

**INTERNATIONAL FINANCIAL REFORM:
REGULATORY AND OTHER ISSUES**

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Introduction

This paper reviews how various mechanisms of prudential oversight over the financial system can help to make an economy more resistant to contagious financial shocks.¹ Other policy measures that in some circumstances play a useful role – such as capital controls, lender of last resort arrangements and the choice of exchange rate regime – are mentioned only tangentially as they are covered by the conference paper by Chang and Majnoni (2000).

The plan of the paper is as follows. The first section argues that better and more realistic supervision of institutions is needed both in capital-importing and capital-exporting countries. The second section looks at international rules for capital ratios – the key supervisory ratio internationally – and considers some of the dilemmas regulators face in trying to set the ‘right’ ratio for their country. A third section looks at how far implicit and explicit guarantees undermine financial agents’ and institutions’ sense of responsibility for their own decisions (‘moral hazard’). A fourth section considers what can be done to strengthen the operation of market discipline for banks. A fifth section raises the issue of the need to develop deeper financial markets so that the concentration of the risks in the banking system can be diluted.

One theme that will recur throughout the paper is that regulators and supervisors face several complex dilemmas in framing their policies and determining their actions in practice. There are no quick fixes. A second theme is that circumstances differ enormously from country to country. Some countries have highly sophisticated banks but others do not. In some countries, the financial markets are deep and varied enough to enable banks to lay off risks; in others, they are not. These elements suggest that supervision will in practice remain a responsibility of the individual country. Accordingly, the focus of international cooperation should be to ensure that generally agreed principles (not necessarily specific rules) needed to ensure strong banking systems are applied worldwide. These international aspects are covered in the final section before a short conclusion.

Better and more realistic supervision

There are two aspects of this: improving supervision in developing countries and ensuring that lending banks in the industrial world properly assess risks in lending to these countries. Recent crises revealed shortcomings on both accounts.

Developing countries

In many countries, the supervision of banks was quite inadequate for well-known reasons. A major international effort is now under way to put in place better supervisory systems, spearheaded by the *Basel Core Principles for Effective Banking Supervision*. This has been supported by work on many detailed questions of implementation.² A noteworthy

¹ “Contagion” is used here in a broad sense to refer to a problem in another economy leading to a shock to the domestic economy, regardless of whether the transmission is through some ‘fundamentals’ such as trade or less tangible influences such as the attitude of foreign investors.

² Groups of national experts have also developed or are working to develop core principles covering disclosure of foreign currency positions, trading and derivatives disclosure by banks, insurance supervision, corporate governance, payment systems and management of credit risks. See White (1999), p10.

aspect of this work is that the principles were developed by a broad group encompassing regulators in emerging markets as well as those in the G10 and that supervisors in the developing countries have been deeply involved in fleshing out the details.

The question of assessing and encouraging compliance with the principles is now being addressed. The BIS and the Basel Committee on Banking Supervision have established the Financial Stability Institute to help spread best-practice supervision globally. This is no easy or short-term task: not only does it take years to train a good bank examiner but also “it takes years to educate the body politic to the importance of good financial supervision and the necessity of independence for the financial supervisors”.³ A recent survey by the Basel Committee found that the most acute problem in many emerging markets is the shortage of skilled supervisory staff and that supervisory agencies in many countries are not sufficiently independent to be able to function effectively.⁴

The World Bank has also been heavily involved in helping countries put their banking systems straight. In addition, the IMF will monitor compliance as part of its regular Article IV reviews of economies. There is much value in making sure that banking system issues are constantly kept before the eyes of policy-makers. Some observers have argued that international institutions should seek to exert very public pressure. For example, the Council on Foreign Relations Task Force (1999) argues making assessments by the IMF and the World Bank public would add to the pressure on countries. Peer pressure among regional groups of supervisors may also be important: several regional groupings (e.g. the Asian Development Bank) are starting to do this. However, it may be hard for international agencies to be both private adviser and public critic. Countries may become wary of providing confidential information if it may be publicly used against them. Staff may become less forthright in their reports if they are to be made public. There is also a very real danger of a public warning by a major international institution bringing forward a crisis rather than preventing one. Worse still, given the uncertainties involved in such analyses and the possibility of ‘multiple equilibria’, the publication of a negative opinion may cause a crisis that would otherwise have been avoided.

