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

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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 har-

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monise 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 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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