International Financial Regulation :
The Quiet Revolution

I am highly honoured to have been asked to be the latest in a very distinguished list of C. D. Deshmukh lecturers. My predecessors are a kind of Who's Who of international finance: Michel Camdessus, Gerry Corrigan, Eddie George and others. Clearly, to mark the new Millennium, you have decided to go downmarket!

I was last in India, in both Mumbai and Chennai almost exactly two years ago. I spoke at a CII conference in Chennai with Mr Narasimham, who was at that time engaged in preparing his second report on the Indian financial system. We orchestrated between us an interesting debate on the lessons which India might draw from the Far Eastern crisis of 1997.

But, in truth, it was then too early to reach a considered view. The dramatic collapses of confidence in Thailand, Korea, Indonesia and elsewhere were far too recent. And indeed in retrospect it can be seen that we were only halfway through the story. The Russian collapse was yet to come, as was the dramatic intervention by the Hong Kong Monetary Authority to combat speculation in the Hong Kong currency and equity markets. Still in the future, too, was the collapse of Long Term Capital Management, in September 1998, which showed that threats to the stability of the financial system could arise from the activities of unregulated hedge funds as well as from regulated banks.

These were highly unusual events. Indeed the risk model operated by LTCM told its managers that the market price movements which occurred on two days in late August were events which should have occurred only once in every 80 trillion years. This may tell you something important about their risk model. But there is no denying that there were some highly unusual price changes which took everyone by surprise.

Indeed financial markets remained very turbulent right up to the end of 1998. And that turbulence particularly affected developing countries. For a time there was a very marked flight to what were perceived to be safer assets and instruments, especially government bonds in developed countries. The average spread on emerging market bonds, which averaged 500 basis points in the first half of 1997, was around 1175 basis points in the last quarter of 1998. It was conventional wisdom in the City of London and on Wall Street at that time that emerging markets would be closed to new

borrowers for years to come. More than one investment bank in London took the axe to its emerging markets department, and everyone at least did some rigorous pruning.

It is clear now that some of these more extravagant forecasts were well wide of the mark. Markets have been much calmer over the last twelve months than was foreseen, and while life has remained difficult for borrowers in developing countries, spreads have fallen back significantly, so that the average emerging market spread over US Treasury bonds in the last quarter of 1999 was only about 850 basis points. This is a welcome reduction for borrowers, but the spread remains considerably wider than it was a couple of years ago.

And almost everywhere around the world equity markets had an annus mirabilis in 1999. The Dow Jones went up 25% during the year and the London FT-SE Index by 18%. Even that dramatically good performance was outdone elsewhere. The Nikkei rose 37% and the Korean market in Seoul rose 83% over the year. In Brazil, the BOVESPA index rose 150% in local currency, while the BSE 30 here passed a more than respectable rise of 64%.

So is all now well? Have we now recovered from what we can now see was a nasty bout of the wobbles? Have we learnt all the lessons and taken the medicine to prevent any recurrence? Can we now look back on the turbulence of 1997 and 1998, confident in the knowledge that it couldn't happen again?

You will detect from the tone of these rhetorical questions that I do not believe the answer to all of them is yes.

I recognise that this is just the sort of time when people are least interested in warning messages from financial regulators. But it is almost certainly the time when they are most needed. Paul Volcker once said that the rôle of the central banker was to take away the punchbowl just as the party was beginning to go with a swing. Just in the same way, financial regulators are paid to be professional wet blankets, to warn of troubles ahead at the moment when there is a risk that past problems are fading in the memory.

So in these good times we need to shout louder to be heard. I do not mean that literally. My aim today is to suggest that the general directions of change adopted by the financial authorities in countries around the world in response to the market turbulence of 1997 and 1998 are correct.

But, even as recovery gathers pace and so one impetus to reform weakens, reforms need to be pursued with more vigour than has been the case hitherto. And that is true both internationally and at the level of the individual country.

But rather than stay at the level of comfortable generality – hands up those who are against prudence and good management – I will try to be a little more specific, in three areas where further change is certainly needed:

- First, the international financial architecture, where important reforms have been made, but where the hard work of implementation still lies ahead;
- Second, in international financial regulation, where there is more work to do to ensure that the right incentives are in place for financial institutions in developed and developing markets to manage their risks more effectively in future; and
- Third, in emerging market countries themselves, where there is a need for more practical efforts to upgrade accounting and legal standards, and systems of financial regulation, and of course to clean up the balance sheets of banking systems which, in many cases, remain very fragile.

