Part III

Specific Issues Confronting Regulators and Supervisors at the International Level

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Four Themes of Sound International Supervision

Susan M. Phillips

It is a pleasure to be here to address this international conference of fellow banking supervisors and other distinguished international participants. Conferences like this one are important forums for discussing current issues in international banking supervision among the supervisors, bankers, and other financial industry participants of many nations. Such communication has become critical as the financial operations of the banks we supervise become more global, complex, fast paced, and interwoven. I would like to thank De Nederlandsche Bank and the Forum on Debt and Development for organising this conference, which I hope will help us build essential bridges among banking supervisors and open new channels of communication internationally at all levels.

Although it is difficult to predict financial crises with precision, financial services firms and their supervisors can navigate the difficulties posed by such crises by utilising sound risk management practices and certain supervisory principles. I would like to focus my remarks today on four fundamental themes underlying the 1997 Basle Supervisors Committee's Core Principles of Effective Banking Supervision. As I discuss each theme, I will naturally draw on our experience in the United States, while making a few observations about the applicability to the current Asian banking situation.

- The first theme is the need to focus supervisory efforts on the specific risk profile of individual institutions.
- My second theme is the need for sound accounting and disclosure systems to provide sufficient transparency to allow the financial markets and supervisory agencies to evaluate institutions' financial conditions.
- My third theme is the need for adequate capital and the challenges we face in keeping capital standards current.
- Finally, we must recognise the need for international banking supervisors to work closely and cooperatively together to achieve effective coordinated supervision of global banks and other financial firms.

I Risk-Focused Supervisory Approach

One of the goals of banking supervisors is to help identify and address

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weak banking practices early so that small or emerging problems can be addressed before they become large and costly. To do that in today's global fast-paced markets, and in an environment in which technology and financial innovation can lead to rapid change, the Federal Reserve is pursuing a risk-focused supervisory approach. Such an approach plays a critical role in helping us to achieve our supervision and central banking responsibilities of:

- working to ensure the safe and sound operation of the banking organisations that we supervise,
- promoting an efficient and effective financial system that finances economic growth, and
- ensuring that financial institutions do not become a source of systemic risk, threat to the payment system, or burden to taxpayers by making them absorb losses arising from inappropriate extension of the federal safety net.

The Federal Reserve has undertaken its new risk-focused examination approach to respond to the dramatic changes that are occurring in the banking and financial services business, including tremendous advancement in technology and securitisation, the breakdown of traditional product lines, the expansion of banks' global operations in the world's financial markets, and the development of new risk management systems. Furthermore, developments in technology and financial products, combined with the increased depth and liquidity of domestic and global financial markets, have enabled banks to change their risk profiles faster than ever before. A key goal of the Federal Reserve's risk-focused approach is to enable banks to compete effectively in this dynamic financial services sector, while focusing examiners on banks' ability and willingness to deal effectively with their own risk exposures rather than on standardised examination checklists. Economists will recognise risk-focused supervision as a form of "incentive compatible" regulation.

US banking supervisors in the past focused primarily on validating bank balance sheets, particularly the value of loan portfolios, as of a specific point in time. Losses on banks' loan portfolios historically have been the principal source of their financial problems. Concentrating on the quality of banks' loans and the adequacy of their reserves was, and continues to be, essential to sound banking supervision. As part of the examination process, examiners reviewed the soundness of management practices, internal controls, and internal audit activities, but that review was not the examination's primary focus. The Federal Reserve's adoption of a risk-focused approach, however, reflects its view that examiners should target their work on individual banks' specific risk profiles, including the traditional examination of loan quality and reserves.

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This need for fundamental change in the traditional approaches of bankers and supervisors became evident in reviewing the lessons learned from the turmoil, stress, and change in the US banking system over the past decade. Ten years ago, many of the United States' largest banks announced huge loan-loss provisions on doubtful loans to developing countries, while many banks were also struggling under the weight of loans to the energy, agriculture and commercial real estate sectors. By the end of the 1980s, more than 200 banks were failing annually. There were more than 1,000 banks on the problem list of the Federal Deposit Insurance Corporation, which is the US banking agency that insures bank deposits and serves as receiver for failed banks. This period includes the costly crisis of the US savings and loan industry – which is composed of institutions chartered to make home mortgage loans available to the American public.

In response to these systemic developments, bankers and supervisors each changed their fundamental ways of operating and managing risks. For their part, bankers recognised the need to rebuild their capital and reserves, strengthen their internal controls, diversify their risks, and improve internal risk management systems. The Federal Reserve, in turn, responded to these changes by adopting its risk-focused examination system tailored to assessing the quality of individual banks' internal processes and risk management systems. The need for this approach is illustrated by the failure of several high-profile international banking organisations that did not have adequate internal control and risk management systems.

Adopting a risk-focused approach improves the examination process by targeting examinations more directly on specific institutions' problems. The approach is appropriate for large complex institutions and for smaller banks. However, it also makes such examinations more challenging for examiners because they must be knowledgeable about each bank's business activities, risk profiles, and risk management systems. Furthermore, we are trying to make these examinations more efficient for examiners and bankers by employing valid statistical sampling methods, as well as by computerising part of the examinations and utilising regulatory and bank data for pre-examination scoping. This initiatives will all free examiner time to devote to banks' specific risk exposures and minimise examiner on-site examination time. Revision of the Board's examination manuals and training curriculum has been necessary to accommodate the new supervision approach and methods.

In addition, banking supervisors need to assess the integrity and independence of a bank's decisionmaking processes, giving special attention to any conflicts of interest or insider influence that could distort this process. The Basle Committee's Core Principles for Effective Banking Supervision

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address this point by recognising the need for effective measures to control directed lending and transactions with affiliates that are not on an arm's-length basis. Specifically, the Core Principles state that, to prevent abuses arising from connected lending, banking supervisors should require that any loans banks make to related companies and individuals be on an arm's-length basis; that such extensions of credit be effectively monitored; and that other appropriate steps are taken to control or mitigate the risks. For example, the Federal Reserve's Regulation O, whose application was expanded to directors in the early 1990s, is aimed at making sure that any loans a bank makes to officers or directors are on the same terms that are available to the general public.

Finally, the Federal Reserve places great reliance on on-site examinations to make the presence of supervisors tangible to bankers and to facilitate the review of records and documents that are essential to assessing a bank's financial condition. Such on-site examinations also permit examiners to observe whether bank policies are being followed in practice, or, alternatively, whether they only exist on paper. Although I recognise that many other countries do not conduct on-site examinations for legal and other reasons, the Federal Reserve concurs with the position taken by the Basle Committee's Core Principles that it is important for supervisors to perform some on-site supervision.

II Need for Sound Accounting and Financial Transparency

The Federal Reserve believes that sound accounting and transparent financial information is a fundamental pillar of a strong banking – and, indeed, financial – system. Transparency is essential for the market to be able to make decisions on an informed basis. The arm's-length negotiations of informed investors and issuing banks provide the strongest market basis for the issuance and pricing of equity and debt securities, as well as loans. Banking supervisors should strongly advocate transparency to aid effective supervision and market discipline. Indeed, they can encourage the process directly through appropriate regulatory reporting requirements and even making all or part of those reports public.

It is important for governments to allow market forces to reward prudent behaviour and penalise excessive risk-taking. Sound, well-managed firms can benefit if better disclosure enables them to obtain funds at risk premiums that accurately reflect lower risk profiles. Inadequate financial disclosure, on the other hand, can penalise well-managed firms, or even countries, if market participants do not trust their ability to assess firms' or countries' fundamental financial strength.

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Regulatory structures that overly protect banks from market forces, or that allow lax accounting and disclosure to disguise firms' financial problems, remove market discipline on banks and permit them to operate less efficiently. Deposit insurance systems and the public safety net are examples of regulatory interference with market forces, despite their public benefit. They create a moral hazard by allowing institutions to take on what might be excessive risk without proportional fear that their ability to raise funds at favourable rates will be impaired. This is illustrated by the costly US savings and loan crisis of the 1980s. Lax accounting and capital standards allowed economically insolvent institutions to continue operating and attracting insured deposits at attractive rates because the deposits were government insured. This, in turn, delayed government and public recognition of the scope of the problem and tremendously increased the cost of its resolution to the deposit insurance system and the American taxpayer.

To be credible to global investors, accounting standards should be established by independent professional organisations and enforced by a combination of market discipline and national oversight authorities. Particular to banking and the credibility of banks' financial statements is the establishment of prudent levels of reserves. Investors must be confident that banks are establishing sufficient levels of reserves and recognising loan impairment in a timely fashion. Compliance with sound accounting, disclosure, and reserving standards not only protects safety and soundness, but also gives the world's investment community confidence in its analysis of risk exposure from investing in various countries and companies. The absence of such confidence, on the other hand, may lead investors to overreact to adverse financial events in such countries by ceasing investment, immediately withdrawing current investment funds and demanding a high return for any remaining or renegotiated investment in such countries. Today's technology and global financial markets enable investors to take these actions very quickly with dramatic consequences, as has recently happened in some Asian countries.

Another issue related to the efficient operation of market forces is that government intervention in the credit and investment decisions of banks distorts market discipline and pricing. Such programmes frequently cause banks to make less than arm's-length investments in, and loans to, noneconomic government-affiliated projects or to individuals associated with such projects. Once these loans are made, it is difficult for national supervisors to demand that banks apply prudent reserve and charge-off policies, let alone foreclose on such loans. In addressing governmental interference with market forces at their meeting in London in February, representatives of the G-7 countries unanimously supported the International Monetary Fund's requirement that countries receiving IMF funds make structural

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reforms to reduce inappropriate government interference in the market economy. The message that governments should heed is that, ultimately, market forces will come to bear with severe results if firms or nations are artificially protected from market forces.

III Sound Capital as a Risk-Absorbing Buffer

My third major theme – the importance of adequate capital – has drawn much attention in the past decade as a result of the Basle Accord. The idea is pretty simple: if we want banks to be prudent in their risk-taking, there is no substitute for requiring banks' owners to have their own money at risk. With that requirement, supervisory interests and banks' private interests are more closely aligned and banks have fewer incentives to take excessive risks. When banks' managers and directors assess the riskiness and profitability of prospective business opportunities, they will weigh heavily the potential effect of new business activities on their banks' capital positions.

Capital must be sufficient, but "How much capital is enough?" The answer is linked, of course, to the level of risk that an institution takes. Institutions that aggressively pursue risky business strategies clearly need a stronger capital base than those with more conservative objectives and products.

While a fairly simple approach, the Basle risk-based capital framework has proven to be a balanced risk-focused framework for setting minimum capital standards for thousands of banks of all sizes worldwide. It is important, though, that banks not misuse this minimum prudential standard by substituting it for more rigorous internal evaluations of capital adequacy suitable for their own risk exposure and the sophistication of their financial strategies. For example, US supervisors support the development by a limited number of sophisticated banks of advanced credit risk models for assessing such institutions' internal capital needs to keep their probability of default within their established parameters. Such systems represent significant advances in developing systems to tailor banks' assessments of their capital needs for their credit risk exposure. On the other hand, the cost and complexity of such systems raises issues about their current feasibility as part of the uniform capital measure for all institutions. In any case, banks must rely on their own internal capital assessment systems targeted to their risk profiles and financial sophistication, as well as complying with the necessarily broadbrush, uniform capital standard established under the Basle Accord. We must look constantly for better ways to design regulatory capital standards and to promote adequate risk measurement in

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banks. On this note, the US Federal Financial Institutions Examination Council held a conference for bankers and supervisors last December to consider a myriad of views on ways that capital regulation should be modified to address changes in banking and risk management. The New York Clearing House Association just completed a pilot study of the pre-commitment approach to capital requirements for market risk. The Federal Reserve Bank of New York also recently organised a conference, in conjunction with the Bank of England, Bank of Japan, and the Federal Reserve Board, for the exchange of economic papers on developments in risk assessment and management, as well as on how such advances should be incorporated into the international capital framework. Although considerable progress has been made in amending the Basle standards in such areas as market risk, there will no doubt be additional changes as new tools are developed to address credit risk differentials, interest rate risk and, perhaps even, operational and legal risk. Indeed, capital standards should be thought of as an evolving process.

