INSTITUTE FOR FISCAL STUDIES

POLICY BRIEF

No. 5

Aug 27, 2018

INTEGRITY: THE FOUNDATION FOR A STRONG FINANCIAL SECTOR

Speech by the Hon. Dr. Kwabena Duffuor, then Minister of Finance and Economic Planning To the Concern Universal Forum, at the British Coucil, Accra, Ghana 12 May 2009

1.0 INTRODUCTION

The financial sector is a critical component for economic development in any country. It is the heart of any vital economy, contributing to prosperity and wealth creation through the provision of financial resources to support businesses, mobilizing savings, and accelerating commerce by facilitating payments and transfers.

2.0 GLOBAL FINANCIAL CRISIS

As we all know, the global economy is currently living through its deepest crisis since the Great Depression of 1929. Around the world, politicians, economists, policy analysts, investors, bankers, etc., are engaging with the impact of this crisis on their respective countries, businesses, investments and global economic growth.

Ladies and gentlemen, first and foremost, this is a crisis of the developed world, the causes of which can be summarized as follows. Over the years, banks in the United States purchased vast quantities of loans used for house purchases. As interest rates increased in 2006 and 2007 in that country, many of the debtors began to default, putting at risk the value of all housing loans. This uncertainty resulted in the share prices of financial and non- financial companies falling, affecting inter-bank lending operations. Financial institutions involved in property such as Northern Rock failed while other institutions experienced increasingly large losses on their investments in the housing markets. Losses of US$200 billion were predicted in the early days of the crisis but estimated losses now stand close to US$2 trillion.

Central banks in developed economies responded by announcing coordinated interventions to provide short term funding needs, established temporary currency swap arrangements, and injected liquidity into the financial markets. Sovereign wealth funds were tapped to fund institutions like

This Policy Brief is a publication of the Institute for Fiscal Studies. All rights reserved. No part of this publication may be published or reproduced without written permission of the Institute for Fiscal Studies. All comments, views, or enquiries should be channelled to: The Executive Director, Box CT 11260, Cantonments, Accra. www.ifsghana.org

UBS, Morgan Stanley, and Merrill Lynch. These actions did little to stem the crisis and a number of investment banks in the United States were hard hit. Lehman Brothers failed, Bear Stearns was bought for a song, and Goldman Sachs and Morgan Stanley changed their regulatory stripes to access deposit bases. The US Federal Reserve provided AIG, a large insurance company, with support of some US$150 billion. The United States was also initially estimated to run a deficit of over US$1.2 trillion in 2009 as a result of the financial crisis.

Signs of spreading of the financial crisis globally are abundant. Governments have committed some trillions of US dollars to support financial systems around the world, and close to US$1 trillion write-offs and losses have taken place since October last year. Share prices in all equity markets across the globe have also dropped significantly.

The financial meltdown has also seriously affected the real sector of the global economy. The rapid economic growth of the Chinese economy, which has been the driving factor behind the commodity price boom the world experienced over the last 6 years ending 2008, has begun to taper, resulting in lower imports and putting downward pressure on commodity prices. Prices of gold, platinum, coal and oil have all dropped significantly in the last couple of months.

The crisis has also compelled monetary authorities in the advanced countries to institute drastic cuts in interest rates, leading to re-alignments in exchange rates on the international capital markets. We are witnesses to how rich countries have moved speedily to support their financial sectors, with most of the industrialized countries now in a situation of negative real interest rates. The United Kingdom now has interest rates at the lowest level in the 314 years of existence of the Bank of England.

Generally, institutions and persons wanting to conduct banking, stock exchange and insurance business are required to obtain licences from central banks and/or regulatory agencies. In assessing a licence request, the central bank or regulatory authority determines whether the applicant meets, and is permanently able to meet the requirements stated in the supervisory laws and regulations. These requirements are related, among other things, the applicant's solvency and liquidity, the administrative organization and internal controls, management information systems, the expertise and credibility of board members and senior management, integrity of shareholders, quality of anti-smuggling procedures, etc. In other words, all the corporate governance issues and other requirements required for maintaining solvency, stability and integrity of the financial systems are evaluated and approved before an institution is allowed to conduct business in the financial sector. Why then do countries continue to have periodic financial crises?

What really triggered the beginning of the current world financial crisis? The answer is simple: a lack of confidence. In fact, all markets are built on confidence, and the financial market is especially dependent on confidence. Confidence in every layer and link in the system: confidence in reliable figures and sound people, and in well-enforced laws against fraud and corruption.

3.0 EFFECTIVE LEADERSHIP

The lack of confidence in the financial sector points to the failure of the supervisory and regulatory authorities to provide effective leadership. The authorities have failed to exhibit integrity, courage, incisiveness, decisiveness, perspective, and perseverance. They lack effective relationship building, and their track records do not confirm the defined leadership traits. Although, generally central banks and financial regulatory authorities have either acquired or have the capacity to generate and align resources, most have failed to define the direction in which the financial sector should go in order to maintain its integrity, and the priorities to pursue to achieve this critical dispensation. In many instances, when circumstances change, the financial sector is unable to flex and adapt. The institutions and systems have become captive to the industry and are unable to effect and sustain radical changes. This underscores the length of time it is taking the sector to transform, despite the existence of a plethora of international standards and codes of conduct.