One approach to this dilemma would be to present better surveillance in a positive light: those countries whose supervisory system is judged adequate could get benefits denied others. One possibility is to require that higher capital be held for international loans to banks whose supervisors do not adhere to the principles.⁵ The right to establish subsidiaries in major international financial centres might be denied to banks from economies whose supervisory

³ Heimann (1999). He also said that, “in the midst of a crisis, countries will sign almost any piece of paper put in front of them by the IMF. After all, they need the money. But that does not mean they will implement the agreed proposals with any degree of determination.”

⁴ See Nouy (1999).

⁵ Paragraph 13 of the Basle Committee on Banking Supervision’s 1999 consultative paper on a new capital adequacy framework envisages this: “claims on a bank would only receive a risk weighting of less than 100% if the banking supervisor in that country has implemented, or has endorsed and is the process of implementing, the 25 Core Principles for Effective Banking Supervision.”

regime is judged inadequate. The private sector may decide to charge higher interest rates on loans to banks in countries that do not conform to the principles. Such measures should all build a domestic constituency for the adoption of the principles.

Another area for action is improved accounting and disclosure standards for banks and for corporations. Lax standards mean that the scale and nature of problems in banking systems is often disguised in banks' published accounts. At least five areas require attention:

- prompt and honest evaluation of bad loans. This needs to be based on a forward-looking evaluation and to be associated with prompt and realistic provisioning;
- fully consolidated accounts;
- appropriate treatment of interest capitalisation to avoid disguising bad loans;
- off-balance-sheet positions, so that leverage can be more accurately analysed; and
- the auditing of banks' statements by internationally recognised auditors using common standards worldwide.

In addition, bringing corporate reporting standards in the emerging markets up to the higher standards of transparency prevailing in most industrial countries will also be needed if banks are to be able to assess risks properly.

In attempting to improve accounting standards for banks, it will not be possible to achieve full harmonisation because of differences in tax law, insolvency procedures and collateral rules and links in some countries of such laws, procedures and rules to accounting and disclosure standards and practices.

A final observation is that it will necessarily take time to build up an effective supervisory capacity, to develop market-based methods of discipline and to create an open, non-corrupt culture.⁶ In the meantime, there may well be a case for putting greater weight on simple-to-enforce regulations than would be desirable in countries with highly developed financial markets. Indeed, this regulatory approach is particularly well-suited to less sophisticated financial systems with poor data. Supervisors have simple concrete rules to apply. This lack of discretion may be a benefit if there is concern that the supervisors could be subject to influence by the banks, either directly by bribes or indirectly by pressure from politicians. Such prudential rules cover capital ratios, minimum capital requirements, liquidity ratios, required reserves placed with the central bank, limits on large exposures (which may be stricter when the loan is to a related party) and sectoral concentrations and limits on open positions. Examples of their use in emerging economies are given in Table 1.

⁶ Eichengreen (1999, p52) cites a study by Calomiris which "estimates that – even under the best circumstances and with the best technical assistance – upgrading risk-measurement and risk-management practices, adopting new regulations, and putting in place new supervisory procedures can take no less than five years and cites the relatively successful examples of Argentina and Chile as cases in point."

