



Global financial stability and the cooperation among central banks: What have we learned?

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CEMLA 60th Anniversary Conference:
Central Bank Cooperation at the Beginning of the 21st Century



Agenda

- Cooperation among central banks as a consequence of the global financial crisis and the increasing importance of foreign bank participation and cross-border bank flows
- What have we learned?
 - Home-Host cooperation and information sharing
 - Collective insurance as an alternative to deal with liquidity risk
- Challenges
 - Home-host cooperation
 - Macroprudential issues
 - International regulatory reforms
- Conclusions

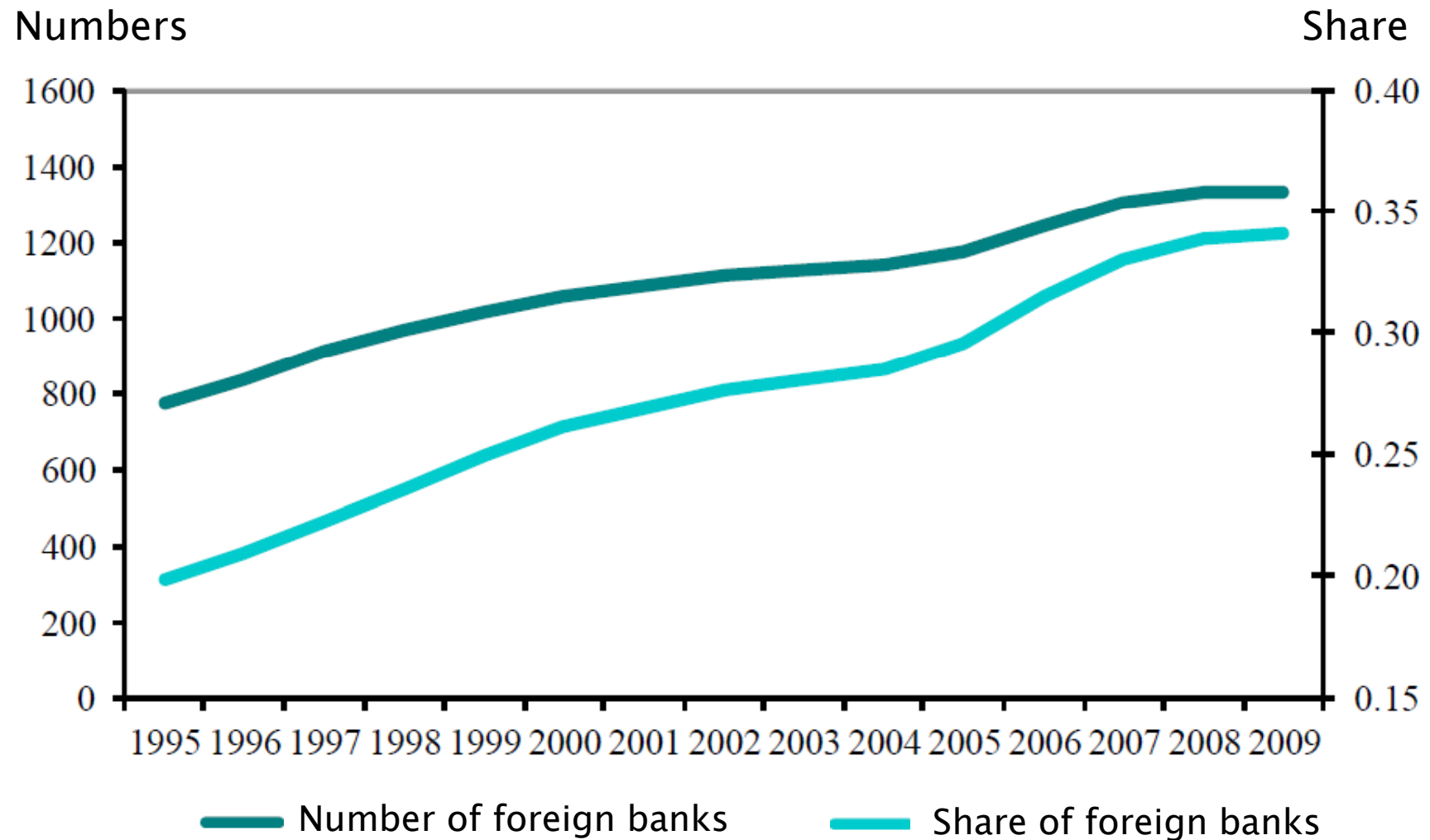


The need to reinforce cooperation among central banks on financial issues is perhaps one of the most important lessons from the global financial crisis

- Central banks have become increasingly concerned about financial stability issues, even if they do not have supervisory powers.
- Financial globalization has resulted in higher exposure to cross-border banking and increased foreign bank participation, characterized by:
 - Increasing complexity and interconnectedness.
 - Potentially exposing local systems to the presence of systemically important financial institutions at the global level.
 - Growing number of “home” countries that have become active as investors, with several EMs becoming important “exporters”.
- As a result, concerns have been raised over: (1) information problems, (2) differences in regulatory regimes among cross-border counterparties, and (3) FX liquidity risk
- We have observed a prompt reaction to these issues, in particular coordination among central banks work well to address the liquidity crisis, but some challenges remain ahead



Foreign bank participation, in terms of number and share of domestic banks, has increased substantially in most countries over the past three decades





What have we learned?