IV Coordinated International Supervision

We all recognise the need to achieve coordinated international banking supervision based on cooperation and strong working relationships between home country and host country supervisors. New challenges in attaining this goal are presented by the advent of new technologies, the geographic expansion of banking activities, and the globalisation of financial markets. We should work together, relying on the leadership of home country supervisors, to analyse banks on a consolidated global basis as the financial market does. Home country supervisors need sufficient global information and international cooperation to perform their supervisory responsibilities, while enabling host country supervisors to oversee the activities of international banks in their countries.

A key issue arising for all of us, both internationally and domestically, is the growing prevalence in world markets of financial conglomerates – which blend banking, insurance, securities, and other financial activities in a single diversified global entity. Universal banking in some nations' financial firms has long combined banking and securities activities, and to some extent insurance powers, in a single entity. Such financial conglomerates, which are growing in number and size, engage simultaneously in a myriad of businesses and seek to integrate those businesses to cross-market their varied products. This presents a significant supervisory challenge because most of our legal frameworks use separate and different approaches for each traditional segment of the financial industry. In many cases multiple agencies are involved. I expect many would observe that the United States is an extreme example of multiple regulators and multiple agencies. In some sense, our system is showing signs of the strain, but, the checks and balances afforded by this multiplicity has permitted significant innovation and expansion in the US financial services sector.

The challenge of achieving coordinated international supervision of such conglomerates is addressed in the consultative documents, "Supervision of Financial Conglomerates," developed by the Joint Forum of Financial Conglomerates. These working papers were announced on February 16th, 1998 by the Basle Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS). The Joint Forum, which was formed to help coordinate the international and inter-industry supervision of financial conglomerates, requested comment by July on these papers. The documents make concrete recommendations for steps that supervisors in each of the securities, insurance, and banking sectors can take to enhance supervision of the group-wide risk exposures of these global and inter-industry conglomerates. The documents also stress the need to enhance cooperation and information exchange among the supervisors in each country and industry segment.

Implementing these recommendations may necessitate changing the legal framework of our financial oversight frameworks, but major changes in our financial institutions and markets demand changes in the supervisory frameworks of our countries. The United States is no exception.

V Conclusion

In closing, I want to reiterate that banking supervisors must work together to achieve effective consolidated supervision of global banks under a shared set of supervisory principles, such as the Basle Committee's Core Principles. Furthermore, I believe that the best way to implement effective global supervision is to focus on the four themes that I have highlighted – the benefits of risk-focused supervision, the value of sound accounting and disclosure, the need for adequate capital, and the importance of international supervisory coordination. I look forward to our continuing joint supervisory efforts toward coordinated international bank supervision.

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Comment on "Four Themes of Sound International Supervision," by Susan M. Phillips

Paul Cantor

Risk Based Auditing

Principal responsibility for the success or failure of the firm rests with its directors and management. Comprehensive corporate governance is one element needed to achieve long-term stability and success. This includes development of the company's policies and procedures, particularly relating to risk management, an effective division of duties, internal and external audit, succession planning and other factors within the control of the firm. However, the supervisory audit by the regulator also should be a key element of overall corporate governance.

The supervisory audit must add value to contribute to effective corporate governance. While traditional tick and check audits may successfully identify frauds or defalcations, they are unlikely to get at core financial sector risk issues. The move toward risk-based auditing, in which the principal risks of the firm are identified and reviewed, promises to enhance the value of the supervisory audit. When this occurs, the supervisor adds depth to the corporate governance process, and as a result, to the credibility of their function.

Change precipitated by market liberalisation creates an environment of potentially increased instability. The importance of the supervisory role increases in recently-opened markets. Firms will seek to expand their operations to capitalise on the new opportunities. In these circumstances, the firm's own corporate governance practices may fall behind the increased market involvement. The result is increased risk, which can lead to liquidity or solvency issues for the firm. Widespread risk management shortfalls in the financial sector can lead to more generalised macroeconomic exposure. This in turn threatens not just the sector and its shareholders but the environment for economic development overall.

Capital Adequacy

The BIS capital adequacy guidelines are an important step in establishing standards by which financial institutions can be compared. Value will be

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added by upgrading these standards to distinguish between sub-categories of credit risk, and extending the guideline further to market risk and operations risk.

The leading edge of risk evaluation is likely to be centred in the risk management divisions of sophisticated financial institutions and their advisers. This leads them to development of risk analysis tools responsive to their needs. The US Federal Reserve has indicated that it is prepared to work with such institutions in the application of these models to the management of their risk. Depending on the portfolio mix, it is probable that this internal analysis will sometimes lead to capital requirements that are lower than those called for by the formula approach. Supervisors will need to exercise caution in accepting this proposition, as adverse changes can lead to erosion of the firm's ability to operate with lower capital requirements.

Moreover, the inevitable issue of precedent will lead to pressure from other firms for supervisors to apply such standards to them. Close liaison among supervisors from different jurisdictions will be needed to avoid regulatory arbitrage in these cases. It also erodes the ability to make comparisons among institutions based on common standards.

These comments are intended to be cautionary not limiting. Efficient allocation of capital contributes to a healthy market

Transparency

The importance of transparency cannot be overemphasised. Exposing transactions to the bright glare of sunlight greatly reduces the risk of undesirable behaviour. Transparency is an issue within the firm as well as between it and outsiders. A financial institution should have separate risk taking and risk review functions. Bank supervisors will wish to assure that the internal risk review function has sufficient access to information on the risk taker's deals to make a good assessment of risk. This is the first line of the defense.

Ensuring that an understanding of the risk is embedded throughout the firm is a key ingredient for ensuring that commercial institutions bear their share of the loss when events go off the rails. Failing this, a lack of transparency becomes a shield for the lender as well as a veil for the borrower. Neither accrues to the benefit of efficient or effective markets.

Coordinated Supervision

Regulators have long recognised the value of working together to deal with issues of fraud and corruption.

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There are new reasons to work together. Global trends in capital flows and technology are causing financial institutions to consolidate their operations. This applies to more than just the mega-mergers seen in recent months such as SBC and UBS. Institutions are merging across business lines like Salomon Brothers and Travellers Insurance. In addition, increased focus on risk means that most institutions are consolidating their risk management functions. The plain fact is that this coordinated approach can work to the disadvantage of regulators and supervisors unless they too work together.

Steps need to be taken to ensure a coordinated approach to financial sector supervision. The United Kingdom has drawn together its supervisory functions for banking, insurance and securities to achieve this. International institutions contribute to this trend. These include the Basle Committee of the BIS and regional and international meetings of financial sector supervisors. Recent initiatives include the Toronto Centre for Financial Sector Supervision sponsored by the World Bank and the Government of Canada in cooperation with the Schulich School of Business at York University. The Toronto Centre gives bank supervisors from emerging market countries direct contact with other bank supervisors in a programme directed to transferring know-how based on their own experience with bank failures and rescues.

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Promoting International Financial Stability: The Role of the BIS

William R. White

I Why Financial Stability is Important

It is not surprising that central bankers worry about financial stability, even those central bankers who do not have statutory responsibilities for banking supervision. Weak financial systems can have long-lasting and insidious macroeconomic implications (the problem of "financial fragility") that are naturally of concern to central bankers. Moreover, sudden failures in financial institutions, financial markets or payment systems (the problem of "systemic crisis") threaten contagion effects warranting the close attention of central bankers given their traditional role as lender of last resort. The seemingly ceaseless string of financial crises through the 1980s and 1990s, in both industrial (e.g. Scandinavia and Japan) and emerging market economies (e.g. Mexico and South Asia), indicates that these are practical and not theoretical concerns.

One problem arising from financial fragility is that central banks will be tempted to forbearance in the conduct of monetary policy, with associated risks to price stability and an increased likelihood of asset price bubbles. Even if the monetary authorities do not choose to behave in this fashion, market perceptions that they may be forced to do so may actually encourage speculative attacks on currencies and eventually a process of self-fulfilling expectations.[1] Conversely, attempting to pursue stabilising macroeconomic policies when the financial system is already fragile can lead to institutional failures, giving rise to both heavy costs for national Treasuries and important negative feedback effects on the real economy.[2] These processes were seen in Sweden, Finland, Mexico and still more recently in a number of Asian countries. A stronger financial system would alleviate both macroeconomic problems. In the same spirit, it should be noted that unstable macroeconomic policies can also contribute to financial instability through asset price bubbles and other channels. In short, monetary stabil-

1 Following the seminal article by Obstfeld (1986), the possibility of multiple equilibria has been noted increasingly in the academic literature.

2 For a summary of the explicit fiscal costs of some recent crises, see Caprio and Klingebiel (1996).

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ity and financial stability are two sides of the same coin and central bankers should be concerned about both. This is perhaps the principal lesson to be learned from the financial crises we have witnessed around the world in the past two decades.

Sudden failures in financial markets or payment systems can also have far-reaching effects. Major changes in the prices of financial assets, perhaps but not necessarily related to movements in underlying fundamentals, could threaten the solvency of individual institutions. A recent example of such phenomena was the impact of the sudden decline in the value of the Mexican peso and some Asian currencies on the creditworthiness of private borrowers and in turn their bankers. Such unexpected developments could also lead to exaggerated concerns about counterparty risk with associated reductions in liquidity in other financial markets. The recent drying up of trade credit in Indonesia and some other Asian countries is an example of what might happen. Finally, technical failures in payment systems, which currently process many trillions of dollars daily in the G-10 countries alone, would threaten a massive payments gridlock whose effects could easily extend beyond the financial sphere into the real economy. The disruptive effects of such a development would obviously increase (and perhaps non-linearly) the longer the problem persisted.

It is also the case in the modern world that financial instability is unlikely to remain contained within national borders. All financial disruptions are likely to have an international dimension because the three pillars of any financial system – financial institutions, financial markets, and payment and settlement systems – are increasingly international. In the early 1980s, virtually every OECD country curtailed or even refused the right of establishment to foreign financial institutions. By 1995 this discrimination had virtually disappeared in industrial countries and is being reviewed in many emerging markets.[3] Cross-border transactions in bonds and equities in 1980 amounted to 10% of the GDP of the Group of Seven (excluding the United Kingdom); by 1995 this had risen to 140%. Derivative instruments were essentially unknown in 1980; daily turnover (notional amounts) had risen to almost $1.5 trillion by 1st April 1995 and one-half of these trades involved a non-domestic counterparty.[4] Finally, the fact that new information is now available instantaneously and almost costless around the globe further increases the likelihood that shocks in individual countries

3 For a fuller treatment of international agreements designed to facilitate international financial transactions and contribute to the health of the international financial system, see White (1997).

4 See Bank for International Settlements (1996a).

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will be propagated elsewhere, even when such contagion might not be warranted by underlying economic fundamentals.

