Policy Challenges for Improving Financial Resilience

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Policy Challenges for Improving Financial Resilience

- **Implications of the Global Financial Crisis**
- **Recovery Process**
- **Challenges Ahead**
- **The Way Forward**

  - Policy Directions for Improving Financial Resilience

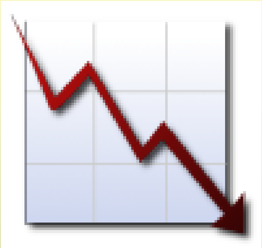
  Fiscal Policy
  Monetary Policy
  Prudential Regulation and Supervision
  Deposit Insurance
  Self Regulation and Risk Management

  - Balancing the Act: Consistency of Policy Objectives for Improving Resilience

  - Policy Choices for Improving Financial Resilience

- **Conclusion**

Implications of the Global Financial Crisis



- The financial crisis began more than two years ago.
- It proved to be among the most difficult challenges for policymakers since the Great Depression.
- The policy response to this challenge has included important successes, most notably the concerted effort to restore financial stability.
- Deposit insurers worked closely with other policymakers, to help develop the collective response to the crisis, and they played a key role in that response by extending coverage scope and limits as needed to stem the panic.
- At this stage, the basic question that need to be answered include:
  - ➢ Has the world recovered from the crisis?
  - ➢ Has policy actions met the objectives?
  - ➢ How to unwind the policy measures taken?
  - ➢ What should be done to insure the resilience of economic structure and financial systems?
  - ➢ What longer-term solutions should be designed to prevent the recurrence of economic crises?

Implications of the Global Financial Crisis

- Stock markets have fallen around the world;
- Large financial institutions have collapsed or been bought out;
- Governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems;
- International trade shrank;
- Growth slowed down;
- Unemployment Increased;
- Budget deficits soared;
- Central banks balance sheets inflated.

Implications of the Global Financial Crisis

- Almost universally, economists failed to predict the nature, timing, or severity of the crisis;
- Only isolated weaknesses in the economic system were identified;
- Several explanations were provided to improve our understanding of the root causes and implications of economic crisis;
- The crisis identifies the complex linkages and mechanisms that amplified the initial shocks and ultimately resulted in the devastating crisis;
- A lot of innovative policy tools and instruments were introduced;
- However, policy effort has so far not produced an economic recovery of sufficient vigor to significantly reduce the increasing level of unemployment;
- Explanations provided do provide assurance regarding the recurrence of the crises in the future;
- At least policy makers need to prepare themselves to with potential implications and improve system resilience, particularly the financial system resilience.

Recovery Process

- Financial markets are for the most parts of the worlds functioning normally now; with record levels reached by the end of 2010, and most markets indicated a strong optimistic start at 2011 trading openings.

- Precious metals and commodity prices soared and registered new records by the end of 2010 caused by accelerated demand and positive expectations about the economic recovery.

- Two-speed recovery, low but positive in advanced countries, fast in most emerging market economies.

- IMF and World Bank expect the two-speed recovery to continue over 2011and beyond.

Challenges Ahead

- Slower than the historical level growth;
- High unemployment rates;
- Macroeconomic imbalances (Budget and current account deficits);
- Volatility in foreign exchange market continues;
- Structural weaknesses in the financial system (inadequate risk-measurement and risk-management systems at many financial firms;
- Gaps and blind spots in the financial regulatory structures
- Shortcomings in some firms' business models, such as over-reliance on unstable short-term funding and excessive leverage;

Basically:

we need to improve our understanding of the causes of financial crisis, in developing policies to contain it, and in designing longer-term solutions to prevent its recurrence, or to focus on developing a resilient financial system to avoid the recurrence of the crisis.

The Way Forward

- Rebalancing of internal and external macroeconomic structure continues to be crucial.
- Without economic rebalancing, the current economic recovery will not be a healthy and sustainable one, and financial crises will reoccur more frequently.
- The growth, in many countries, before the crisis, came from private domestic demand, be it consumption, or housing investment.
- Current growth, in many countries still use fiscal policy to prop up domestic demand.
- This was needed, but it is not sustainable. More reliance is needed on external demand, on exports.
- Without rebalancing the macrostructure, the recovery cannot continue. Continued fiscal expansion, or a return by consumers to their old, low-saving ways can sustain demand and growth for some time. But they will recreate many of the problems that were at the root of the crisis.
- The rebalancing requires collective economic and financial policies and need to be formulated in a coherent consistent manner and implemented in consistent cooperation.