- Coordination among central banks and regulators is fundamental, in particular in times of stress.
- Coordination helps to address the following issues:
 - Information sharing
 - Regulatory differences
 - FX liquidity risks
- Colleges of Supervisors and bilateral coordination among central banks and regulators help to strengthen Home–Host cooperation and information sharing
- Collective initiatives, such as Flexible Credit Lines and Swap Lines can help to deal with liquidity problems during a financial crisis



An effective supervisory oversight of international banking groups requires strong Home-Host cooperation and information sharing

- Colleges of Supervisors represent an important initiative for these purposes
 - They can help to understand the risk profile provided by Home supervisors, and compare them with the supervisory strategies of other countries
 - In addition, they can help to improve the surveillance techniques and get a better understanding of global exposures
- However, Colleges should not be seen as substitute for wider bilateral or multilateral cooperation between supervisors, nor should they undermine effective national supervision



In Chile, the authorities actively participate in Supervisory Colleges and have subscribed several bilateral MOUs

- Supervisory Colleges of Spanish and Brazilian banks helped to improve the general overview of the financial system, and shared supervisory initiatives and risk profiles of foreign banks
- At the bilateral level, Memoranda of Understanding (MOUs) were subscribed with Argentina, Canada, China, Colombia, Spain, and U.S. authorities
- In order to be consistent with international standards, there has been a gradual adoption of international standards of banking regulation
- Furthermore, there has been active participation in the recently formed Working Group on Home-Host Cooperation and Information Sharing created under the Regional Consultative Group for the Americas

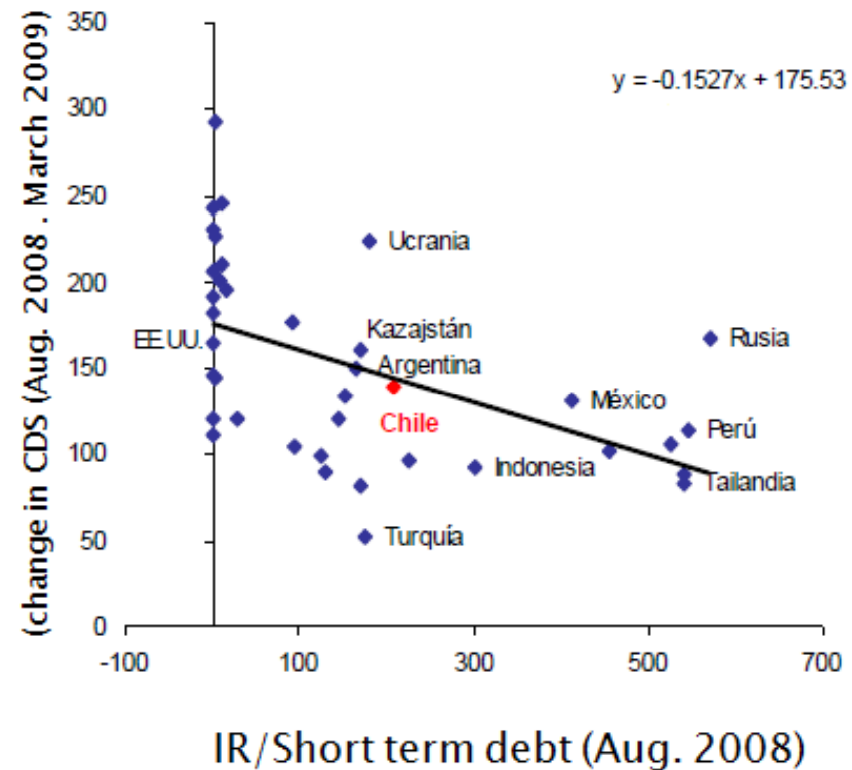
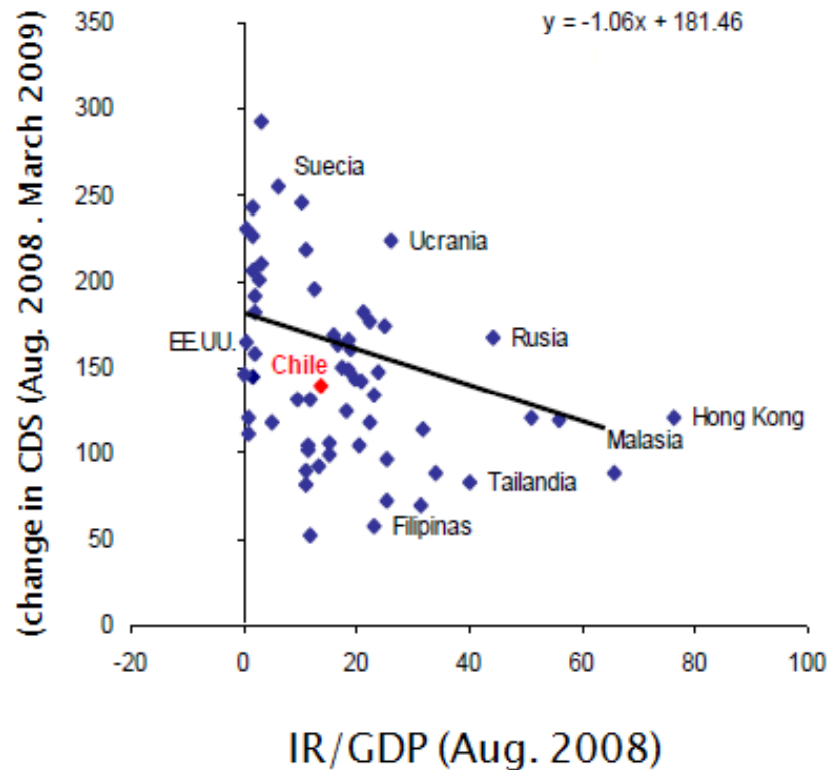