II A Strategy for Promoting Financial Stability

Any strategy for promoting global financial stability must begin by recognising two facts. First, the pace of change in modern financial markets is extraordinary, ongoing and irreversible. Second, financial transactions are becoming increasingly complicated and opaque and are involving an ever widening and changing cast of characters. The implication is that the "system" which policymakers aim to stabilise is both difficult to define at any moment in time and rapidly changing.

An important underlying force driving both developments is continuing improvements in computing and telecommunications which have implied a sharp reduction in the costs of carrying out even extremely complicated financial transactions. Deregulation, which implies a significant expansion in the importance of market forces, has also contributed materially to the process of change to date. Yet, in part at least, deregulation is a by-product of technological change which has made it far easier to avoid existing regulations. For example, when Microsoft can be traded at a transactions cost of 2 cents a share on the Internet, Japanese domestic regulations that enforce a cost of $5 are simply unsustainable.

Better and cheaper communications has also contributed materially to the breakdown of sectoral and national distinctions in international financial markets, as well as to the growing participation of a whole host of new players. The importance of this last development should not be underestimated since such new participants as pension funds, mutual funds and hedge funds are not likely to behave like traditional banks, a possibility which implies new uncertainties about how the international financial system might react during periods of stress. The fact that emerging markets are also far more important on the global stage than they were ten years ago, and that emerging financial markets have many idiosyncratic properties (often including a lack of transparency and good corporate governance), further complicates the task of formulating policies to ensure financial stability.[5] This combination of complexity and rapid change, allied with the increased integration of the international financial system, points however to four strategic implications.

First, measures to strengthen the system must be *comprehensive*. There

5 See Goldstein and Turner (1996) and White (1996).

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are no simple answers. This implies that wide-ranging measures must be directed to promoting the good health of each of the major components of the international financial system: financial institutions, financial markets and payment and settlement systems. In each instance, the overriding objective must be the stability of the system as a whole; that is, policymakers must seek to ensure that disturbances in one component of the system are not easily transmitted throughout the system because they can interact with some other weakness elsewhere.

The second strategic implication is that policymakers and regulators must rely increasingly on *market-led processes* to provide the discipline required to lead to prudent and stabilising behaviour. It seems to be a fact that regulators everywhere are having trouble keeping up with modern investment practices. Nor do they wish to respond with still stricter regulation of the traditional sort. This would be very costly in terms of efficiency, would only invite more evasion, and would likely lead to moral hazard problems and still greater dangers in the future. Rather, regulators are increasingly choosing to rely on the judgements of market participants, who are likely to be more up to date with evolving practices. In turn, the market will allocate rewards and punishments as necessary, both to owners of firms and to their directors and managements. This will help improve internal governance and encourage appropriate behaviour.

For market discipline to work effectively, regulators should put growing emphasis on disclosure and increased transparency. Better information aids "good judgement" as well as minimising the risk of "bad judgement"; say the likelihood that creditors might mistakenly shun good counterparties. However, since firms are often hesitant to increase voluntary disclosure, an important role for the public sector is to convince a small number of important and well managed firms to start the process going. Other firms will then have little choice but to follow for fear of being accused of having something to hide. This strategy was recommended in a recent BIS document[6] (the Fisher Report) on the disclosure of derivatives transactions, and also underlies the strategy of the IMF in asking for better macroeconomic data from emerging countries (SDDS) in the wake of the Mexican crisis.

This approach might also be used to support efforts, recently undertaken, by the G-10 Deputies[7] and the Basle Supervisors,[8] to reduce the risk of financial instability in emerging markets. Here the basic idea would be to build on the recently agreed set of international "Core Principles" govern-

6 See Euro-currency Standing Committee (1994b).
7 See Group of Ten (1997).
8 See Basle Committee on Banking Supervision (1997a).

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ing the behaviour of (say) banks and their supervisors. Subsequently, a set of quantitative indicators of the health of the financial system might be drawn up[9] and applied in the first instance to countries whose financial systems were known to be in good condition. With time, the market (including rating agencies) might come to insist on similar information from other countries which in turn would encourage pressures for desirable financial sector reforms. Recognising that the Core Principles were conceived of as minimum standards, the "hurdle rates" sufficient for banking systems to be judged healthy might be significantly higher in emerging than in industrial economies. Financial systems of many emerging markets are subject to relatively large macroeconomic shocks, to potential transitional problems in the context of financial deregulation and may be prone to greater swings of sentiment than in more developed markets.[10] All such considerations should be taken into account when setting minimum requirements.

The third strategic implication is that market discipline must be a *complement to*, rather than a substitute for, *the traditional activities of regulators and policymakers*. Publicly available information may arrive too late or be of too poor quality to support adequate market discipline. Moreover, safety-net provisions may also alter the incentives of market agents to respond appropriately to the receipt of new information.[11] Finally, it would be simply naive to assume that the markets will always exercise discipline appropriately. Throughout history, there have been instances recorded of excessive price volatility in financial markets, "bubbles" and other misalignment of financial asset prices.[12] Moreover, banks and other financial institutions, buoyed by waves of "excessive optimism" or even "irrational exuberance",[13] have frequently lent large sums of money to borrowers who ultimately proved unable to pay. Recent events in a number of Asian countries would seem to provide further evidence of this particular kind of market failure, albeit along with a number of other important shortcomings.

It is particularly worth noting at the present moment that imprudent behaviour and excessive risk-taking by financial institutions often follow

9 This follows along lines originally suggested by Goldstein (1997).

10 See Goldstein and Turner (1996).

11 In the recent Asian experience, a number of central banks failed to provide timely data about their own exposure in forward markets and/or their commitments to support the foreign exchange requirements of private sector entities. Safety-net considerations may have affected the willingness of local depositors to keep their assets with local banks and the willingness of foreign banks to lend to local banks.

12 For an overview of such considerations, see Bank for International Settlements (1996b) and (1998a).

13 This former phrase was introduced by McKinnon and Huw (1996), the latter more famously by Alan Greenspan.

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periods of declining profits due either to deregulation, and the associated loss of monopoly rents, or bad investment decisions in the past. Examples of such phenomena can be found in the domestic behaviour of US banks in the 1980s[14] and the expansion of Asian loans by certain Japanese and European banks more recently.[15] Given the strong current trend to financial deregulation in emerging markets, and the likely effects of similar phenomena in industrial countries ("Big Bang" in Japan, the effective demise of Glass-Steagall in the United States and the effects on European banks of the introduction of the euro[16]), regulatory oversight will continue to have an important role to play for the foreseeable future. Indeed, it is plausible to argue that the combination of these changing circumstances, allied with the spread of Internet and other technologies[17] (as well as important demographic changes[18]), could be ushering in an unprecedented period of transformation in modern financial markets. If so, policymakers will need all the instruments available to them if this process of change is not to prove disruptive.

The role of policy overseers will, however, have to change to reflect this required complementarity between market discipline and regulatory oversight. Just as monetary policy in a deregulated financial system must be conducted "with the grain of the market", regulatory oversight must be increasingly directed to improving market processes. In response, regulators have already begun to strengthen the focus they put on the adequacy of internal control procedures. This applies both to financial firms and to firms providing infrastructure services in the international financial

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14 The losses associated with the debt crisis of the early 1980s were followed (if not necessarily caused) by vigorous expansion into LBOs, property loans and proprietary trading.

15 At a CEPR conference in London on 4th-5th February 1998, David Folkerts-Landau of Deutsche Morgan Grenfell stated that many European banks had responded to declining rates of return in European banking in the early 1990s by "targeting middle-market Asia". French banks have been repeatedly warned by the Bank of France to cease making international loans at margins that are too low to cover all-in costs. Crédit Lyonnais is known to be the French bank most significantly exposed to Asia.

16 See McCauley and White (1997).

17 Technology allows both the unbundling and the rebundling (pooling) of risks. This contributes to the development of securities markets as opposed to the use of intermediated credit. Moreover, new technological developments have supported the advancement of non-bank financial intermediaries at the expense of banks, and the advancement of specialist "non-banks" to the detriment of both. Finally, by making information cheaper to obtain publicly, technology directly attacks the insider information which is at the heart of relationship banking.

18 The broad implications of projected demographic trends in the OECD area has been the focus of recent OECD studies. See Roseveare et al. (1996). The Deputies of the Group of Ten currently have a Working Group looking into the macroeconomic and international financial implications.

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system.[19] There must too be a greater willingness to use market developed (firm specific) models for evaluating risk exposures of various sorts (market risk, credit risk and liquidity risk); this process too is also well begun. Regulators will also wish increasingly to set or suggest standards for external disclosure. This will foster the use of market discipline in general and will facilitate the participation and contribution of rating agencies in particular. Finally, it is worth noting that as markets evolve, as they will certainly continue to do, the complementary nature of the relationship between the regulator and the markets will have to continue to evolve as well.

The fourth strategic implication is that regulation or guidance from policymakers must be the by-product of *international agreements among policymakers* from different countries. Given the reality of international competition, efforts must be made to establish a "level playing field" for regulatory purposes. Participation in such agreements must also be widespread enough to avoid the danger of regulatory competition (regulatory arbitrage) for non-participating countries. Finally, given the required complementarity between regulatory and market discipline, the dialogue leading up to international agreements must somehow involve both public sector and private sector participants. The BIS plays an important role in facilitating such an international dialogue.

III The Role of the BIS in Promoting Financial Stability

The Process of Achieving Agreement

Before turning to what the BIS does, it is perhaps useful to be clear about what it does not do. In particular, it does not normally use its own financial resources to promote or finance particular courses of action by its members. In these respects, its mandate is completely different from that of other international financial institutions such as the IMF, the World Bank and the regional development banks. Rather, since being founded in 1930, its unchanged mandate has been to promote international cooperation on monetary and financial issues, principally but not exclusively among central banks. Leaving aside the banking services provided by the BIS to central banks and international institutions (which have resulted in a balance

19 In the realm of the governance of banks see Basle Committee on Banking Supervision (1998b). With respect to governance issues in the area of financial infrastructure, see Committee on Payment and Settlement Systems (1997c).

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sheet of about $130 billion), the BIS could be described as being essentially a talking shop. However, this talk had led to many important decisions being taken with significant international implications. While the small BIS staff organises and facilitates meetings, and its research papers (both published and unpublished) help raise the analytic quality of the debate, the greater value added is provided by the national representatives who attend meetings at the BIS and contribute to international cooperation in other ways.

International cooperation at the BIS is based firmly on the principle of national (state) control.[20] This recognises the reality that sovereignty in the modern world still resides at the level of the nation-state and that national legislatures (particularly from larger countries) are often not willing to cede their power to international bodies. Moreover, this approach also helps alleviate concerns about the existence of a "democratic deficit"; that is, the fear that important decisions might be made by technocrats rather than public servants directly accountable to nationally elected politicians. The depth of such concerns is evident to anyone following the current debate about the introduction of the euro, the desirability of the European Central Bank being politically accountable, and the future political structure of Europe. Yet such concerns are by no means confined to Europeans alone.

Members of the various committees which meet at the BIS negotiate positions among themselves. Each clearly pursues national objectives and, in general, each has been in close contact with private sector agents in his own country to ascertain their views. The objective of the exercise is to find a negotiated agreement which is mutually acceptable, across countries and to both public and private sector agents, and which can then be ratified by Ministers and Governors and subsequently implemented using national legislation or regulation. The fact that the size of committees is relatively small facilitates the decisionmaking process, as does the tradition of making decisions by consensus. The recognition that a failure to reach an international agreement would open the door to both unfair competition and regulatory arbitrage also drives the process forward.