Table 1
Prudential ratios

	Capital (% to risk-weighted assets)	Liquidity ratio	Required reserve ratio	Single borrowers exposure limit (% to capital)
China	8	25	8	10
Hong Kong	10–12	25	0	20
India	8	25	11	25 (group 50)
Indonesia	4 (12 by end-2001)		3–5	15 (group 45) aggregate 500
Korea	8	30	3	25
Malaysia	10	17	13.5	25
Philippines	10	7	7–10	25
Singapore	12 (at least 10% Tier I)	18	3	25
Thailand	8.5	6	0	15 (collateralised 25) aggregate 300
Argentina	11.5	20		5–30
Brazil	11	none	75 (demand) 20 (time)	10 (collateralised 25)
Chile	8	*	9 (demand) 3.6 (time)	individuals 10 corporates 30
Colombia	9		16 (demand) 2.5 (medium term) 0 (long term)	10–30
Mexico	8	**	0	10 (group 20)
Peru	9	8 (domestic), 20 (foreign)	7 (local currency) 38 (foreign currency)	25 aggregate 230
Venezuela	8	none	19	25 aggregate 800
Czech Republic	8			25 aggregate 800
Hungary	8		12	
Poland	8			15 (group 30) top 6 aggregate 100
Russia	8			25–50 aggregate 800
Israel	8		8	
Saudi Arabia	8	20	7 (demand) 2 (time)	
South Africa	8	5	2.5	

* 100% on demand deposits over 2.5 times capital; 10% on foreign currency deposits.
** 10% of profits allocated to reserve fund until equal to capital.

Source: Hawkins & Turner (1999), Tables A1 and A3.

Moreover, macroeconomic-type rules could well have a role to play. Two in particular deserve careful consideration:

- ceilings on the growth of bank lending, either total lending or lending to particular categories (e.g. real estate lending). The rationale is that the more rapid the growth of lending the greater the risks⁷ (particularly if fuelled by an asset-price cycle);
- limits on foreign currency lending to residents. This has often been inadvertently encouraged by macroeconomic policies (fixed-exchange-rate-based stabilisation policies) and sometimes by aspirations to become an international financial centre.

Such rules may have a role to play in countries at an early stage of financial development, even if over time they are increasingly circumvented. However, it is necessary to ensure that regulations are not so tough as to stunt the growth of the financial system. The main reason the regulatory approach was gradually discarded in many advanced economies is that banks found ways to avoid the regulations and non-bank financial intermediaries grew up to undertake activities denied to the banks. This risks leaving the authorities controlling a decreasing proportion of the financial system. This both erodes their influence over the real economy and raises the danger of the financial system being disrupted by trauma among non-bank financial intermediaries.

Lending banks

The recent crisis revealed that many international banks underestimated the risks of lending to some emerging markets. In some cases, the bank's credit risk assessment procedures were inadequate. In other cases, informal enquiries have revealed that the bank's management overruled the warnings given by their own credit departments. This was only in part because of expectations of official bailouts.

Banks have no shortage of excuses for their own failures: “the supervisors (or the IMF, or Moody's) did not warn us” is a common refrain, and has indeed prompted an extensive examination of how to improve the early warnings of the IMF and the rating agencies. There is of course much merit to this. But relying on one or two institutions to ‘blow the whistle’ has serious drawbacks. The main danger is that a public warning could trigger sudden and simultaneous attempts by all banks to cut their exposure, and could provoke a crisis. Because of this, the issuance of any such warning is likely to be very carefully reviewed, often to the point of delay: the monitoring institution knows it will have to be able to defend its decision in public. By contrast, an individual bank making its own confidential assessment will be able to react much more quickly. If very many banks are independently doing this, the chances of imposing progressive discipline on a country running into trouble – rather than provoking a sudden discontinuous drying up of foreign inflows – are greatly enhanced. For this reason, the

⁷ One senior bank supervisor's rule-of-thumb was that “any bank which has doubled its loan book in three years will fail during the next three years”.

fragmentation of monitoring across many different banks and other institutions can help the market mechanism to work more smoothly.

Capital ratios

Capital ratios, the most important supervisory ratios to be applied internationally, can have a pervasive impact on bank lending in developing countries. Not only are the capital ratios applied by supervisors in developing countries important but the risk weights applied by lending banks to loans to developing countries also exert an important influence. Two controversial issues are: should capital ratios for banks in developing countries be higher than those in developed countries? To what extent are capital ratios procyclical? These two questions are considered in turn.