My emphasis will lie heavily on the financial system, and on the financial regulation aspects of the problem, not on monetary or macro-economic policy. It is not because I do not think important for countries to adopt sound macro-economic and monetary policies – indeed it is an essential pre-requisite of a healthy financial system that they do. But when the Financial Services Authority and the Bank of England separated a couple of years ago I agreed with the Governor that I would keep out of his garden if he kept out of mine. That has so far proved the basis of an excellent relationship!

International financial architecture

In the aftermath of the Asian crisis it seemed, for a time, that a kind of international design competition had been launched, with the creative departments of every finance ministry in the world (if that is not an oxymoron) putting forward their own ideas for a new international financial architecture. There were a number of freelance contributions, too, from academics and commentators around the globe.

Some argued for a new Bretton Woods settlement. Chintaman Deshmukh, who was present at Bretton Woods himself, would have appreciated that. Others pressed the case for a kind of world financial authority with the power to regulate all cross border business, a Financial Services Authority on a universal scale.

These more extravagant ideas have not, in the event, commanded majority support. And an evolutionary, pragmatic approach has been adopted. There are clear advantages to proceeding in that way. It is far quicker, cheaper and more effective at international level to adapt existing institutions than to set up new ones. And in my view the key need was, rather than new architecture, enhanced plumbing: in other words better linkages between the different international financial institutions and groupings we already have. I will say more about this enhanced plumbing in a moment. But it is important to recognise that there have been some structural changes of significance.

There is the establishment of the G20, which met for the first time in Berlin last December, and of which India is of course an important member. It will be interesting to see how the agenda of the G20 develops in the future and especially how it addresses the main vulnerabilities affecting G20 economies and the global financial system. I note that all ministers and governors of the G20 agreed in principle to the preparation of Financial Sector Assessments, to be produced by the IMF and World Bank. I shall say more about these Financial Sector Assessments in a moment.

We have also seen the establishment of the Financial Stability Forum which began to meet last April. The Forum brings together, for the first time, supervisors and their international groupings, (the Basel Committee, IOSCO and so forth) central bankers and finance ministries, together with the IMF, the World Bank, the OECD and the BIS. Representation, which initially was limited to the G7, now extends to Australia, Netherlands, Hong Kong and Singapore. I would not be surprised if its doors were opened even wider in the future.

The gap which the Forum is designed to fill was initially identified by our Chancellor of the Exchequer, Gordon Brown, at the end of 1998. He pointed out that there was no forum in which regulators, central banks and finance ministries came together to look at financial crises, and indeed to try to share information which might lead to better forecasting and conceivably prevention of future crises, together with more financial stability. Hans Tietmeyer, then President

of the Bundesbank, was invited to examine this proposal in more detail, and the eventual composition and remit of the Forum reflects his work.

I am one of the UK members of the Forum, which perhaps conditions me to regard it as an important new initiative.

So far we have tried to do two things. First, to work towards developing a better "early warning system" than was previously available. I do not underestimate the difficulty of that task, and I am sure we will never be able to specify a list of indicators which can be guaranteed to flash red at the sign of impending disaster. But I cannot think it is anything other than useful for those of us who are closely involved in supervising markets to exchange opinions and impressions of market developments, in an attempt to scope out future shocks, and to think about how we would go about responding to them should they occur.

Secondly, the Forum is trying to specify concrete actions in areas where progress is needed. One of the three working groups set up by the Forum is focused on the problems for financial stability created by highly leveraged institutions, including both the impact of the LTCM affair, and also the various market episodes in 1998 in which hedge funds and other highly leveraged institutions are argued to have played a potentially destabilising part. I am chairing that group, which includes representatives from Hong Kong and Australia: we plan to report to the next meeting of the Forum in Singapore at the end of next month.

So we are in the process of formulating our conclusions now, and I do not wish to prejudge them today. But I can say that we have done some useful and original work in looking at the details of particular episodes of market instability, and the ways in which different types of institution interacted with each other during those episodes. We shall publish that analysis, and a series of case studies on individual countries and their experiences. I hope that the authorities in both developed and developing countries will at the very least find the report a useful contribution to their understanding of market dynamics.