The fact that national legislators have been willing to accede to such a process, and that private sector participants likely to be affected have also generally signed on, testifies to the moral authority exercised by these international agreements and the perceived legitimacy of the process itself. Moreover, although the committees which meet at the BIS have generally

20 Fuller description and analysis of alternative processes for achieving international agreements can be found in Kapstein (1992) and (1994).s

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drawn their members from the G-10 group of countries, many of the agreements reached (most notably, capital adequacy standards for internationally active banks) have simply been accepted by non-G-10 countries as effective global standards. In this regard, the influence of private rating agencies has often played a useful supporting role as have the efforts made by the various committees to disseminate publicly their findings and agreements.[21] Other international financial institutions, such as the IMF and World Bank, have also played a major role in communicating to a wide range of non-G-10 countries what might be thought of as "best practice" in the industrial world. It is also notable that this model, which leaves decisionmaking firmly in the hands of experts from nation states and relies on international organisations to spread the word, is the model recently recommended by the G-10 Deputies (in association with many representatives of emerging markets) in their recent report on financial stability in emerging market economies.[22]

These positive comments about the "Basle process" should not blind us either to shortcomings evident in the past or to some important challenges for the future. The most important problem in the past has been that, in spite of problems often being identified at an early stage, it sometimes took a crisis of some sort to galvanise into action the process of finding a solution. By way of example, the Basle Committee on Banking Supervision was set up only after the failure of the Bankhaus Herstatt in 1974, even though it had been recognised well in advance that banks with large international operations posed special problems. It is also instructive that the problem of "Herstatt risk" (i.e. the credit risk arising from lack of simultaneity in the settlement of the two legs of foreign exchange transactions) was highlighted at the same time (1974) but the first significant attempt to address the problem was not made until over twenty years later.[23] Having registered this shortcoming, it is also true that the various committees meeting at the BIS have become significantly more proactive in recent years. This will become evident below.

As for future challenges to the current process, the first complication is the need to involve participants from emerging markets. Hong Kong and Singapore are already the fourth and fifth largest foreign exchange markets in the world and other financial markets are expanding rapidly elsewhere. The growing industrial might of countries like Korea, China, Brazil and others must also be recognised, even if recent events in Asia suggest that

21 A full list of all recent publications by the BIS and the various committees which meet there can be found at http://www.bis.org.

22 See Group of Ten (1997).

23 See Committee on Payment and Settlement Systems (1996b).

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there can be setbacks along the way. If the credibility of the decisionmaking process rests on the involvement of national experts from jurisdictions most affected by the decisions taken, then input from emerging markets will be increasingly important. The issue is how to reconcile such an expansion with the maintenance of the intimate club-like atmosphere (also involving shared values and shared conceptual frameworks) that facilitate agreement and decisionmaking on the basis of consensus.

A second important complication is the breaking-down of the barriers between different markets and different kinds of financial institution. Not only are national regulatory frameworks generally based on such distinctions but so also are international committees. At the very least, there needs to be a channel for communication among such bodies as the Basle Committee on Banking Supervision, IOSCO and the International Association of Insurance Supervisors (IAIS). The recent decision in the United Kingdom to consolidate all forms of financial supervision in the hands of a super-regulator may presage a more radical solution to this problem, but one which raises still other complications. In particular, the decision to site this regulator outside the Bank of England, but to give the Bank responsibility for overall systemic stability, raises the question of overlapping mandates for those two bodies. Again, there may be international implications if non-central banks come to play an increasingly important role in the BIS process. Similarly, the establishment of the euro and the European Central Bank raises the question of future representation on the various BIS committees. The answer to this will presumably depend on the nature of the relationship which evolves between national supervisors and the supranational European System of Central Banks.[24]

A final challenge has to do with managing the balance of influence between public sector and private sector representatives in the process. While in the past, public sector participants generally made proposals and the private sector responded, increasingly the opposite is true.[25] This trend is, however, to be welcomed in that it is consistent with the concept that it is the private sector that should be held primarily responsible for avoiding possible failures in private financial markets. The role of the public sector will increasingly be to ensure that such private initiatives are commensurate with the total costs (including externalities) of such failures. As noted above, however, it may well take many years for this new balance to be struck.

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24 For a discussion of such issues see McCauley and White (1997) and Centre for European Policy Studies (1998).

25 Consider the recent reports by the Group of Thirty (1997) and the Institute of International Finance (1997).

Specific Measures to Promote Financial Stability

The objective of this part of the paper is to record more specifically how various committees meeting at the BIS contribute to implementing the strategy for financial stability described above. Before doing so, it seems worth reiterating that the likelihood of financial stability, both at the national and the international level, will be significantly enhanced if governments follow stabilising macroeconomic policies. This objective is also firmly endorsed by the BIS which indeed regularly organises a wide range of meetings directed to improving the conduct of monetary policy in participating countries. While these meetings have traditionally focused on events in the G-10 countries (regular meetings in Basle of the G-10 Governors, the Gold and Foreign Exchange Committee, economists, model builders and many others), an increasing number of meetings now focus on macroeconomic developments in emerging markets as well.[26] However, since macroeconomic stability is a necessary but certainly not a sufficient condition for ensuring financial stability, the implication is that more specific measures to foster financial stability are still warranted and are indeed urgently required.

In this regard, it was suggested above that the international financial system is based on three pillars; financial institutions, financial markets, and payment and settlement systems. The analytical model underlying this suggestion is that of a flow-of-funds matrix underpinned by the infrastructure (payment systems and other "plumbing") required for it to function.[27] Perhaps more by luck than design, there is a BIS committee dealing with each of these individual pillars; the Basle Committee on Banking Supervision (institutions), the Euro-currency Standing Committee (markets) and the Committee on Payment and Settlement Systems (infrastructure).[28] Pursuing the analytical framework one step further, it is evident that disturbances at the level of institutions, markets or infrastructure will have implications for market clearing conditions (interest rates, exchange

26 The proceedings of some of these meetings and the papers prepared for them are now available in a new series of BIS Policy Papers. See for example, Bank for International Settlements (1998b).

27 See White (1994).

28 For the sake of completeness, it should also be noted that various other Committees of national experts also meet regularly at the BIS and contribute in rather more technical ways to issues having implications for international financial stability. The Committee of Legal Experts has at various times considered the possible undesirable implications of having different legal codes (in particular, bankruptcy procedures) governing financial transactions in different countries, and the Committee has recently considered as well legal questions surrounding the introduction of electronic money. Committees of security and →

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rates, etc.) in the flow-of-funds matrix which could well have macroeconomic implications. While all three of the BIS committees recognise these interactions, and increasingly share information in consequence, it is the Euro-currency Standing Committee that has traditionally been most interested in the overall dynamics of these systemic processes.

a. The Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision, whose traditional preoccupation has been the stability of banking institutions, is the best known of the committees which meet at the BIS. Set up in 1974, the Committee first directed its attentions to ensuring that all internationally active banks were adequately supervised on a consolidated basis. The first agreement of this sort was the Basle Concordat[29] which established the principle that no foreign banking establishment should escape supervision, and that such supervision should be adequate. The Concordat has been revised a number of times in light of changing circumstances and perceived shortcomings, but a key principle has been maintained throughout; the home or parent supervisor is responsible for the global operations of banks headquartered in their territory and should supervise them on a consolidated basis.

The Minimum Standards paper of 1992[30] was a further effort to put such principles into practice. Four standards were laid out to ensure that home supervisors do practise effective supervision (if not, the host country can refuse a banking license) and to ensure that the home supervisor has adequate access to information about cross-border activities of its banks (if not, the home supervisor can refuse to allow the business to continue). Nevertheless, members of the Basle Committee and other supervisors continue to feel that the flow of information among themselves remains subject to legal impediments. Accordingly, at the International Conference of Banking Supervisors in Stockholm in 1996,[31] delegates from over 150 countries endorsed a further report prepared by a joint working group of the Basle Committee and the Offshore group of Banking Supervisors. In

computer experts meet regularly at the BIS and commonly exchange views on technical issues having systemic implications. One such issue currently receiving attention is how the official community should itself respond to the "Millennium bomb" problem. This work complements the recent document (September 1997) issued by the Basle Supervisors directed to encouraging the private sector to address this problem in a serious way (see Basle Committee on Banking Supervision, 1997b). A global conference, jointly organised by the Basle Supervisors, IOSCO and the Committee on Payment and Settlement Systems will take place at the BIS in April 1998.

29 See Basle Committee on Banking Supervision (1975).

30 See Basle Committee on Banking Supervision (1992).

31 See Basle Committee on Banking Supervision (1996).

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this report 29 recommendations were presented. These included suggested procedures for the conduct of cross-border inspections by home authorities monitoring their own banks, and approaches for dealing with corporate structures which create potential supervisory gaps. Ongoing problems include those posed by countries which still do not allow onsite inspection by home country supervisors (Singapore and France, for example) and fears that information sent to other supervisory agencies will find its way into the public domain under the laws of the recipient country (a particular concern in the United States). In both cases, changes to domestic legislation are required which may prove difficult to achieve.

A second preoccupation of the Committee has been to ensure that internationally active banks maintain a level of capital commensurate with the risks they run. The Committee's first achievement in this area was the promulgation of the Basle Capital Accord[32] which was published in 1988 and laid out minimum capital adequacy requirements based on relative levels of exposure to various forms of credit risk, both on and off balance sheet. While a number of issues remain to be resolved by the Committee, such as the treatment of short-term capital flows into emerging markets via domestic banks, this hard-won agreement did succeed in both levelling the international playing field and increasing levels of bank capital after a long period of deterioration in most G-10 countries. By September 1993, all G-10 banks with significant international operations were meeting or exceeding these minimum requirements.

This success clearly owed something to the legitimacy of the Basle process, but also reflected the fact that the Accord suggested a clear quantitative standard on which market participants could focus and impose discipline. More recently, the complications posed by having different accounting conventions in different G-10 countries have received more attention and this problem is also beginning to look more capable of resolution. Ongoing discussions between the Accounting sub-group of the Basle Supervisors and the International Accounting Standards Committee are directed to resolving some of these problems. Success in this area would also provide international benchmarks to help guide and improve accounting standards in many emerging markets. Without such improvements in the basic numbers, it is difficult to draw much comfort from banks in emerging markets claiming to have met the minimum capital adequacy requirements.

The Basle Committee has recently made a further significant extension to its work in the area of capital adequacy. Whereas credit risk initially fig-

32 See Basle Committee on Banking Supervision (1988).

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ured centrally in the calculation of minimum capital requirements, increased attention is being paid to market risk. Moreover, in its calculation of exposure to market risk, the Committee is now prepared to use the results generated by firms' own internal models, subject to certain restrictions.[33] This has been a significant step, among many others, in the direction of regulators working more closely with the grain of the market. Yet new challenges in the area of capital adequacy are also emerging. Credit derivatives are rather new instruments but are spreading rapidly, and they may have the potential to change dramatically the nature of financial intermediation. Consequently, the required form of regulatory oversight might eventually also have to be reviewed.