Bank capital ratios in developing countries

There are two main reasons why banks need adequate capital. The first is to provide a “buffer” that allows deposits to be repaid even if there is some fall in the value of banks’ assets. The second is to ensure that the owners of the bank have a lot to lose if the bank fails, so that they avoid excessive risks. However unless capital ratios are set very high the bank still has a significant ‘option value’ to them; if a riskier strategy is followed they reap all the upside but the downside is generally limited to their initial capital contribution. This need not necessarily be the case: shareholders could be required to “pay in” only a proportion (e.g. 25% in some cases) of the authorised capital but remain liable to meet future calls for capital in the event the bank faces difficulties. Under some much earlier arrangements, shareholders were exposed to double-liability if ‘their’ bank failed (i.e. they had to contribute an additional amount equal to their initial capital subscription). In a similar vein, supervisory authorities in Brazil and India have forced shareholders to put up additional capital. This may be a necessary provision wherever connected lending is a problem: shareholders should lose more than their capital if they have been directing bank lending towards companies with which they are associated.

Whether banks in emerging markets should face more demanding capital requirements is a controversial question. Any analysis of this question must start from the central point that capital ratios are only as good as the provisioning rules that underpin them. Provisions made for possible losses must reflect the true risks of repayment. In many emerging markets, provisioning rules have been far too lax. When supervisors tightened the rules for the classification of non-performing loans in the wake of recent crises, the result was that

measured capital became low or even negative. In reality, then, true capital ratios were often far lower in emerging markets than they were in industrial countries.⁸

The case that is often made for applying stricter provisioning and capital rules is that emerging economies typically have both more volatile domestic sectors and face relatively larger and more volatile capital flows (Table 2). This means that loans are, on average, riskier. In a perfect world, where capital charges (or provisioning) on each individual loan were graduated according to some “objective” measure of risk, banks in riskier environments would automatically hold higher levels of capital. But the real world has imperfections: capital requirements are not very closely related to the risks of individual loans (e.g. under the present capital accord 100% risk weight applies to lending to domestic corporations).

Table 2

Volatility of macroeconomic and banking indicators 1980-98¹

	GDP	Inflation	Bank credit to private sector²	Capital flows²	Real interest rates
India	2.0	3.9	4.8	0.8	4.5
Hong Kong	4.1	3.3	6.8	0.0	1.9
Indonesia	5.0	11.7	18.7	2.6	7.3
Korea	4.5	6.7	5.6	2.7	2.9
Malaysia	4.8	2.2	7.8	7.2	2.0
Philippines	3.3	10.6	17.8	3.3	7.3
Singapore	3.4	2.5	5.0	5.7	1.3
Taiwan	2.3	5.1	8.3	6.4	1.6
Thailand	4.8	4.3	7.7	4.6	4.0
Argentina	5.7	833.1	31.7	1.8	154.0
Brazil	4.0	883.7	50.0	1.4	108.9
Chile	5.6	8.5	18.9	4.4	9.2
Colombia	1.7	4.0	9.2	2.0	3.9
Mexico	3.9	37.5	22.7	2.9	14.0
Venezuela	4.6	25.8	19.6	4.8	13.1
<i>Memorandum:</i>					
United States	2.0	2.9	3.4	0.7	1.5
Germany	1.8	1.8	3.5	1.7	1.2
Japan	2.2	1.9	2.6	1.0	0.9

¹ Measured as the standard deviation of annual percentage changes, except for capital flows and the real interest rates where it is measured as the standard deviation of annual absolute changes. ² As a percentage of nominal GDP.

⁸ At the very least, proper provisioning means classifying loans that are more than three months overdue as “substandard”, and requiring a minimum provision of 20% of the value of the loan (i.e. to be deducted from the value of capital in the balance sheet). Ideally, regard should also be paid to the debtor’s financial status and credit rating, its future prospects, a realistic (and realisable) valuation of collateral and the likelihood of support from guarantors or related companies if it faces difficulties. One common trick against which supervisors need to guard is “evergreening”; that is, a debtor being technically kept out of arrears by being advanced new loans to meet repayments or interest on old loans. A bank may then argue that no bad debt recognition or provisioning is required.