Another group established by the Forum is looking at the particular rôle of offshore financial centres, especially the availability of accurate data, compliance with key standards, and sanctions for non-compliance. And a third group is examining some of the issues surrounding short-term capital flows, that will undoubtedly be of considerable interest to the Indian authorities, focusing

on management of risks, including debt; the volatility of capital flows; and capital controls. Again, these reports are to be submitted to the next meeting of the Forum, and published soon after.

It is of course too early to say how the Financial Stability Forum will develop. But in my view it is potentially a very useful innovation. Clearly, if it develops successfully, there will be a need to consider the balance of its membership, and the case for including, in particular, other large developing economies among its numbers. I should emphasise, though, that the working groups have already reached out beyond the formal membership of the Forum to include representatives from countries particularly affected by the problems under discussion.

International financial regulation

But I think it likely that, in the future, these institutional developments will be seen to be of less significance than a range of individually modest, but collectively important enhancements to the systems of co-operation and co-ordination between institutions. Before explaining those developments in a little more detail, I should take a short step back, to explain how I see the theory of international financial regulation, and how the practice today seems to fall sadly short.
In theory, financial regulation around the world is governed by standards set by three main groups of regulators. For banking, it is the Basel Committee, set up under the auspices of the BIS. For securities firms and markets it is the International Organisation of Securities Commissions (IOSCO), and for insurance companies it is the International Association of Insurance Supervisors (IAIS). The latter two are more recent creations with a wide membership. The former is a much tighter grouping of developed country supervisors only, but one which has earned considerable authority around the globe, largely as a result of the quality of its output. In effect, it also sets standards for countries outside its membership.

All three organisations have established principles of good regulatory practice, to which most countries in the world are, at least nominally, signed up. These principles describe the appropriate structures for regulation, with requirements for independence from political interference, they set out an approach to capital, and many other desirable features of a soundly regulated financial system. So far, so good.

But these principles do not appear to have been effective in preventing, or perhaps more realistically mitigating, the effects of financial crises. And we can see from the aftermath of the Asian crises that the Korean banking system was not adequately capitalised in line with Basel principles, and in Indonesia and Thailand the available capital was quickly wiped out by a wave of bad debts. Very significant recapitalisation of those banking systems has been subsequently necessary – indeed it is a process which remains to be completed. The sums of money involved are enormous. It is estimated that the costs of the banking collapse in both Indonesia and Thailand will amount to more than 40% of GDP, and around 15% in Korea. Should we therefore conclude that the Basel capital standards, for example, set up in response to crises of a similar order in Latin America in the 1980s, are hopelessly inadequate? I do not think so. While there are many problems with the existing structure of the Basel Capital Accord, which are being addressed currently, the better explanation seems to be that banks in Asia were not being properly supervised in line with internationally accepted best practice.

I do not have time today to go into detail on the ways in which the regulatory systems fall short. But it is clear that many banks were in reality undercapitalised. Their provisions for non-performing loans were inadequate. Their accounts lacked objectivity and transparency and rules on connected lending were not effectively policed. They also ran very significant and under-appreciated indirect currency risks through their lending to companies who themselves were not adequately hedged.

Once currencies came under pressure, and inadequate external liquidity became the issue, the opacity of local accounting standards, the insecure basis of provisioning policies, uncertainties in enforcing collateral, dubious corporate governance and the inability of central banks and supervisory authorities to impose discipline were all important factors undermining confidence and aggravating the collapse.

Of course there were other factors that work in these crises, including unstable macroeconomic policies and, perhaps, inappropriate incentives as lenders believed they would be bailed out in the event of devaluation. But my focus, as I said at the start, is on the regulatory dimension.

It seems clear, therefore, that there is a need to enhance supervision, particularly in economies open to capital flows, and to strengthen their compliance with internationally agreed best practices. I use compliance both in the sense of firms complying with the standards set by their

supervisors, and in the sense of those supervisors complying with international standards. In practice, the second sense will embrace the first. he traditional approach to compliance has been to assume that all members of a particular club, such as Basel or IOSCO, would comply with the club's rules, the supervisors would bring to colleagues attention their own experiences of interpreting rules and that informal contacts would provide a kind of peer review. This traditional approach breaks down either when some members do not apply the rules (for example in the financial crises of the 1990s I have described) or where there are marked inconsistencies in the way countries apply them.