A landmark extension of the work of the Basle Committee was mentioned briefly above. In October of 1997, at the time of the IMF meetings in Hong Kong, the Committee released a new set of Core Principles for Effective Banking Supervision, based on large part on their deliberations and decisions taken over previous decades. These principles reflect the strategic considerations described above and constitute a significant development in at least four respects. First, they are comprehensive and cover all aspects of banking. Second, they provide a checklist of good practice for use by supervisors, international financial institutions, rating agencies and other market participants. Third, they were drawn up with the active participation of official representatives from emerging markets. And finally, they apply to all banks and not just those that are internationally active. This is a major development, the significance of which may not yet have been adequately appreciated.

The obvious remaining challenge is to ensure that these Core Principles are actually implemented. The Committee intends to begin by asking supervisors around the world to endorse the Core Principles and this will be followed by a questionnaire to determine whether actual supervisory practices are consistent with them. In cases of inconsistency, the intention would be to agree on a clear and definite timetable for change with a report on progress made being prepared for the next International Conference of Banking Supervisors in October 1998. This implementation strategy will complement the broader efforts being made to implement the results of the recent G-10 Deputies' study on financial stability in emerging market economies.[34] Broadly put, such implementation will demand an

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33 See Basle Committee on Banking Supervision (1995).

34 The Secretariat of the G-10 Deputies has recently sent out a questionnaire to a wide range of national and international bodies to ascertain what each has done to support the strategy laid out in the original G-10 report. A report on progress to date and potential further steps will presumably be put forward to the Ministers and Governors of the G-10.

important degree of political will in all countries concerned. Mustering such will, particularly in the face of monopoly rents and the entrenched interests they support, will not be an easy task. Ways must also be found to evoke market discipline in ensuring that required changes are carried out.

Reflecting the breakdown of sectoral barriers and the growth of international financial conglomerates, the Basle Committee has had increasing contacts with its international counterparts representing both the securities (IOSCO) and the insurance (IAIS) industries. Indeed, all three groups now meet regularly in the Joint Forum on Financial Conglomerates and joint documents are beginning to emerge.[35] To facilitate such work, the IAIS Secretariat moved physically to Basle at the beginning of 1998. However, it is a fact that progress in establishing a consolidated supervisory framework has been slow, sometimes because of the difficulties of ensuring cooperation among different regulatory agencies at the national level. Such concerns may have provided some of the motivation for the recent proposal by the Group of Thirty (1997) that the relatively few, large international conglomerates should establish, promulgate and oversee their own industry standards, subject to review by a single international auditor with the active cooperation of supervisory bodies. What remains to be determined is whether this would provide an adequate degree of complementarity between market and regulatory discipline. An active debate on this issue seems both needed and likely.

b. The Euro-currency Standing Committee

Financial markets are the second major pillar of the international financial system. Analysing new developments in this area and the possible policy requirements arising from them has traditionally been of interest to the Euro-currency Standing Committee. This Committee was originally established to look into the expansion of international bank lending, and the LDC debt crisis was its principal preoccupation for much of the early 1980s. To provide increased possibilities for the official and private sectors to monitor risk in this area, the Committee gave the BIS a mandate to coordinate the collection and dissemination of relevant international banking data from national (creditor) sources. Indeed, in recent years the international banking statistics have expanded in both content and geographic scope and further improvements are underway.[36]

The Working Group which prepared the original report (including many participants from emerging markets) has also been reconstituted as an Advisory Group for this endeavour.

35 See Basle Committee on Banking Supervision (1998a).

36 Loans made by banks will increasingly be available on an "ultimate risk" basis. That is, loans made to (say) a Brazilian bank in the United Kingdom will be classified as →

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The BIS statistics on international bank lending have received particular attention recently in light of the Asian crisis. This crisis is similar to the debt crisis of the early 1980s in that banks have been the principal international creditors.[37] Moreover, the BIS is now also maintaining an extensive data base on international securities markets and has dramatically expanded its coverage of derivatives markets. In addition to the triennial survey conducted by central banks, seventy-five major financial institutions will begin regular reporting on their derivatives activity commencing in June 1998. Analysis of recent data and associated regulatory developments in all these areas (banking, securities and derivatives markets) is presented in various BIS publications.[38] While seeking to be neither alarmist nor prescriptive, this analysis does also attempt to highlight points of strain in the international financial system. Examples going back to 1996 included comments on the heavy exposure of Thai and Korean banks to short-term foreign currency financing, and the sharp reduction in both credit and market risk premia associated with relatively risky investments worldwide. The fact that these concerns were generally ignored, as were the similarly muted warnings by other international financial institutions, seems worthy of further reflection.

Over the last decade, the Committee has focused on the implications of financial innovations – and in particular of the rapid growth of derivatives markets designed to facilitate the transfer of market risk – for the functioning and stability of markets. While the general conclusion reached has been that derivatives enhance market efficiency,[39] financial innovation has also brought with it a diminution of transparency in markets and made it more difficult for market participants to assess the creditworthiness of individual counterparties. To help deal with these problems, the Committee (in association with the Supervisors) has taken steps to encourage key market participants to improve their public disclosure practices, notably in the area of market and credit exposures, by drawing on information generated by their internal risk management systems. The semi-annual global statistics on derivatives markets, which the BIS will begin to col-

Brazilian and not UK exposure. The number of reporting countries is also likely to expand to record loans by (say) Korean banks to (say) Russian borrowers. The timeliness of the statistics is also being addressed.

37 In contrast, it differs from that crisis in that sovereign borrowers were of primary importance in the early 1980s and today it is primarily private borrowers in Asia.

38 In particular, see the quarterly "International Banking and Financial Market Developments" and the semi-annual "The Maturity, Sectoral and Nationality Distribution of International Bank Lending".

39 See Euro-currency Standing Committee (1986) and (1994a).

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lect in mid-1998, should also help participants assess the significance of their own positions in these markets.[40]

Since the financial world is always changing, new questions pertinent to the mandate of the Euro-currency Standing Committee are always arising. One set of issues has to do with the implications for financial stability of structural changes in financial intermediation, notably a world in which non-bank financial entities and markets are coming to play increasingly prominent roles. A further source of concern is the resilience of liquidity in linked markets under stressful circumstances.[41] Many markets are dominated at the wholesale level by a relatively small number of key players (-albeit often different ones in different markets), and their interactions as they strive simultaneously to adjust to common shocks can be an important determinant of market outcomes. Although short-term financial market volatility seems to have decreased over the last decade or so, we have observed occasional bouts of price "gapping" as well as sudden reversals of longer-term price movements without any obvious economic rationale. The reasons for this, and the possible implications for the solvency of market participants, need further assessment.

c. *The Committee on Payment and Settlement Systems*

The third pillar of the international financial system is the payment and settlement system. As the gross volume of financial transactions has expanded in recent years, the exposure of individual firms to possible non-payment by a counter-party has increased commensurately. Absent timely settlement, they too might be unable to meet their obligations, raising the prospect of gridlocks of potentially significant proportions. In recent years, the Committee on Payment and Settlement Systems has made many concrete proposals as to how these systems might be strengthened. While the focus has been on the timely settlement of large-value transfers, issues relating to retail payment systems (especially the implications of electronic money)[42] have also begun to receive attention. Typically, the action needed requires cooperation between the public and private sectors, but as far as possible the private sector has been encouraged to help itself.

The work of the Committee has consistently emphasised the importance of large-value interbank fund transfer systems, for the obvious reason that

40 See Euro-currency Standing Committee (1996).

41 For a recent discussion of market dynamics, market liquidity and the role of information in price determination in stressful situations, see Euro-currency Standing Committee (1997).

42 See Committee on Payment and Settlement Systems (1996a).

banks continue to be at the core of the international financial system. One of the Committee's first projects was a detailed analytic review of payment system developments in the G-10 countries, the results of which were published in 1985 in the form of a "Red Book" on payment systems. Since then, similar books have treated payment systems in a number of other countries, both industrial and emerging, and Red Books are regularly revised in light of changing practice. As well, considerable efforts have been put into evaluating different kinds of cross-border and multi-currency interbank netting schemes and various reports have laid out agreed (by the G-10 central banks) minimum standards for such private sector systems.[43]

The Committee's most recent work focused on banks is a Report on Real-Time Gross Settlement (RTGS) systems.[44] These systems, which are now in place in most G-10 countries along with many others, protect against gridlock by ensuring final settlement of all transactions, transaction by transaction in real time. The Report not only provides an overview of key concepts and principal design features but also the risks associated with such systems and some broader policy implications. It addresses the particular differences between systems already in place, the management of liquidity in such systems, and the various procedures used to queue payment instructions. The Report is the first of its kind and is likely to prove particularly useful to both emerging and industrial countries still in the process of modernising their settlement systems.

In recent years, the Committee has extended its interest beyond banks to settlement systems for securities and foreign exchange, and clearing arrangements for exchange-traded derivatives. In all cases, the nominal values of the daily transactions are very large. Various reports on arrangements to support securities transactions have been published since 1992, with the latest effort focusing on a disclosure framework for systems operators that will allow participants in such arrangements to better evaluate the risks they are running.[45] As for exposure to settlement risk in foreign exchange markets, the Committee has established that settlement exposures are much larger than had previously been thought. In a Report published last year,[46] they also indicated ways in which participants could reduce such risks and strongly suggested they do so to avoid a punitive response from public sector authorities. As for clearing arrangements for exchange-traded derivative instruments, the Committee published a report

43 Among others, see Committee on Payment and Settlement Systems (1990a), (1990b), (1993) and (1995).

44 See Committee on Payment and Settlement Systems (1997a).

45 See Committee on Payment and Settlement Systems (1997c).

46 See Committee on Payment and Settlement Systems (1996b).

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in March 1997 which systematically reviewed such arrangements, identified weaknesses and made recommendations for remedying them.[47] As with many other Committee reports, it contains a great deal of factual and comparative information not available elsewhere.

Finally, the Committee recognises that issues having to do with the use of collateral to manage risk, and with the operational reliability of the infrastructure (e.g. business continuity planning, especially with regard to IT services) are also germane to a well-functioning payments system. So too are many legal issues, such as the enforceability of netting agreements and the complications likely to arise from the absence of an international agreement on bankruptcy procedures for internationally active financial institutions. The bottom line is that the task of ensuring timely settlement in all circumstances remains incomplete and the Committee's agenda is still full.

d. Global Participation in the Work of the Committees

Finally, the increasing efforts made by the various committees to involve non-G-10 countries in their work deserves to be emphasised. The Core Principles were drawn up with the close cooperation of non-G-10 supervisors, and the "Report on cross-border banking" was prepared jointly with the Offshore Group of Banking Supervisors. Regional supervisory groups meet regularly with representatives of the Basle Committee in attendance, and there has been a significant increase in supervisory training by G-10 supervisors in association with the Secretariat of the Basle Committee. Finally, the Committee has recently initiated joint meetings with regional supervisors on the occasion of its quarterly meetings in Basle. All of these efforts are directed to building a truly global network of supervisors and the wide dissemination of documents, standards and guidelines developed by the Committee in association with others. Similar initiatives have recently been undertaken by the Committee on Payment and Settlement Systems with similar objectives in mind. The Euro-currency Standing Committee had, for many years, "extended" meetings involving representatives of important non-G-10 financial centres. However, it is now actively engaged in discussing how broader participation might be made more effective.

47 See Committee on Payment and Settlement Systems (1997b).

IV The Role of the BIS in Crisis Management

It has been analytically convenient above to deal separately with the three major components of the international financial system and the BIS committees which support each. This approach also emphasises the comprehensive reach of the Committees' concerns. However, a deficiency of this approach is that it fails to emphasise the relationships between the various components of the system, as well as the further links to macroeconomic variables of interest to central bankers. In fact, it is the complex reality of these interrelationships that makes the pursuit of financial stability such a challenging task and also accounts for the fact that there have been so many financial crises along the way.