Whether the response is ensuring the general provisioning rules (which require capital be written down as loans are extended) require higher provisions in riskier environments or having higher capital ratios (as applied by several emerging market jurisdictions with relatively strong banking systems) is perhaps less important. In circumstances where risks are not finely calibrated higher blanket capital requirements or more demanding provisioning rules can be an effective second-best response for banks in riskier environments. They do not necessarily violate the level playing field desideratum.

A thornier question is the treatment of different diversification possibilities. The riskiness of a bank's portfolio depends not only on the riskiness of individual loans but also on the scope for diversifying risk by means of a varied loan book. In many emerging markets, the scope for diversifying risk is inevitably smaller than in larger, more developed economies – because of size, because of more concentrated production and trade or because of concentration on certain markets. Such limited risk diversification possibilities may itself require higher capital ratios – even if individual loans are no riskier. Banks in emerging markets may thus appear to be placed at a competitive disadvantage, especially against foreign bank branches. But such disadvantage fundamentally stems from the realities of their banking market.

Procyclicality of regulatory ratios?

The question of the procyclicality has several aspects. One concerns the timing of any tightening of capital rules – which usually occurs after a crisis when bank lending is in any case being curtailed. Another concerns the inherent cyclicity of any invariant minimum capital ratio. A third is that capital ratios themselves tend to move in a procyclical way – the proposed use of credit rating agencies could exacerbate this tendency. A final possible element is a supposed regulatory bias in favour of short-term, rather than long-term, lending which means that emerging markets are more vulnerable in a downturn.

Timing of tightening capital rules

The timing of measures to tighten capital or loan classification rules is bound to be controversial. It has been argued that regulatory rules should not be tightened when macroeconomic conditions are adverse because the very sharp change in reported bad loans that would result might undermine confidence. In practice, most countries allow a phase-in period for the tightening of prudential ratios or in dealing with generalised problems. US money centre banks whose loans to heavily indebted countries exceeded their capital in the early 1980s were allowed several years to adjust – but there was no doubt that they would have to adjust. The Basle Accord itself, published in July 1988, envisaged a transitional period to the end of 1992 (backed up with an interim standard to be met by the end of 1990). Following the recent crisis, several Asian countries have established timetables for meeting

specified capital standards or for adopting realistic rules for loan-loss provisioning. In Thailand, for instance, tighter requirements for loan-loss provisioning are being phased in over a two-to-three years transitional period. As each deadline during this period is reached, additional capital can be required.

One consideration that often argues against tightening capital rules too abruptly is the reluctance to take banks into state ownership – which in effect occurs if the full and immediate recognition of losses wipes out a bank’s capital and the government injects new equity. In countries with efficient state institutions that are not susceptible to corruption and with a well-established tradition of keeping economic activity in the private sector, a temporary state takeover of a private bank may work well (as in Sweden, for example). But in countries where these preconditions are not satisfied (or in countries which have only recently managed to privatise their banks), it may be better to leave the bank with the original owners who may be more likely than government-appointed administrators to implement the necessary restructuring, ensure that loans are extended on commercial criteria and keep up the pressure to collect on bad loans. If so, there may be a tactical case for not forcing shareholders to fully or immediately write down the losses incurred.

None the less, it is important to make clear that any departure from usual prudential norms decided upon in exceptional times is temporary. There should be a commitment to meet normal standards according to some explicit timetable. And because temporary forbearance can be effective only if it does not damage confidence, it must be accompanied by measures that build confidence in the long-run viability of the banking system. For instance, any protection granted to the stronger banks should be accompanied by urgent measures to close or restructure the weakest banks.

Inherent procyclicality arising from minimum capital ratios

The second aspect concerns the possible procyclicality of capital ratios. Loan losses tend to rise in a recession. To the extent that they are not covered by loan provisions (and in practice these usually prove inadequate), such losses will lead to capital write-offs. If capital ratios then fall near or even below the required minimum, banks will have to raise new capital or reduce assets with high risk weights, especially loans. Because raising capital is difficult in a recession, banks are likely to choose the second option and cut lending. There is strong evidence that banks do indeed act in this way.