The groups of supervisors themselves do not have the basis on which to enforce rules among their voluntary membership. The Basel Committee in particular has tried hard, and with some success, to reach out beyond its membership, but of course it has no firm mandate to do so.

So the last two years have seen a growing, albeit far from complete at this stage, acceptance by supervisors and by the international financial community generally that the standard setting rôle of international supervisory bodies needs to be complemented by arrangements for assessing compliance with those standards. And these arrangements need to go beyond peer review, which has been only modestly successful.

Instead, the necessary expertise, resources and willingness to pass judgement on compliance with these standards are being put together by the IMF and the World Bank. The IMF has a worldwide responsibility for economic surveillance, which – surprisingly you may think – has only recently been extended to cover financial systems in any depth. Both the Fund and the Bank have lending programmes designed to help countries recover from or avoid financial crises and both institutions are expanding their financial policy departments and enhancing their liaison with supervisors in developed countries in particular, who have agreed to lend staff resources to the international financial institutions to support this compliance assessment work. In the case of banking supervision, arrangements are now moving forward, though much work lies ahead in the practical application and there are some doubts about whether the IFIs have the records they need to complete the job. The securities and insurance areas are a little behind, as they discuss with the IFIs how best the work should be done, and who should take the lead.

The Fund and the Bank have now completed around 30 country assessments of compliance with the core principles of banking supervision, and more are planned. Increasingly these assessments

are being done within a much broader framework, known as the financial sector assessment programme – a joint Fund/Bank collaboration effort based on joint teams and drawing in supervisors from some national authorities, including the FSA. Around a dozen FSAPs are underway or in preparation. I understand that India is one of the countries currently discussing an assessment programme. The Reserve Bank of India has already taken one important step in preparing a self-assessment of its own compliance with Basel Core Principles, which it has also published on the Internet. This is a commendable move, which other supervisors would do well to follow.

The outcome of these assessments will be available to the authorities in the countries concerned and to the senior management of the IFIs. There is no agreement, as yet, on how much further to go. Some governments will no doubt choose to make public the full assessment, though perhaps with the exclusion of sensitive information about individual institutions. Other governments see difficulty in the Fund and the Bank combining their rôle as confidential policy adviser with that of impartial assessor. Squaring this circle may involve convincing reluctant governments that it is in their longer term interests to be open about their financial sectors and reform plans. My own view is that there should be a strong presumption in favour of publication as you have done with your self-assessment. But of course the most important thing is follow up. Compliance assessments should help national authorities design and carry through programmes to strengthen their financial systems and those programmes may well be given added credibility by being supported by international assessments.

And supervisors in other markets will, I believe, increasingly use the Basel Core Principles, and the Fund's view of compliance with them, in assessing the health of banks with branches in their jurisdictions.

So, to summarise a rather complex picture, I would maintain that we are in the midst of a quiet revolution in international financial regulation. The main elements of that quiet revolution are:

- much more outreach for banking supervisors, above all to supervisors in emerging markets;
- increasing acceptance by all supervisors that core principles of supervision, rigorously applied in all countries of the world, are essential;
- increasing acceptance of the need for external monitoring to ensure compliance

with those core principles;

- a willingness by supervisors to work much more closely than before with the financial institutions as the leaders of that monitoring exercise;
- greater willingness by supervisors to work more closely with each other across borders and across traditional sectors of banking, securities and insurance;
- a willingness by the Fund and the Bank to take on the rôle of monitoring and to integrate financial sector surveillance and reconstruction much more closely into their work; and
- a desire by the international financial community to consider more carefully the threats to financial stability, to put in place better incentives for avoiding such crises, and to bring together the key government officials, supervisors, central banks and the financial institutions, through the new Financial Stability Forum.

So what are the implications of this quiet revolution for emerging market countries?

Implications for emerging markets

My answer to that question must begin with an important disclaimer. I have never run a financial system, or overseen one, in an emerging market. For a while in the 1970s, the United Kingdom seemed to be a disappearing market, but we have recovered from that, and London is now the most international and sophisticated financial market in the world. We also benefit from a very well capitalised banking system, a traditionally open and competitive market, and a very well established set of institutions, with a well developed tradition of leaving decisions on regulatory matters to independent institutions insulated as far as possible from political interference. I recognise that these features of the UK scene, which we tend to take for granted, are luxuries in many emerging markets.