Before turning to the role of the BIS in crisis management, it is important to note that, even at the *domestic* level, a certain "constructive ambiguity" often applies about the potential role of the public sector. This is to avoid bad behaviour and moral hazard on the part of the private sector. Given that no two crises are the same, the amount of preplanning that can be done is in any event limited. Perhaps the most that can be hoped is that the prospective players in the unfolding drama – the central bank, the Treasury, supervisory bodies and deposit insurance agencies – know each other well and have well established lines of communications, so that decisions affecting all can be speedily agreed upon. At a moment of crisis, the time allowed for decisionmaking is not likely to be great. Moreover, as we have seen in South Asia, the failure of domestic policymakers to take credible policy actions quickly (particularly if these policies have been prescribed in the context of an IMF programme) can result in the market imposing heavy penalties.

The provision of *international* support to help resolve financial crises with international ramifications should be equally ambiguous if moral hazard is to be avoided.[48] In any event, liquidity support from the International Monetary Fund to sovereign borrowers must continue to be firmly linked to conditionality and the adjustment of domestic policies. Moreover, support should be provided in such a way as to insure that all the parties whose behaviour contributed to the crisis (both debtors and

48 A new but unwelcome form of ambiguity has emerged in the context of the Asian crisis. The short-term liquidity requirements of a number of countries have been so great as to call into question whether the Fund had adequate resources to restore confidence on the part of private creditors. For example, as of July 1996 the short-term debt (less than one year to maturity) owed by Korean debtors to international banks amounted to almost $70 billion. See Bank for International Settlements (1998c). Private bankers did finally agree to establish a process for rolling over this debt. However, to the extent this was not purely voluntary, the difference between this procedure and a debt rescheduling is moot.

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imprudent creditors) pay some part of the costs. As for liquidity support to internationally active banks, the G-10 Governors have agreed that such support should be provided in the first instance by the home country authorities. However, this decision still leaves unclear whether the home authorities will be prepared to do so. The willingness of the Bank of England to allow Baring Brothers to fail is a welcome indicator of this ambiguity. What is also unclear is the extent to which other national authorities might act to support the home authorities in different circumstances. The 1996 agreement between the Federal Reserve and the Bank of Japan, under which the Bank of Japan could obtain dollar funds through repo arrangements, gives some indication of the possibilities in this regard. Given the scope, increasingly wide participation and the regularity of the meetings which take place in Basle, the BIS makes an important contribution to international financial stability by ensuring that policymakers (at least central banks and other regulators) know each other well and have open lines of communication. This is the institution's most important contribution to crisis management although not its only one. The international community (in particular the central banks of the G-10 countries) have often found it appropriate to provide bridge loans through the BIS to countries in financial difficulties who are awaiting the receipt of funds from the IMF, the World Bank or other such bodies. Such bridge loans often provide needed liquidity, are an indication of international support for the policy changes normally associated with Fund programmes, and ensure a continuing central bank involvement in the process of crisis management. While this role might be thought less important in the future, since the Fund can now disburse much more rapidly than before given the new Emergency Financing Mechanism, some possibilities still remain open. For example, given its expertise with arranging bridge loans, the BIS might be asked to help draw up multilateral legal agreements to ensure equal and fair treatment of sovereign creditors should loans go bad. Attempts to use bilateral agreements to secure a "second line of defense" in support of the IMF programme for Korea in recent months have become extremely complicated and are not yet complete.

For completeness, it should be noted that the BIS, in addition to providing support for bridge loan facilities, is also prepared to act as a principle and to lend funds on both a collateralised and an uncollateralised basis. Needless to say, the sums available in this fashion must be strictly limited by concerns about prudent behaviour and the continuing good financial health of the BIS itself. Nevertheless, there have been occasions when even the relatively small loans made by the BIS may have been useful in stopping small problems from potentially turning into much bigger ones.

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V Conclusions

As the process of liberalisation and globalisation proceeds, markets increasingly replace the dictates of governments and regulators. This is perhaps even more true with respect to financial markets than in other areas of economic activity. As a corollary, the influence of those government bodies which work closely with markets tends to be enhanced. In part, this may explain the perception that both the domestic and international profile of central bankers have risen in recent decades. Without delving too far into bureaucratic theories of institutional behaviour, the desire to expand their influence may be a further reason explaining why both central bankers and other regulators are increasingly relying on market processes to achieve their objectives. The role and reputation of the BIS has been similarly enhanced in that international cooperation among central banks and other regulators in large part takes place in that forum.[49]

Another change affecting the work of the BIS in recent years has been the growing emphasis being put by governments on issues having to do with financial stability as opposed to price stability and traditional macroeconomic preoccupations. It is of some note that the last three G-7 Summit Communiqués (Halifax, Lyon and Denver) put strong emphasis on such issues while hardly mentioning international macroeconomic policy coordination; the Birmingham Summit seems likely to have a similar focus. It is also notable that, at the semi-annual meetings of the G-10 Governors and Ministers, the General Manager of the BIS has in recent years reported regularly on work being undertaken at the BIS in this area. This is not to say that traditional macroeconomic concerns have somehow become less important. Rather, these recent developments indicate that the BIS, and those who regularly meet there, now seem to have a wider scope for contributing to global economic welfare than perhaps ever before.

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Comment on "Promoting International Financial Stability: The Role of the BIS," by William R. White

Armand Pujal

I would like to begin with underpinning the main aspects of Bill White's presentation, which tackled the issue of financial stability as a whole. I will then focus on the way in which the Basle Committee contributes to addressing the issue of financial stability.

Financial Stability: The G-10's Response

Given the prominence of financial markets in the globalisation and deregulation process, it is worth underlining the increasing responsibilities of central bankers and other regulators, who are often closer to the markets than governments. Moreover, financial stability has become one of the major priorities for international organisations, although the more traditional macroeconomic preoccupations remain an area of considerable concern as well. In short, monetary stability and financial stability are the "two sides of the same coin", thus justifying the central bankers increasing involvement.

The strategy to promote financial stability has taken place within the G-10 Deputies Report proposals, which were released last year. In this respect, it is important to highlight that the strategy has to be global – involving developed and emerging markets – and that those overseeing the policy have to endorse new responsibilities in order to reflect the required complementarity between market discipline and regulatory oversight. It induces a strong cooperation between policymakers from different countries as well as an increasing involvement of both public sector and private sector participants.

In this context, the BIS has demonstrated that it has many assets to enhance international cooperation. For years, it has been the best place for G-10 central bankers to meet, and its role is being extended to emerging countries. It is a talking shop where national experts have become used to a high level of cooperation. The Committees wherein this work has taken place have dealt with topics related to the three "pillars of the financial

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system", that is: (i) the financial institutions; (ii) the financial markets; and (iii) the payments and settlements systems.

The cooperation between the Committees dealing with these three issues has led to crucial decisions with significant international implications. However, we should avoid understating past shortcomings nor keep silent regarding the future challenges the BIS will have to face. One such challenge is that the trend of enlarging the number of participants (mainly including more emerging countries) and the maintenance of a club-like atmosphere (which has proven very efficient up to now) will have to be reconciled. Other challenges I would like to emphasise are: (i) the far-reaching consequences of the vanishing barriers between different markets and different financial institutions, requiring the different supervisors to set up adequate communication links; and (ii) the growing influence of the business community, which is primarily responsible for avoiding possible failures on financial markets.

Regarding the specific measures the Basle Committee has taken to promote financial stability, I will focus on the first "pillar" and on the Basle Committee which, to my mind, implements the relevant approach towards improving efficiency in all the topics under review. This will lead me to focus on: (1) the dissemination of universal principles for banking supervision; (2) the initial outcomes of the international supervisory cooperation on financial conglomerates; and (3) the development of current prudential issues.

Core Principles for Sound Banking Supervision

The trend of extending the influence of the BIS standards to the non-G-10 countries – especially the emerging countries – and of welcoming them as participants in the standardisation process, is a major challenge for the G-10 and, therefore, also for the BIS. The strain on the banking system, which several major emerging countries are currently witnessing, reinforces the necessity to address this issue. The 25 "Core Principles for Effective Banking Supervision" is the first remarkable outcome of a global action, involving the main multilateral institutions. It establishes a universal standard for creating a sound supervisory environment.

The purpose of these achievements – to promote the Principles and to monitor the responses to their implementation – and the way they have been elaborated, rely on the cooperation between G-10 and non-G-10 countries, as well as between the BIS, the IMF and the World Bank. The BIS has monitored the conception process and has the leadership role in the promotion of the principles through the Liaison and the Consultation

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Groups. The IMF and the World Bank instead have focused on the implementation of these principles. Such a joint action ensures the legitimacy and the enforceability of the resulting standards. Combined they form a strong leverage for financial stability. To summarise, on a global and cooperative basis the Basle Committee has managed to set a universal standard, within a reasonable time period, and has provided the practical tools to promote its implementation.

The Core Principles are not only a successful example of a widespread cooperation, but they also ensure the progressive shift from basic quantitative prudential standards – to be enforced by the banks – to global ones, including both qualitative and quantitative criteria, involving the banks and other participants (mainly the supervisors). All of these elements are critical in reaching the target of financial stability which encompasses many different concerns: financial, organisational or institutional, all of which require a global oversight.

The BIS has clearly demonstrated that these achievements do not result from a short-term strategy, but that they are a permanent response to the present challenges. The BIS has planned to set up, towards the end of 1998, a Training Institute for Financial Stability, which will provide assistance to G-10 and non-G-10 supervisors concerning either banking or non-banking issues.

Cooperation Between Supervisory Institutions and the Leadership of the Basle Committee on Prudential Issues

As we have seen, the cooperation has improved between G-10 and non-G-10 countries, as well as between the major institutions which are involved in promoting financial stability. Nevertheless, the cooperation process may require further efforts. Indeed, the barriers have fallen between the actors of the different financial market segments, i.e. banks, insurance companies, and other financial institutions. However, on the regulators' and supervisors' side, adequate cooperation remains to be improved. Realising this, the joint Forum on Financial Conglomerates, in which the Basle Committee, the IAIS and the IOSCO operate jointly, tackles the following issues: (i) appraisal of a conglomerate capital adequacy on a group basis; (ii) information-sharing between supervisors and an easing of legal impediments; and (iii) coordination of supervisors' actions, as well as identification of the main coordinator.

We must acknowledge that this process has been a long-standing one. One may point out here the weakness regarding the process of addressing the Herstatt risk issue. Even having taken into account the complex techni-

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cal background, the practical outcomes may appear minimal at the moment. As a matter of fact, the pending legal impediments concerning information sharing remain an obstacle.

It is clear that, as a talking shop, and in its role of creating consensus, the BIS structures have reached a limit in terms of their influence on national regulations. Nevertheless, as barriers have fallen throughout the financial markets, the different regulators will acknowledge that a joint action on common concerns is necessary. In that respect, the in-depth research and the consistency of the works-in-progress under the aegis of the BIS are the essential factors from which to expect some practical outcomes in the long term.

Obviously, the Basle Committee's works do not encompass only the international and trans-sectorial cooperations. Despite the fact that the mandate of the BIS, and of its hosted committees, does not include the direct management of crisis (e.g in Asia), they are strongly involved with crisis management. This raises the question as to whether the BIS can practically contribute to ensure and/or restore financial stability. The answer is"yes" by all means. Hence, many of the issues which have emerged from the present crisis have been or are being addressed by the Basle Committee.