Collective insurances, in the form of Flexible Credit Lines and Swap Lines, may act as substitutes for self insurance mechanisms in times of stress

- These instruments (FCL, Swaps) have emerged as (less costly) alternatives to deal with potential external liquidity and balance of payment crises
- However, their sole existence does not eliminate the demand for self insurance mechanisms, such as the accumulation of international reserves, as increasing the stock of reserves in turn facilitates access to these credit lines
- Moreover, the evidence suggests that large stocks of international reserves accumulated by emerging countries over the past decades had a deterrent effect during the global financial crisis
- However, more often than not, international reserves were not used, suggesting that collective insurance alternatives may act as substitutes for international reserves in times of liquidity needs



Countries with higher levels of reserves experienced a smaller increase in sovereign spreads measured by their CDS



Source: Contreras, Jara, Olaberría y Saravia (2012)



Challenges

- Challenges regarding Home-Host coordination and information sharing
- Challenges regarding macroprudential issues
- Challenges regarding unintended consequences of regulatory reforms



Challenges regarding Home-Host cooperation and information sharing

The RCGA Working Group have identified some important challenges:

- Recovery plans, resolution and crisis management processes are not completely developed in the region
- No formal process exist for communication to the home authority
- Perceived weakness of current accounting provisioning under IFRS
- Incomplete view of financial group/conglomerate, as some jurisdictions do not have laws that allow for consolidated supervision
- Regulators face resource constraints in developing Home-Host relationships and attending supervisory colleges



Challenges regarding macroprudential issues

- We need to learn about the international experience regarding macroprudential issues: What works and what doesn't?
- There is a need to strengthen the cooperation among central banks in order to ensure the coherent application of domestic macroprudential policies and enhance their effectiveness (in particular when foreign branches exist)
 - Reduce the scope for leakages and international regulatory arbitrage, and avoid regulatory competition (e.g. countercyclical capital buffers)



Challenges regarding international regulatory reforms

- Global regulatory reforms and those introduced by some jurisdictions (Volcker and EBA) may have unintended consequences in emerging and developing countries
- The treatment of sovereign risk (Basel II.5), higher demand for risk-free assets (Liquidity coverage ratio (LCR)), higher regulatory requirements (GSIFIs) and leverage ratio on trade credit, may create some unintended consequences on emerging and developing countries:
 - Distortions in local bond markets due to less participation of non-residents and LCR, which can be aggravated by the Volcker rule and the fact that EMEs are characterized by lower size and turnover of bond markets
 - Retrenchment of global banks from lending in EMEs due to higher capital requirements, may be a concern
 - For open EMEs, this may lead to less (more expensive) cross border credit, or lower foreign participation in local banking systems.



Conclusions

- Cross-border financial flows and foreign bank participation have grown considerably over the past three decades
- While in general this may be seen as a positive trend, it calls for higher coordination among central banks and regulators, in particular in times of stress
- As a consequence of the GFC, there has been renewed importance of the College of Supervisors and bilateral agreements among supervisors and central banks in order to address the issue of coordination and information sharing. Similarly, collective initiatives, such as the FCL and Swap Lines can become (less costly) instruments to deal with liquidity crises
- However, several challenges still remain, in particular in terms of Home-Host coordination and the coherent application of domestic macroprudential policies
- Finally, there are important challenges regarding international regulatory reforms and their potential unintended consequences



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