This is a roundabout way of saying that when I suggest what might need to be done in emerging markets to enhance the strength of their financial systems, I am not on the firmest of ground.
So with that disclaimer firmly before you, I will nonetheless hazard a few observations which I hope may be helpful.

Perhaps the best place to start is with the markets themselves. Why have normal market mechanisms not operated properly to weed out poorly performing institutions and create a healthy competitive financial system? There are a number of potential answers to that question. But

factors which can encourage banks and other financial institutions to take on too much risk, with the occasional panic when reality takes hold, include:

- excessive safety nets at the national level, including too extensive guarantees to depositors, and a reluctance to take prompt action to deal with failing banks; this is seen as leading to banks' risk-taking being partly underwritten by the authorities;
- excessive safety nets at international level, arising from large country rescue packages, which can allow banks to enjoy returns higher than justified by the risks;
- incentives, for example in the 1988 Basel Capital Accord, which may unduly encourage short term capital flows; and
- excessive reliance on banks for financial intermediation; and insufficient use of other mechanisms, especially securities markets.

So it is important to ensure, for regulators to do their job effectively, that the appropriate pre-conditions for effective banking supervision are in place. The Basel Committee defined five pre-conditions for effective supervision in banking, and I am sure that something very similar applies in the case of both investment and insurance business. They are:

- First, a reasonably stable macroeconomic environment (an easy thing to say, of course);
- Second, a well developed public infrastructure for financial markets, particularly including well specified accounting rules and implementation practices. I cannot emphasise too strongly the importance of good accounting practices. Economically sound financials are the cornerstone of any properly functioning market economy. Without that, supervision and regulatory systems are houses built on shifting sands;
- Third, effective market discipline through transparency and the avoidance as far as possible of uncertain or implicit government guarantees;
- Fourth, procedures for efficient resolution of problems in financial institutions; and
- Fifth, appropriate, and by that I mean limited, safety nets.

I would personally add that competition, particularly foreign competition, is another important requirement for a healthy financial sector. It is worth noting that most countries in Latin America, following their extensive banking crises in the early 1980s, opened up their financial systems and strengthened supervision, whereas many countries in Asia have made it more difficult for foreign

competition to enter, thus closing off one important transmission mechanism for good management and new techniques to strengthen the domestic financial sector. In South East Asia it is ironic that the open trading policy so successfully pursued by many countries and manufacturers, and which was celebrated in the so called East Asia miracle, were not followed in financial services. Reform programmes in these countries now put a welcome emphasis on opening trade in financial services and on the cross border establishment of competing firms. There are important developments under way in India which will open up important sectors here, notably insurance.

I would also add another linked point. Emerging markets would do well to broaden their financial intermediation systems in future. There are clear advantages to be had from avoiding excessive reliance on banks. Measures to promote domestic bond markets are well worth considering. Of course low and stable inflation is an important prerequisite, but there may be other tax and market infrastructure issues to consider as well.

Beyond these pre-conditions, there is of course the need for appropriate regulatory institutions, and for those institutions to be given the power and independence to pursue the good principles of supervision which are available, in the well specified form, from the international groupings of regulators. The appropriate institutional arrangements will certainly vary, country by country, depending on the nature of their public institutions, on the one hand, and on the structure of the financial markets, on the other. In some cases it may be appropriate for banking, securities and insurance supervision to be carried out separately. That may be so, for example, where the sectoral divisions are enshrined in law, as has been the case until very recently in the United States, for example.

In a country like the United Kingdom, where there are no impediments to banks owning insurance companies, or vice versa, and where both can engage in securities business, there is in my view a powerful case for a single regulatory institution, as we have now established, following models pioneered in Scandinavia. We have since been followed by Japan and Korea, among others.