Let us just briefly point to the results of the Basle Committee's work so far:

- The creation of a practical framework for the assessment of banking internal control systems.
- The setting of principles for the management of interest rate risk.
- The introduction of market risks to the 1988 Amendment, which includes the possibility to use the banks' own risk measure with internal models.
- The continuous promotion of the markets' transparency and the harmonisation of accounting practices in banks.
- Finally, in addition to financial and accounting issues, the Basle Committee has extended its action to more operational matters, such as preparing the information systems for the year 2000 and the management of both electronic money and electronic banking activities.

This approach is consistent with the release of the Core Principles, since the same comprehensive approach has been implemented for the more specific workshops. As a result, a complete toolkit of best-practice standards is being created, step by step, in order to develop sound, global banking management, which is the minimum requirement to ensure financial stability.

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Floor Discussion of "Specific Issues Confronting Regulators and Supervisors at the International Level"

The Multilaterals: A Clear-Cut Division of Roles?

A first issue raised was whether the roles of the BIS and the IMF could be clearly distinguished. Tom de Swaan agreed with William White's assertion that BIS recommendations and guidelines ought to address all countries and he suggested some questions to guide the discussion. "A major issue at stake is how can the BIS work in such a way that these countries feel incorporated and represented in the work of the BIS while maintaining the high level of efficiency that the BIS has shown in the past? What is the relationship of the BIS to other multilateral institutions like the IMF, the World Bank and the regional development banks, and how can it contribute to the issue of financial stability?"

Yilmaz Akyüz observed that the BIS is not a universal organisation and wondered to what extent this is a problem in setting general rules. "There are similar cases such as the evolution of the OECD Multilateral Agreement on Investment which was negotiated in closed shop by the OECD members. To what extent does this lack of universality pose a problem for the BIS and for developing countries? With regard to mandates, of course, institutions have tried to avoid trespassing on each other's territory, but it is becoming quite difficult with WTO going into financial services and discussing ideas about trade in financial instruments needing similar rules as other services. To what extent would this cause overlap, interaction or even gaps between WTO and BIS?"

Jack Boorman responded that the delineation of mandates is relatively clear, particularly on the issue of capital account transactions and movements versus the provision of financial services. "The WTO sees its mandate in the area of the *provision* of financial services, which means the rights of establishment and so forth, capital account *mobility* is an area for which the Fund has a mandate."

Roy Culpeper questioned BIS' leverage in dealing with issues of systemic risk. "I am not convinced that an institution which takes a soft law approach is the right kind of institution to deal with the rapidity and thoroughness that systemic risk demands. Since the response time is quite often in terms of weeks, days or even hours, you cannot simply rely on the goodwill of the gentlemen of the club to persuade their legislators to do something about it."

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William White stressed that his paper hardly deals with crisis management, because that is almost entirely the realm of the Fund, while structural issues fall under the World Bank's competence. "Crisis management, and indeed the macro elements of preventing a crisis, belong to the Fund. The BIS commands a narrow, but nonetheless very important range of territory which does not conflict with the important work being done by others – it is different.

Having said that, there is one element of overlap in crisis prevention. In the G-10 Deputies study it is recommended that national groups work together to set standards, international principles, best practices, etc. The deputies then recommended that it was the job of the IMF and the World Bank to apply and monitor these principles. There is a system of feedback between these national and international organisations which should encourage interaction in a way that will lead to better policy, in an evolutionary manner, over time. So, while we have our separate areas, there is an interaction as well."

Stephany Griffith-Jones emphasised the possible emergence of gaps. "Are there places where the market dynamic has been so rapid that there is *no* regulatory oversight or concern with systemic risk? For example, who would regulate institutional investors? Securities regulators don't have this type of concern, and although the IMF does, it doesn't have the power. So it seems that in addition to overlap, institutional gaps exist as well."

White referred back to the G-10 Deputies study which suggested the desirability of additional international standards in some areas. "The study noted nine gaps where one could foresee the need or desirability of having international standards. Those nine gaps were: (1) infrastructure for deep and liquid markets; (2) transparency and reliability of information; (3) corporate governance; (4) safety net issues (which I think are terribly important); (5) the value of the franchise; (6) rents (can they get too low?); (7) legal frameworks (particularly conflicting international legal frameworks); (8) making the best use of information (why did the foreign banks lend so much money to Asian countries? why did the Asian countries borrow it?); and (9) dealing with weak institutions. These nine areas raise a number of questions. Is it indeed desirable to have international standards in each of these areas? Is it feasible? And if so, who is going to do it? So there are gaps, but at the BIS a process is underway to identify them and do something about them."

Boorman stated that while the institutional architecture was in a state of flux, he did not view it as a major problem. "Certainly we look to the BIS and particularly the Core Principles as giving us the guiding architectural design or framework that we can take to the individual countries. The Fund does not pretend to have the capacity or the desire to assess the situ-

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ation of individual institutions in the financial sector. We see ourselves doing an overview of the architecture of the supervisory institutions in place. Are they sensibly structured? Or are they, for example, within the Finance Ministry which also happens to be the owner of the institutions, therefore raising questions about conflict of interest? We are not examiners and we do not intend to become examiners. The work of the BIS and its committees is extremely important in terms of providing us with the framework for our mission chiefs and I think it is working reasonably well.

The same issue arises with the World Bank in terms of how we define and delineate our responsibilities. We view ourselves as the identifiers of problems, and if it involves something like bank restructuring, then we call in the World Bank which is bolstering its expertise in this area. The channel of communication between the Fund and the Bank, as well as the BIS works quite well.

There are gaps though, and we are in a particularly dynamic environment now. The demise of Glass-Steagall, as Bill put it, is going to change the operations of American banks, perhaps in very significant ways. The competitive forces between major international banks are going to force them into areas they may not have been in before. The financial vice-presidents of major corporate, non-bank institutions are engaged in enormous transactions cross border. It is very fluid and how it will play out is not yet clear. The kinds of issues that Bill is pointing to require more examination by committees, and the committees of the BIS are probably the right place to do it."

Akyüz was not so easily persuaded, "Surveillance is going into various areas which are considered as structural weaknesses, including certainly the financial sector. I don't see the distinction between the IMF and BIS as being as clear-cut as you may wish it to be. As far as WTO's involvement with trade and financial services is concerned, the UNCTAD view is that the distinction between the capital account liberalisation and the trade and financial services is not as clear-cut as these two institutions (IMF and WTO) would like to make it seem."

De Swaan agreed with Boorman about the existence of a state of flux. "This is true for the role and function of the IMF, as well as the BIS. The report Bill White was referring to was written by the 'enlarged' Deputy G-10 because it included a substantial number of non-G-10 countries. It recognises that, given the complexity of issues such as supervision, regulation, oversight of payment systems, etc., it is wise to rely on national experts. They are closely connected to the individuals who actually do the inspections in banks and witness the developments in the markets, so it is better to leave the establishment of rules and minimum standards to those

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national experts. The IMF is playing the major role of insuring that these rules and standards are being implemented."

White responded to Boorman's comment about the need for BIS committees and groups of experts to examine issues arising from the particularly dynamic banking environment. "I want to point out that when BIS committees get together and look into these things, they are in large part basing their insights on documents produced by the OECD, the IMF and the World Bank who have invested substantial effort in understanding the dynamics."

Yung Chul Park was also sceptical about the clear-cut distinction between the multilateral organisations. "We have been told today that everything is OK, there is no conflict of interest between these organisations, there is a flow of information between them, it is all very smooth and adequate... but in my experience this is not alway the case. In Korea, we have dealt with the IMF, the World Bank, the OECD, the ADB, and on top of that with the US, the EU, and sometimes even with the French and British governments. They all come with a different perspective, different objectives and different interests, and there is no way we can coordinate their different policies. This situation is made worse by the fact that we have to service our debts to all of these different parties."

Bank Behaviour and the Herding Instinct

Godert Posthumus brought up the issue of herding behaviour by banks. "One rule of banking is to do what all of the other banks do. This raises the question of whether we can somehow monitor how many creditor banks are doing what and where? Normally, this should be done by the country concerned, but as of yet, they don't have the system to do it."

White joined in by asking, "Why did the banks lend so much to Asia? Bankers said, 'Asia is the future, so we had to give them the money.' And when you asked them whether they looked at problematic aggregate statistics – I mean, a year and a half ago we knew that Korea had close to a $100 billion worth of international bank exposure and that 70% was due within 3 months – did you not think this could be a problem? They answered 'no, we didn't really look at that'. This kind of herd behaviour has gone on forever and I don't know what can be done about it. One thing we should look at more carefully is the issue of the safety net. Why wasn't there a run on the Korean banks domestically by the depositors? Because they all thought that the Korean government was going to bail them out. Why did the big international banks lend them so much? In the first instance, they thought that the Korean government was going to bail them out. And indeed, the Korean government told them at one point that they would do just that. And if they didn't get bailed out in Korea, they thought they would be bailed out at home because they are too big to fail. Some of the most active banks were the European banks who had either a poor capital position or who had government guarantees. Safety nets deserve careful study."

Amaret Sila-On commented that more thought should be given to the moral responsibility of the lender. "We got into trouble because of the ease of off-shore banking. Anyone can borrow 2 million dollars. How do you tell the lenders to be more careful? If the example is made that the IMF doesn't bail them out every time, perhaps we will have a better system and more financial stability."

De Swaan stated that the herding instinct becomes dangerous when banks and institutions lose their own vision because they are simply following their neighbour's lead. Jack Boorman warned against viewing the issue of herd behaviour in a naive fashion. "You have separations between research departments, analysis people and the people who cut deals. You don't make money in banks and investment houses by staying in the centre, you make money by being at the margin and the individuals doing this get rewarded. An aggravating fact is that there is a tendency of second-tier institutions to think that the first-tier institutions know what they are doing. And then, when there is a problem, the second-tier institutions run away, so there will always be crises."

Paul Cantor found it difficult to fathom how such a situation could evolve, given that all major banks in the world run annual country-risk analysis programmes. "These are a very important part of the lending process because they allow senior management to make an overall assessment about the risk exposure in individual countries, and on the basis of this, to delegate authority to lenders and traders during the course of that year." Griffith-Jones suggested that one problem was that the analysts are not always listened to by the managers. "It is true that they all have research departments, but often the senior managers don't listen to them. Bonuses are an additional aggravating factor." White relayed an experience at a BIS meeting with private bankers. "It was amazing how many of them said, 'yes, indeed, our own people had warned us.' A number of them suggested that more discipline could be imposed if loans of this sort were actually made market to market in order to bypass the bonus issue." He added that regardless of where you looked, people are willing to take on risk which one would assess as inappropriate a number of years ago.

Susan Phillips observed, "Rogue traders can bring down very large firms and we have seen some examples of this in recent years. Whether we like it or not, on occasion we are going to have people in individual institutions who take risks which are not proportional to the capitalisation of the firm

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or the risk profiles that the bank wishes to undertake. Trying to find ways to make these incentives a bit more compatible is a challenge. From a supervisory perspective, the best thing we can do is look to internal controls. Try to look for separations within internal audit systems. See if banks have approaches in place to determine whether there is the capacity for a trader to go off the screen and trade the firm into bankruptcy."