Not only that, but also many central banks and regulatory agencies have failed to inspire innovation, drive action and build confidence in the financial sector. The financial sector is not organized in a way that allows people and the institutions that participate in it to constantly challenge convention, strive to effect changes, and define new realities. Participants in the industry are not constantly goaded into action and pushed for results. The financial systems have become entrenched, no one questions processes, and it is easier to repeat what worked yesterday than go through the trauma of trying to do something new. As a result, the industry struggles to break away from the traditional pack, where information and ideas are seldom shared, secrecy is worshipped, and fear of failure is crippling. Uncertainty, hesitance and caution have become common characteristics of the financial sector, gradually eroding its integrity, and thus the confidence.

Traditionally, integrity of the financial sector relates to the adherence of financial institutions and affiliated persons and institutions to standards that are rooted in laws, regulations, guidelines and recommendations issued by the central bank and/or regulatory authority, codes of conduct drawn up by the financial institutions or sector themselves, and socially accepted unwritten rules of conduct. For each standard, infringement thereof damages or can damage confidence in complying with the obligations resulting from performing financial services of the institutions with regard to the purchaser of the financial services offered or rendered by them, or the proper functioning of the financial sector in which the institutions operate.

4.0 INDEPENDENCE & POLITICAL ACCOUNTABILITY

In the past decades, major financial crises have been worsened by political interference in financial regulation and supervision. Political pressures not only weakened financial regulation generally, they also hindered regulators and the supervisors who enforced the regulations from taking action against banks that ran into trouble. In doing so, they crippled the financial sector in the run-up to the crisis, delayed recognition of the severity of the crisis, slowed down needed intervention, and raised the cost of the crisis to taxpayers.

Increasingly, policymakers and policy analysts have recognized that regulators charged with preserving a financial system's stability can carry out their mandate effectively when they are independent of political influence. Even though independent regulatory agencies have proved themselves in practice, creating them and keeping them independent and accountable poses difficulties that cannot be ignored. An agency that is independent of political control may run the risk of "regulatory capture" by other interest groups, i.e., become subject instead to pressure from the industry it regulates, undermining the effectiveness of regulation and creating deficiencies in political accountability.

Making financial sector regulation work requires striking a proper balance between effective independence – paying serious attention to the key aspects of independence, viz. regulatory, supervisory, institutional and budgetary – with political accountability. Political accountability is needed for effective financial regulatory and supervisory independence, and indeed the greater the degree of independence the more important accountability arrangements become.

5.0 CONFIDENCE

Confidence is closely related and interlinked to integrity. Confidence is essential for economic transactions and that confidence is based on the integrity of market players. It is therefore understandable why integrity played an important role in the causes of, and the solutions for the current financial crisis.

The financial sector needs to demonstrate that it has embraced integrity as its cornerstone. It should also realize that sound conduct goes beyond strict compliance with the laws and regulations. The laws and regulations reflect the prevailing social norms and values. Since regulations codify norms and values, it is vital that the financial sector keeps abreast with the changing views in the society on what integrity involves and what type of conduct is worthy of confidence.

Confidence is not just about integrity. The solvency and stability of the financial system, accountability and transparency are also crucial for maintaining confidence in the sector. But the sector still needs to observe business integrity in a way that the society finds admissible and acceptable.

6.0 INTEGRITY SUPERVISION

Monitoring and safeguarding business integrity is the job of the supervisors of the financial sector. Integrity supervision entails: personal integrity, organizational integrity, relationship integrity and market integrity. The Central Bank should target risks that could harm the activities of financial institutions their reputation. For financial institutions, the personal integrity of the leadership, i.e., the directors in the broad sense, is more crucial for business integrity than the conduct of individual employees. The trustworthiness, sense of responsibility, law-abidingness, honesty, uprightness, etc., of directors and those who determine policy should be beyond doubt.

The highest standards of integrity are also required from the employees of financial institutions. A sharp awareness of integrity at all layers of the organization, not only through rules and regulations, but also through training sessions on integrity at the work place, is also crucial. Such sessions lend the employees greater insight into the integrity dilemmas that may arise in their work and also offer them the opportunity to discuss integrity and what it means for the supervisory role of the central bank. Unsound conduct by the central bank or its employees could have detrimental impact on public confidence in the organization.

Financial institutions must at all times apply the basic criteria: know your customer and know your business. This is because, even if the institution's employees are sound, they may unwittingly do business with dishonest customers. Banks could be drawn into money laundering, terrorist financing, fraud, harm to third party, insider trading, etc. – activities engineered by criminal organizations that use complex methods to finance these operations for criminal gains. From the perspective of integrity supervision, one would consider reporting unusual transactions and the further application of know-your customer principle (customer due diligence). Other areas of interest would include the illegal acquisition of funds by financial institutions, and cooperating with or taking insufficient measures against the access of third parties to and using financial markets by third parties for illegally acquired securities.