And what of the rôle of the central bank? Here, again, I do not think that there is a general answer, applicable at all times and in all countries. We have reached the view that, in the UK's circumstances, it makes sense to separate banking supervision from the monetary authority. That is partly, indeed perhaps very largely, because we believe that banking, securities and insurance

supervision should be put together. And securities supervision, particularly the investor protection dimensions, are not the natural habitat of central banks. The government also took the view that it would be easier for the Bank of England to establish its credibility as an independent monetary institution if it were not at the same time engaged in the messy, and sometimes mucky business of banking supervision! Bank failures there inevitably will be, even in the best regulated market – perhaps particularly in the best regulated market, I might add! (Since, following my earlier strictures about the rôle of markets, a financial system in which bank failure was impossible would be highly unlikely to be the most efficient and effective system available).

On the other hand, in countries where the central bank is well established as an independent institution, and where the interplay between the banking system and the government's finances, perhaps because of state ownership, or state run programmes of lending, is close, then one can see a stronger argument for central bank involvement in banking supervision.

I think it is fair to say that, internationally, there is a modest trend towards the separation of monetary and supervisory responsibilities, but that is certainly not true everywhere, and a recent paper from some academic enthusiasts for merging banking, securities and insurance supervision has argued that, in many developing countries, the central bank remains the most appropriate home for prudential supervision.

I would re-emphasise that, in my view, independence and the ability to take unpopular decisions and carry them through is far more important than the title of the institution, or its relationship with the central bank or ministry of finance.

Lastly, and this is always a popular point to make to institutions responsible for financial supervision, it is vital to have well staffed, well trained and well paid financial regulators! It is a struggle, everywhere, to maintain a strong cadre of regulators. While financial institutions complain about regulators, often rather vociferously, they also show an enormous appetite for recruiting and employing their staff. We find that the right structures and disciplines are created if the regulator is as close as possible to the market place and, in particular, if the regulator is paid for by financial institutions themselves. That is the case in London. It does not resolve all funding problems, but it does mean that if we need to raise more funds because market salaries are rising, then the institutions concerned can understand the point, and indeed have the basis to contest it if it is wrong. So I am strongly in favour of market based funding systems for regulators, which put

the incentives for economy and efficiency, on the one hand, and for maintaining appropriate levels of expertise on the other, in the right place. It also has the optical benefit of achieving a reduction in recorded levels of public expenditure, something which ministries of finance around the world are devoted to achieving.

Conclusions

As I close, I will try briefly to summarise the argument I have attempted to make this evening.
The financial market crises of 1997 and 1998 vividly illustrated the need for reform in the international financial system. Much of the early debate around that reform centred on proposals for a new international financial architecture, and for new international institutions. Some have been disappointed that only modest institutional changes – the establishment of the G20 and the Financial Stability Forum – have been forthcoming and have, in my view wrongly, concluded that little has changed.

But my own analysis suggests that, below the parapet, so to speak, there are more important and far reaching changes underway in the international financial plumbing than has generally been perceived. Indeed it is arguable that those changes, taken together, amount to a quiet revolution in international financial regulation with, for the first time, the monitoring and compliance muscle of the international financial institutions linked to the standard setting expertise of the regulatory clubs. Much of the framework is now in place; a great deal of work and hard political decisions lie ahead in making it a reality worldwide.

That new alliance, reinforced a by a renewed awareness around the world of the huge public costs of financial system failures, should gradually create stronger pressures on countries to engage in financial system reform and restructuring programmes. It will create greater pressure, too, for implementation of the core principles of good supervision, established by Basel, IOSCO and the IAIS. And it will throw sharp focus on the nature of the national regulatory institutions in place, and the status and quality of those institutions, which are responsible for promoting and policing good practice.

There is no one simple institutional model which can be recommended for universal application. And each country will wish to assess the pros and cons of different structures, in the light of their own financial markets and political structures. The developed countries offer a range of working

models from which to choose. What is crucial is to ensure that the regulatory institutions have the independence and authority to take firm, sometimes unpopular decisions in a timely manner.

Finally, let me add one reality check. I do not think that all of this reform, all this market surveillance, all this regulatory good practice, will produce a world free of financial crises. Financial markets are inherently unstable. They are there to manage and intermediate risk. They will go up and down, sometimes dramatically.

We should not try to prohibit this volatility. Of course we want to be in a position where we can manage crises, and mitigate their worst effects. But a realistic aspiration might be to design a system which will cope with three of the next five crises, rather than five of the next three. Or to put it another way, if we over-control, we will damage the economic utility of the very markets we are trying to develop. So I wish you a volatile, but not too volatile, future.