Policy Directions for Improving Financial Resilience

- Fiscal Policy
- Monetary Policy
- Prudential Regulation and Supervision
- Deposit Insurance
- Self Regulation and Risk Management

→ Financial Resilience

Balancing the Act: Consistency of Policy Objectives for Improving Resilience

Policy	Primary Policy Objective	Current Policy Focus	Ultimate Objective
Fiscal Policy	**Manage Aggregate Demand**	**Contain Deficit: Sustain the Recovery**	**Resilient Financial System that Promotes Economic Growth**
Monetary Policy	**Maintain Price Stability**	**Stay Expansionary; But watch Inflation**	
Prudential Regulation and Supervision	**Prevent Distress of Financial Institutions**	**Strengthen Macro and Micro Regulatory Structure**	
Deposit Insurance	**Protect Less Financially Sophisticated Depositors**	**Enhance Depositor Protection; Containing M.H.**	
Self Regulation and Risk Management	**Achieve Sustainable Returns to Shareholders**	**Improve Risk Management at all Levels.**	

Policy Choices for Policy Objectives

- Each Authority has several policy tools to achieve its primary objective;
- primary objective for one policy could be a secondary objective for other policy;
- No one policy does the job;
- No one tool for single policy objective;
- No one size fits all;
- Coordination and harmonization improve policy effectiveness.

Unwinding Fiscal Policy Measures

<u>Basic Function in Promoting Stability for Sustainable Growth</u>

Countercyclical Management of Aggregate Demand

Basic Challenge

<u>Unwinding Exceptional Fiscal Policy Tools Introduced during the Crisis</u>

•Capital Injection
•Debt Guarantee;
•Asset Purchase;
•Recapitalization Using Public Funds

Improving Monetary Policy Management

Keeping the Conventional Role but Changing the Course

- Reserve Management;
- Lender of Last Resort;
- Exchange Rate Management;
- Provision and Management of Financial System Infrastructure (e.g.. Payment and Settlement Systems).

Reverse the direction

Basic Challenge

Unwinding Exceptional Policy Tools Used for Crisis Management

- New Lending Programs
- Open Bank Assistance
- Liquidity Support (Withdrawal)
- Asset Purchase (Sale)
- Capital Injection (Avoid Conflict of Interest and Rid Monitory Authority from these Investments)
- Troubled Asset Relief
- Supporting Inter-bank Lending

Enhancing Prudential Regulation and Supervision

Off-site Supervision

Compliance with Banking Regulations and Directives

OR

- Comprehensive Appraisal of Risks
- Monitoring and Evaluating Safety and Soundness
- Providing Early Warning of Potential Problems

On-site Supervision

Compliance with Banking Regulations and Directives

OR

- Risk Assessment
- Assisting Banks in Managing their Risk
- Evaluate Potential Problems Identified by Off-site Examination
- Assessment of the Quality of Assets, Management, Earnings, Capital, and Funds Management, as well as the Bank's Internal Control, Audit, Management Information…etc.

Unwinding Blanket Guarantees and Reforming Explicit Systems

Credible Well- Designed Limited-Coverage Deposit Insurance System

Strengthens

Market Monitoring

Contains

Moral Hazard

Limits

Banks Risk Taking

Improves

System Resilience

In Compliance with the Core Principles for Effective Deposit Insurance System (Compulsory Membership, Credible Coverage Limit, Risk Based Premium etc.)

Advancing Self Regulation and Risk Management

Pursuant of Sustainable
Or
High Returns

Incentive Structure
(Short Term or Long Term)

Financial Leverage
And Risk Taking

<u>Credit Risk</u>
Credit to TA Ratio;
Concentrations;
Sensitivity to
Business Cycle

<u>Market Risk</u>
Exposure Limits

Risk Management
Techniques

<u>Operational Risk</u>

Revisiting the Internal
Control System

<u>Liquidity Risk</u>

<u>Insolvency Risk</u>

To Conclude

- Improving financial resilience is the main challenge ahead given its essential role in achieving sustainable growth;
- Risk management, by itself, can't do it all;
- Regulators should ensure the harmonization among primary policy objective (s) with the objective of improving financial resilience;
- Effectiveness of policy tools is time sensitive and country specific;
- The enhancement of financial resilience requires effective coordination among all policy makers in charge with: prudential regulation and supervision, monetary policy, deposit insurance, and fiscal policy;
- Prudential regulation and supervision along with deposit insurance must play wider roles, given the limitation of monetary and fiscal policies.