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Editorial

Global governance: Global banks and shadow banks supervision

The recent global financial crisis has highlighted the importance of a process of consultation, interaction, exchanging of views and information sharing amongst market participants, policy makers, researchers and regulators. Following the recent global financial crisis, these four protagonists of the financial market and the global economy have learnt to increase their interaction and sharing their points of view and data etc. with each other thereby contributing to improved functioning of global financial markets. One of the outcomes of such interactions amongst these four protagonists has been joint conferences and events that also generate and report research outcomes which are beneficial for the global financial market. This special issue is one of these contributions resulting from the interaction between individuals representing these four protagonists who came together as part of the Australasian Finance and Banking conference and who are now are in a position to disseminate their thoughts and research to the finance community. The main theme of this special issue is global governance and the supervision of global systemically important financial institutions and shadow banking institutions.[1]

In recent years, a number of major research works and reports have been generated by the Financial Stability Board (FSB) as part of the FSB's mandate to contribute to global financial stability. In this editorial article, a number of the recent reports by the BIS are used to analyse some of the issues that may contribute to the emergence of a more effective global financial system and global governance. A number of recent publications by the FSB have focused on global systemically important financial institutions (G-SIFIs) in recent times. One can see a number of issues with respect to the progress so far, including issues related to the resolutions of the G-SIFIs, and factors hindering progress towards the implementation of some of the reforms associated with the functioning of G-SIFIs, International institutions such as the FSB and others are doing their best to provide solutions and policy recommendations for some of the major issues facing the global banking and financial system. However, the main drivers of the global economy are national governments whose national economic, political and other priorities influence the direction and the pace of implementation of some of the recent international rules and agreements designed to contribute to a better global financial system and global governance and consequently mitigate the occurrence of future global financial crises over time.

The purpose of this editorial article is to first take some of the key points raised by the FSB and others regarding factors contributing to a better global banking system and then analyse how the recognition of the evolution of nations towards the process of an increasingly globalised society could facilitate the emergence of effective global infrastructures over time that may accelerate the process of financial integration and contribute to the more effective functioning of G-SIFIs, other financial institutions, including shadow banks and increase global financial stability.

To this end, Section 1 discusses aspects of a few of the recent reports from the FSB and then provides some global perspectives on how one could improve the supervision of G-SIFIs. Section 2 deals with some of the challenges of bailing in or out for large financial institutions. Section 3 deals with collection of financial data at the firm level and how such data could assist the global policy makers to ensure a more stable global banking system. Section 4 discusses issues related to a new international monetary system and the importance of stable global currencies, and Section 5 briefly discusses shadow banking and its role for global financial stability.

1. Challenges of supervising G-SIFIs and shadow banks

In its recent publication, FSB (2013a) stated the following with respect to the supervisory capacity of G-SIFIs:

Significant weakness: The FSB issued its first recommendations for enhanced supervision of financial institutions, in particular G-SIFIs, in October 2010. The report highlighted the key elements required for effective supervision, which were (i) strong and unambiguous mandates, (ii) independence to act, (iii) sufficient quality and quantity of resources and (iv) supervisors having a full suite of powers to execute on their mandate (FSB, 2013b). However, despite the completion of policy development, findings from the International Monetary Fund-World Bank Financial Sector Assessment Program (FASP) revealed significant weaknesses remain. As stated by FSB (2013b), the FASP revealed that only 25% of FSB member jurisdictions are fully compliant with the BCBS principles on regulatory independence and resources (with an additional 50% largely compliant). Moreover, based on the FSB (2013c), out of the 61 jurisdictions ranking highly in financial importance that were prioritised for assessment, 17 have yet to demonstrate sufficiently strong adherence to the relevant regulatory and supervisory standards (of which five are FSB members).

In emerging markets and developing economies particularly, the lack of human resources in regulatory authorities, in terms of both numbers and expertise, is the most important constraining factor cited by these authorities.

[1] This special issue is based on papers selected from those presented at the 25th Australasian Finance and Banking conference, held in Sydney, Australia. The papers in this special issue cover a number of topics with respect to finance, systemic risk, governance and aspects of global financial stability. I would like to thank Michael Liu and Christopher Wong for their research assistance work.

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Cross-border supervisory co-operation and co-ordination: Another factor identified by the FSB (2013b) is related to cross-border activities. A key element of the supervision of SIFIs is for home jurisdictions of G-SIFIs to enable the sharing of information for the purpose of rigorous, co-ordinated assessments of the risks facing-SIFIs by supervisory colleges, and as the FSB (2013b) states, more work is required to achieve this.