Financial institutions are expected to promote sound market conduct by preventing malpractices like price manipulation to influence transactions. This point of interest is preponderantly related to stock market activities.

Besides the integrity supervision of persons, business relations, organizations, and market conduct, the Central Bank should also concern itself with the integrity of the entire financial sector. Here too, integrity goes beyond compliance with statutory rules and regulations. Unsound conduct can damage the sector as a whole, even if no violations have occurred. Wrong incentives, such as transaction-related bonuses, could induce sound people working in sound companies to exhibit behaviours that impact negatively on market integrity generally.

Effective auditing and reporting of the performance of financial institutions is also necessary for enhancing the integrity of the financial sector. This can be accomplished by upholding ethical requirements, accepting and reporting misleading information, and expanding the scope of work to include issues of probity, transparency, and accountability. This could become difficult in practice because of the need to strike a balance between transparency and confidentiality of auditing in the private sector. Unlike the public sector, the financial reporting framework, laws and regulations in the private sector may require certain disclosures in financial statement. However, the information obtained during the audit and communication between the auditor and the auditee is generally confidential unless a law, regulation, or professional duty requires its disclosure.

7.0 INTERNATIONAL RESPONSE

The issue of integrity of the financial sector needs to be tackled internationally. This is because globalization has removed the borders in the financial sector. Since financial risks have become marketable and borders between countries have become blurred, financial crises and the associated losses are spread quickly and more widely. Countries not only reap the rewards of globalization but also the costs, because everybody is affected when things go badly wrong. That is why there is the need for global discussions and actions on matters such as integrity of the financial sector.

Over the past two decades and beyond, the international financial community has been in the process of devising consensus on international standards and codes of conduct to achieve financial stability and develop a robust financial system. These standards and codes of conduct, regarded as “best practices”, have been promulgated through international forums, such as the Basil Committee, Joint Forum on Financial Conglomerates, Financial Stability Forum, etc. The ‘’Core Principles for Effective Banking Supervision’’ of the Basil Committee constitute the global standard for banking supervision. Together with 11 other standards, these form the key international standards for sound financial systems. There is also the IMF-World Bank Financial Sector Assessment Program, designed as an instrument for diagnosing potential vulnerabilities and development priorities in the financial sectors of member countries. The primary focus of these international standards has been financial crisis prevention, financial stability and, more recently, financial sector integrity.

Enhancing financial integrity would entail a broad, rule-oriented framework to which unfettered discretion, non-transparency and cronyism must give way. But such a framework should not only be a matter of substantive scope, it should also be deep in implementation and enforcement. A comprehensive and coordinated framework will accordingly need to interconnect the legislative, administrative, supervisory, regulatory enforcement and judicial administrative processes in every country. In addition to good central and commercial banking laws, securities and securities market laws, insurance laws, a wide range of interconnected and supporting laws are also needed. These include modern laws in the areas of contracts, property, property security rights, commercial and finance law, insolvency, corporate governance, foreign investment, licensing, intellectual property and taxation.

Optimum transparency in the industry is necessary so that all players understand the rules of the game and the game can continue successfully. The emerging international consensus on the requirements of financial stability is built on the principle of transparency and for this reason the financial and legal infrastructure of any emerging market must be transparent. Moreover, transparency, together with accountability, probity and competence form the foundation for integrity.

Corruption can undermine any efforts at establishing and maintaining integrity of the financial system by undermining public confidence. Certainly, corruption is counterproductive to sound and sustainable economic development. Related to the need to crack down on corruption is the ongoing fight against using financial institutions for illegal purposes. These problems go to the core of the integrity of financial sector and its management.

8.0 CONCLUSION

The financial and economic crisis confronting the world today is in large part due to the failures of national and cross-border regulatory and supervisory regimes in assessing and managing the build-up of risks in financial institutions and systems. It is the absence of leadership, i.e., the failure of the supervisory and regulatory authorities to drive change by inspiring people, institutions and systems to do new things fast. The absence of leadership in the global financial sector undermines the sector's integrity, which in turn is reflected in the low level of confidence shown in the international financial institutions and systems. National or domestic efforts to address the global financial and economic crisis therefore need to find external resonance in the reform of the international financial architecture and multilateral institutions, and in the renewal of global commitment to transparency and mutual accountability. All of these factors are critical and their combined effect would support the creation of the type of leadership that is required to significantly enhance the integrity of the global financial sector and to restore confidence.

INSTITUTE FOR FISCAL STUDIES

Residential Address
No. 13, 2nd Close, Airport Residential Area, Accra, Ghana

Postal Address
P.O. Box CT 11260, Cantonments, Accra, Ghana

+233 302 786 991
info@ifsghana.org
www.ifsghana.org