

- Macro/prudential tools
- Preserve benefits of globalization

Support Credit

- Rebuild capital
- Secure stable funding
- Restart "safe" securitization
- Resolve/restructure weak banks
- Careful monetary, financial exits

Key challenges and objectives

The reform agenda

Potential impact

How to get the balance right

How to view the reform agenda

Sector

- Reform agenda is so far largely **bank centric**
- Need to advance on **non-banks**

Focus

- **Micro-prudential** – basic agreement on bank level regulation
- **Macro-prudential** – many systemic issues still unresolved

Time

- **Short-term** – decisions by year-end
- **Medium-term** – to be implemented by end 2012

The reform Agenda

- **Reform Agenda**
  - **Micro-prudential**
    - **Basel 2R: Capital / Risk Capture / Leverage**
      - Higher and better capital
      - Higher capital charges for certain risks
      - leverage ratio
    - **Basel 2R: New minimum quantitative liquidity standards**
      - Liquidity Coverage Ratio: to survive a 1 month stress
      - Net Stable Funding Ratio: requires longer term funding sources
  - **Macro-prudential**
    - **Systemic risk:**
      - SIFIs “TBTF”: supervision; COCOs; Volker Rule; surcharges; Levy OTC derivatives and central clearing; non-bank financial institutions
    - Countercyclical provisioning and capitalization; accounting; compensation; CRA; resolution

What has been proposed

Capital

Better quality, consistency and transparency of capital

- Predominance of Tier I capital
- Phasing out of Hydrides
- Phasing out of Tier III
- Harmonization of deductions

Limit leverage

- Leverage ratio

Forward looking and counter cyclical capital

- Capital conservation measures
- Forward looking provisioning
- Counter cyclical capital

What has been proposed

Liquidity

Liquidity coverage ratio

High quality unencumbered liquid assets > net cumulative outflows

30 day period
Stress scenario

Net stable funding ratio

Available funding > Required funding

One year period
Risk factor approach

Why it matters for the Middle East and Central Asia Region

- Some banks have to make adjustments
- Islamic banks may be challenged by liquidity requirements
- Consistency between regional and global reform agendas needed for enhanced efficiency

Why it matters for the Middle East and Central Asia Region

Contagion/spillover effect

- Impact on growth and stability in advanced economies
- Capital outflow/ inflows
- Regionally and globally active banks
  - Regulatory competition
  - Cross-border supervision
  - Cross-border resolution

Why it matters for the Middle East and Central Asia Region

Macroprudential tools are very relevant

- Lack of independent monetary policy under pegged exchange rate regimes => importance of macroprudential tools

- Counter cyclical capitalization and provisioning policies relevant to commodity exporters to mitigate lending procyclicality and asset price bubbles with commodity price cycles