Given the above statements from the FSB, one should note that financial globalisation coupled with the revolution in IT including the internet and other means of telecommunication, amongst a number of other factors, have led financial markets to become increasingly global in nature. The rapid expansion of business activities and the new financial products generated by large banks and their ability to bypass, sometimes, the national regulatory system of the host countries as well as the expansion of their operations to some off-shore centres have made it hard for both national and international policy makers and regulators to fully understand and supervise their worldwide operations. The above statements and observations of the FSB in 2013 regarding some of challenges to effectively supervise G-SIFIS will remain ongoing issues for the foreseeable future, not to mention the growing expansion of shadow banks in some countries. It appears that there is a dichotomy between some of the principles of good supervision laid out by the FSB (such as (i) strong and unambiguous mandates, (ii) independence to act, (iii) sufficient quality and quantity of resources and (iv) supervisors having a full suite of powers to execute on their mandate) and the reality of the nature of global finance which is still predominantly driven by national policy makers and regulators whose interests and priorities may not be in conformity with the relevant international rules and agreements. Such a dichotomy is one of the reasons why one should consider how to create effective and appropriate global governance that has the capacity to create ownership of global issues and which could rely on the support of national policy makers and regulators for issues that influence global financial prosperity and global financial stability. There is no question that the emergence of new global governance and a global banking system is a process that may take some time to achieve. Nevertheless, it is important that we raise these issues, as our generation should become more aware of the options available to it, if the global economy is going to prosper with fewer interruptions as a result of uncertainty and possible future global financial crises.

Global systemically important financial institutions (G-SIFIs) operate in a large number of countries, with some financial products that are extremely mobile able to cross borders instantly. Good supervision requires, amongst other factors, much closer collaboration between national governments and regulators and relevant international institutions. However, the structure of global governance and the role of the current international institutions have changed slowly over recent times, despite the rapid changes in global finance and the exigencies of the time which seem to require a more inclusive and more integrated global economy and global financial architecture.

One of the fundamental challenges of our generation is the recognition of the evolution of human society over the last several thousand years that has generated progressively wider cooperation and harmony amongst smaller entities such as family, tribe, city state and nation. With the emergence of the Industrial Revolution and the process of globalisation since the 19th century, we have witnessed financial globalisation that is now becoming an increasingly dominant force that can reshape national financial markets, and their stability and soundness. The emergence of G-SIFIs, the expansion of shadow banking and the acceleration of the process of financial globalisation call for an acceleration in the process of building a new global financial system associated with an emerging new global governance that is more interdependent with existing national financial systems and which would enjoy the support of various international institutions that have the capacity to implement globally agreed rules and principles (see Moshirian, 2012).

2. Bail out or bail in of the G-SIFIs

According to the FSB (2013d), emerging market developing economies have expressed concerns regarding regimes established to address the cross-border resolution of G-SIBs. They stress the need for adequate involvement of host jurisdictions in crisis management groups and in the design of group-wide resolution plans and resolution strategies for G-SIBs (see FSB, 2013). These economies note that, while key host jurisdictions of internationally active banks are included in crisis management groups, other jurisdictions where the G-SIB's presence is smaller (as a share of the overall group's activity) but still systemically important from that jurisdiction's perspective are not included (see FSB, 2013d). Moreover, the FSB (2013d) highlighted the need to ensure equal treatment of creditors of the same class across the entire group, as host authorities would be less willing to support a resolution led by a home country in the absence of fair and equitable treatment of host country creditors.

The above challenge of taking full responsibility of the operations of large banks in various jurisdictions and providing an incentive on the part of these large banks to cooperate with various national regulators, national creditors etc. highlights the importance of creating a more global accountability mechanism for these large multinational corporations.

As part of this process, one of the main challenges is how to create mutual responsibility of all parties, including the government, depositors and/or taxpayers, shareholders, bondholders of the source country of some of these large banks and those players from the host countries in which these large banks operate.

Where there is a process of integration such as the US as a federation with its banking system or the current European model of banking union, albeit still in the process of developing and maturing, such mutual respect and accountability amongst all sources and host countries would be easier to enforce. Ultimately, a world banking union with collective responsibility of all national governments will be required to create a more secure global banking system that embraces all financial institutions. However, to achieve this goal, one should see this goal as a process that will take time to be realised, and dependant on progress in dealing with other international issues that are currently challenging the world economy.

It should be noted that in a global economy where large banks and other financial institutions, including shadow banks are operating in an environment which has an interdependent and effective global, regional and national banking systems in place, business activities and demand for credit and other financial products will expand much faster, with more confidence and less volatility as compared to the current global banking system which is not inclusive of all key financial institutions, and in which there is, despite the fact that, not much global and regional responsibility for large multinational banks may happening at the present time, this process may improve over time.

One could relate the concept of a global banking union and its gradual emergence over time to some national banking systems in which a federal approach has proven to be effective in creating greater stability within a national banking system. For instance, the US model of Federalism (while it may not necessarily be a perfect model) which resulted in the Federal Reserve System with effective collaborative work and coordination amongst twelve regional Federal Reserve Bank numerous privately owned U.S. member banks and various advisory councils could be considered as a model for consideration for a global banking system (taking into account the level of technology that existed in the early twentieth century and