Supervision and Regulation

Tom de Swaan said that the enormous increase of attention on the supervision of individual institutions indicates a clear movement from the macroeconomic steering of the economy to a more micro focus. "There is also a move away from what I would call the regulatory form of supervision to a market-based form of supervision. The best example of this is the market-risk package in the capital accord that came into force on January 1, 1998, whereby the supervisors allow individual banks to calculate their regulatory capital requirements, based on internal econometric models they use for assessing market risks. But the main question is whether these models are robust enough to encompass other risks as well. An additional question is whether international cooperation and international standard setting in this field should be dictated by a relatively small number of very sophisticated global operation institutions. In a large number of countries, we are witnessing very severe problems with traditional credit-risk taking which should be covered, in my opinion at least, by very traditional forms of capital adequacy."

Louis Kasekende suggested that strict supervision and regulation might make capital shy away from countries that are going through a transition. Phillips said that it was a delicate balance because supervision instills confidence and that this may attract capital. "But we also recognise that a supervision system cannot be developed overnight. In the US, we are required to certify that foreign banks, desiring to establish themselves in the US, are subject to consolidated, comprehensive supervision in the home country. Given that many are unable to do that, we were able to amend the Act to 'demonstrated progress toward this goal'. This has been particularly helpful given the context of emerging markets."

Yung Chul Park expressed concern about the emphasis put on supervising individual institutions rather than the industry or a group of financial institutions. "I am sure that this will increase the tendency to cross the line of prudential regulation if you start looking into the books of every individual institution. Wouldn't the regulatory power of the supervisory authorities be increased to such a degree that it would defeat our efforts to liberalise and globalise financial markets? It might be better to try to harmonise rules and standards of supervision at the regional level rather than at the global level. There is going to be a EMU and a European Central Bank, and NAFTA countries will pretty much follow US standards and rules of supervision, so perhaps the regional level will be more influential.

With regard to market-based supervision: In this electronic age, software vendors come up with new risk-management software every day. How can supervisors still handle commercial banks which rely on very sophisticated risk-management models? These models are so sophisticated that, except for a few people at the computer division of these institutions, no one knows how they work. The senior managers have a hard time understanding what the computer print-outs really mean. To avoid this problem in Korea, we have been thinking of requiring most of these banking institutions, especially the larger ones, to use a single risk-management model. If they use the same model across the industry, the supervisory manager would then know at least what they are doing in terms of managing risk."

Phillips responded by admitting that it was a challenge to stay ahead of the curve with regard to the models, but she was wary of a one-model approach. "It cuts off innovation and the development of new and better ways to manage risk. This concept might be more useful if you are going to have a two-tiered level of regulation for smaller institutions and smaller banks that are just getting started. In these cases, the one-model approach or the 8% across the board international capital standard probably makes sense. In the US, I was told five years ago that we would never be able to keep up with the models. In the Basle supervisors' committee, there was initially strong reactions against using internal models at all. But the fact of the matter is that supervisors can be educated. So to the extent that we view it as a process, we don't become so concerned with constantly being behind the curve."

She continued by explaining the pre-commitment approach to capital as a way of training examiners to judge the merit of sophisticated models. "At the beginning of a period, the banks would pre-commit to how much capital they would need to address market risk. If they don't hit those levels, then some kind of a penalty would be applied. Now this approach has all kinds of problems, not the least of which is the issue of appropriate penalties, but it is an approach that is worth considering. Why shouldn't we ask institutions to put their money where their risk is and commit to it up front? At least, in terms of transparency, everyone would know what kind of risk approach the individual institution is taking."

Stephany Griffith-Jones raised the issue of greater volatility of international capital flows going in and out of developing countries and how this will influence supervision. "We can assume that this greater volatility is

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reflected in greater volatility of macroeconomic variables like in the exchange rate. If you have a crisis in Europe, you have certain devaluations, but they are never as large as the devaluations we have seen in Asia or Mexico. And if the effects in the real economy are greater and more damaging, the negative welfare effects are also greater because there are many more poor people. The question then is: Should there be different or stronger criteria for bank regulators in developing countries given this situation? Should there be higher capital adequacy requirements? There are, of course, costs and benefits to this approach because higher capital ratios are costly and would increase the cost of credit. While this is undesirable, it may give a stronger buffer if we think that crisis will be more likely. Maybe this higher cost at the microeconomic level for firms is compensated by a lower likelihood of costly banking crises.

A second set of issues concerns the implications of this potentially greater volatility of emerging markets for the regulation of bank lending. What have we learned from the Mexican crisis and from the Asian crisis for bank regulations, particularly for short-term flows? Should the standards be tightened up and if so, how? While there is a desire to discourage excessive flows, stifling flows may also be damaging for both the banks and the developing countries, so it is a very thin line to tread.

Third, because these risks are also present in other kinds of flows, such as securities flows, should the same factors which are considered for bank flows also be considered for portfolio flows? In this area, I have proposed cash reserves, also for institutional investors like mutual funds, which would not only provide a more level playing field, but which would apply the same concept of risk rating which is increasingly important in the international arena. Of course, I understand that there are important differences between these institutional investors and banks, so it would have to be adapted, but some of the general principles are valid because they are also vulnerable to the same kind of volatility."

Susan Phillips emphasised that the Federal Reserve approach does not only concentrate on large banks in industrial countries. "Certainly the large sophisticated banks may be able to utilise some kinds of risk management systems that smaller banks may not be able to, but we have very much the same kind of challenge in the US. Quite frankly, we have openly discussed the notion of a two-tiered regulatory approach to large and small banks. So I wouldn't want to say that some of these risk-based systems are not applicable to emerging countries, because in fact they are. While the regulatory structure that you end up with for smaller institutions might be somewhat different than for larger, it is still a risk-based approach."

She continued by focusing on the difference between regulatory capital and economic capital. "We see that banks try to assess the appropriate cap-

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italisation based on economic risks, which would include market risk, as well as credit risk and even legal risk, reputation risk and operations risk. Trying to capture that approach to apply it to regulatory capital calculations is part of the challenge. And bankers themselves are just getting to the point where they are developing more sophisticated approaches to bottom-line economic capitalisation."

Phillips then responded to Griffith-Jones' concern about capital requirements for mutual funds and other types of financial institutions. "We have had capital requirements for securities markets for many years, but they are not as risk adjusted; they tend to be a bit mechanistic and there is a good deal of room for improvement in those areas. In the case of mutual funds, for example, capital is not the problem because they have the assets, so the original purpose of the capital requirements for mutual funds does not apply. What we are trying to do is to prevent mutual funds from concentrating in particular countries."

Barbara Stallings suggested that the supervisory issue was much more dramatic. "In large parts of the world, we find institutions that are just learning to be banks. They never had to do things that banks engage in everyday. That is certainly the case in Central and Eastern Europe, where the whole notion of markets had to be developed. But in Asia and Latin America, moving off the government-directed credit notion of a bank, toward banks that have to do things like credit analysis, is a whole new experience. Unfortunately, the banks and the supervisors have to begin to engage in these activities in a context that is increasingly sophisticated. These banks are learning to be banks at the same time that there are so many actors on the scene who are so sophisticated that it is almost an unfair game. Given this, how can we begin dealing with some of these issues at a basic level?"

Ariel Buira concluded by suggesting that two-tier capitalisation for small and large banks or for banks in industrial countries and emerging economies might affect competition. "Certain groups of banks might be placed at a permanent disadvantage because they are required higher capitalisation. In this way they would never be able to compete with the larger, more sophisticated banks."

Data Dissemination and Transparency

Jack Boorman explained the Special Data Dissemination Standard which is being developed in the Fund. "It is not just a mechanism for dumping statistics, but it is a statistical system with components which try to assure the quality and integrity of the data that will ultimately be distributed. We have been pressed to extend this in a number of areas to improve reporting

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on external debt, including debt of the private sector and reserve related liabilities, as well as on data in the prudential area. Individuals are looking for something, from the macro prudential point of view, which will give a sense of the vulnerabilities in the banking system and also the evolution of risk taking in the banking and financial sector. If you are a bit backward-looking in this area, some of the things you might look at are capital adequacy ratios and problem loan ratios, but in light of what Susan has said regarding risk-based supervision and examination, I am asking myself, whether a ratio of capital to some measure of unadjusted assets has any particular meaning? You've got to look to the riskiness of the assets to know how much capital you want. A similar situation arises with the problem loan ratio – will a system that is based on risk taking even generate something like that if there is not an audit approach to the balance sheet of the institution? We are being pressed to try to incorporate these things within the SDDS, but we may be well behind the curve if we take up traditional measures. If that is the case, what should we be thinking of and who do we work with in this area?"

The discussion turned from data dissemination to transparency when Amaret Sila-On voiced a note of caution. "I am neither an academician nor a central banker, but I have done something difficult for my country. In doing so, I have come to learn that you have to take other elements into consideration, particularly the political and cultural elements. If supervision and international arrangements for stability are to become effective, these elements of international relations and understanding various national traits will have to be taken into account.

Just to illustrate. In Thai the word 'yes' has five meanings. The first is 'I hear you'; the second means 'I understand, but'; the third means 'go jump in the lake'; the fourth one means 'perhaps we can do something together'; and the fifth one means 'okay, it will be done'. Now I suggest that Indonesians probably have more than five meanings and those meanings are not very clear to my friends at the IMF. This is something that the individuals around this table who are trying to fashion a new model for financial stability will have to think about. It doesn't matter how sound your system is, if people do not accept it because they have different rules and cultural backgrounds, they will not apply it and it will not work. We have the same laws as you have because we copy them from you, but we practice them differently. We practice them according to the structure of society. If you commit a crime, theoretically, you are equal under the law, but in practice, the law will be meted out in accordance to your place in society. This is true in many countries around the world. Unless the people in the West understand this, there are bound to be more mistakes.

In many countries, in institutions like commercial banks or even central

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banks, they will always hide the real figures – they will hide them from themselves, from other departments, from the government and from the international authorities. Even at the depth of our problems, I have experienced this with the government and the Central Bank. Unless you probe very cautiously and know where to push the button, the real figures will not emerge and this is only because they want to preserve what little power they still have. Unless you know how to deal with this, you will not get the real figures and you cannot fashion a workable solution."

Yung Chul Park, responded to Sila-On. "With all due respect to Mr. Sila-On, is it not about time for us to change? To make sure that 'yes' means 'yes'. Why do we insist that the West understands our culture? We should at the same time try to understand their culture. That is what transparency is all about. This is the mistake we have made for a long time. We have long felt that we have our unique Asian culture, unique Asian values, whatever they are, and then expect that other societies will understand our system and our way of doing things."

Sila-On agreed that Asians should change their ways but observed that "it will take time. It will take time before Indonesia will move to even a Korean standard, maybe 10 years."

Susan Phillips finished up the discussion by pointing out that disclosure could be beneficial to the institutions which are doing the disclosing. "I am reminded of an experience when I was involved with stock exchanges. We were trying to get the exchanges to be more transparent in terms of what they publicise. We encountered massive resistence from NASDAQ, which is our over-the-counter market. However, once they finally decided that they would go with disclosure, they found it to be a wonderful advertising tool for the liquidity of their markets. Furthermore, if there is not an improvement in transparencies, capital is going to be withdrawn. Capital can flow in and capital can flow out. If countries or firms want to rely on international sources of capital, transparency is going to become the norm, and as these arm's length transactions occur, the lenders are going to start demanding increasing transparency. It is not only the supervisors who are requesting it, but we are starting to see more market pressures for disclosure."

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