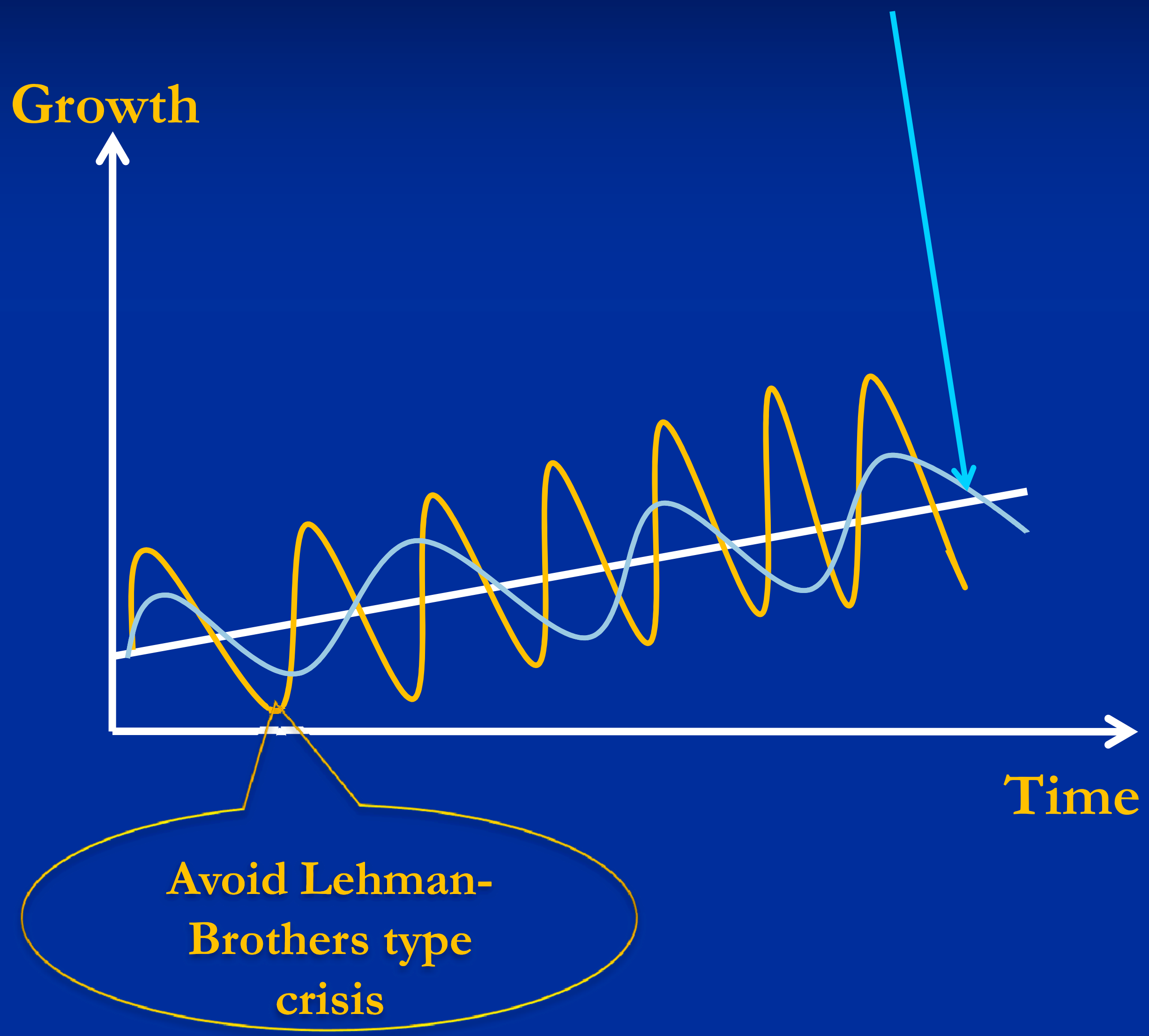
Key challenges and objectives

The reform agenda

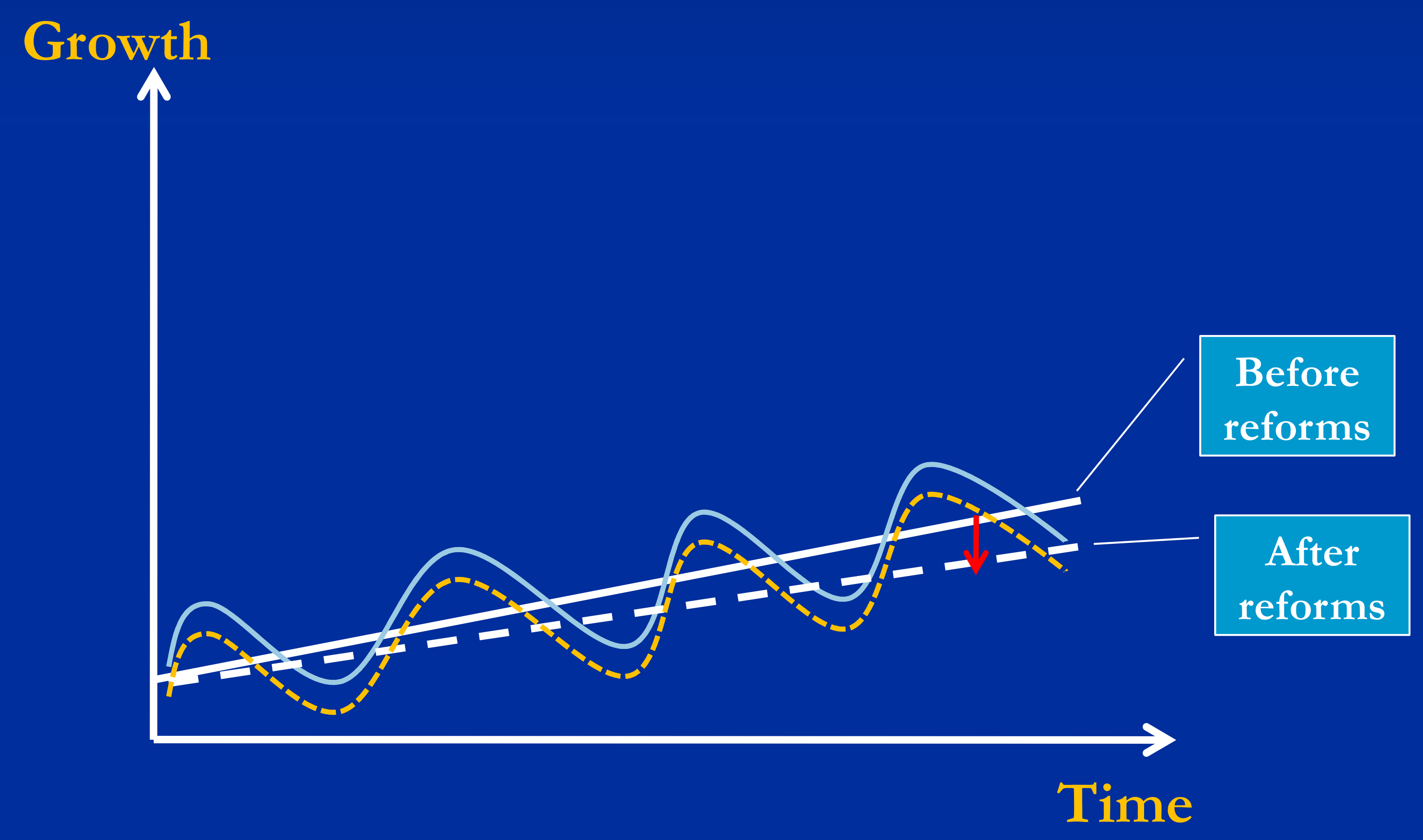
Potential impact

How to get the balance right

The objective :less volatile growth



The danger: over-reaction by policymakers



Reform agenda and impact on growth

Potential impact

- Higher lending cost
- Lower supply of credit
- Larger impact on risky sectors (speculative--positive / SMEs--negative)

Potential mitigations

- Monetary policy response
- Lower risk premium for safer banks (funding)
- Financial stability lowers risk premium (lending)
- Banks cost cuts
- Non-bank financial sector supports lending

However, we should not forget the costs of financial crises

- **Output losses** of systemic banking crises averaged about 20 percent of GDP during the first four years of the crisis
- **Fiscal costs**, net of recoveries, associated with crisis management averaged about 13.3 percent of GDP
- These costs do not include the **contagion cost** to other economies and the **loss of fiscal revenues**

Financial stability

… it is in the interest of …	… as its absence could result in
Shareholders	loss of equity
Bank managers/employees	loss of jobs and income
Depositors (investors)	loss of deposits or investments
Borrowers	credit squeeze
Tax payers and public sector	bail out cost and loss of revenues
Central banks	monetary policy impediments
The overall economy	welfare losses → social costs
Global economy	contagion/spillover cost

Outline

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- **How to get the balance right**

How to get the balance right

- Assessment of the potential impact to guide the size and timing of reforms
- Clear transition timeframe to reduce uncertainty
- International coordination to avoid regulatory arbitrage
- Expand the regulatory perimeter to avoid shifting the risk to the shadow banking system

How to get the balance right

- Develop government securities (including sukuk) to facilitate banks’ liquidity management
- Active participation in the global debate about the reform agenda to reflect the region’s interest
- Avoid substituting higher capital and liquidity requirements for quality of supervision

The Fund indentifies that good supervision has to be

Intrusive	intimate knowledge of the supervised entity
Proactive	always question, even in good times, the industry's direction or actions
Comprehensive	being especially vigilant about what's going on the edge of the regulatory perimeter
Adaptive	keeping abreast of new products, new markets, new services, and new risks
Conclusive	don't just identify problems, follow up too

Thank you