One ad hoc response to this problem is to set the required capital ratio higher when output is above trend. The supervisory review pillar proposed in the Basel Committee’s consultative document could encourage banks to take account of cyclical influences in assessing their capital adequacy needs. In practice, of course, it is often very difficult to

identify the true cyclical position.⁹ Furthermore, it would be even more complicated to translate it to cyclically adjusted ratios for individual banks because banks lend to various sectors and thus have different exposures to cyclical conditions.

The ideal response to procyclicality is for provisions made for possible loan losses (i.e. subtracted from equity capital in the books of the bank) to cover normal cyclical risks. If done correctly, provisions built up in good times can be used in bad times without necessarily affecting reported capital.¹⁰ To ensure this, and because all loans have some risk of loss, it is important to maintain some general provisioning that applies to all loans. But there are some possible impediments when it comes to the practice.

The first stumbling block is that tax laws often severely limit the tax deductibility of general provisioning and may insist on evidence that losses have actually occurred. This is important because loan loss provisions increase internal funding for the bank only to the extent that they reduce taxes. This problem is complex (ministries of finance generally view measures which bring forward reductions in tax collections with scepticism), but does require attention.

A second possible stumbling block may be the securities laws. For example, the SEC in the United States has argued that precautionary provisioning could distort financial reports and may mislead investors. Allowing banks to build up reserves to cover possible losses that are not foreseen in any detail may prove difficult to square with the demands of having well-documented accounting because the decision of how much reserves to set aside is inherently judgmental.

A third possible stumbling block is that the management of banks may be too eager to report strong improvements in earnings during booms (and so too reluctant during good times to make adequate provisions for losses). The present wave of takeovers in the banking industry may accentuate this eagerness: good reported earnings and high share prices serve to fend off takeovers.

Procyclical capital ratios: danger of using credit rating agencies?

The 1988 Capital Accord is under major review. Under that Accord, the risk weight for sovereign entities is basically decided by OECD membership, and this approach is also reflected in the risk weights for banks. All corporates receive a single risk weight of 100%.

⁹ Japan's problems in the 1990s dramatically illustrate this point. The weakening of growth in early 1992 was at the time regarded as a cyclical downturn in an economy with an underlying growth rate of around 4%. With the benefit of hindsight it was the early stage of a decade when growth would only average 1½% a year.

¹⁰ Under the Basle Capital Accord, loan loss provisions can count as tier 2 capital.

These ratings were not cyclically sensitive – indeed one frequent criticism of them is that they are not sufficiently risk responsive.

The recent consultative paper (Basel Committee, 1999b) envisages a major overhaul of this approach. One possible alternative is use of “credit assessment agencies” – a deliberately broad expression to encompass export insurance agencies, credit registers, market data as well as credit-rating agencies. But it is credit-rating agencies that have attracted the most attention. The possible risk weights for sovereigns (based on S&P’s ratings) are shown in Table 3. The risk weighting for banks will, under one possible option, be one notch higher than the weighting of its home country. Top-quality corporates will receive a 20% risk weighting, while corporates with a very low rating will receive a 150% weighting. All other corporates will continue to be weighted at 100%.

Table 3

Risk weightings for emerging economies

Credit rating	Risk weight	Unchanged* 1997-99	As at June 97	As at June 98	As at Dec 99
AAA to AA-	0%	Singapore Taiwan	Korea		
A+ to A-	20%	Chile Czech Rep. Hong Kong	Malaysia Thailand	Malaysia	
BBB+ to BBB-	50%	China Hungary Poland	Colombia Indonesia	Colombia Thailand	Korea Malaysia Thailand
BB+ to B-	100%	Argentina Brazil India Mexico Peru Philippines South Africa Turkey Venezuela	Russia	Korea Russia	Colombia
below B-	150%			Indonesia	Indonesia Russia

*In some cases, the rating has changed by a notch or two but not enough to imply a change in risk weighting.

Sources: Basel Committee (1999b), Standard & Poor’s.

Many would be wary of putting too much emphasis on the assessment of credit-rating agencies. Their performance during the Asian crises certainly suggests a marked cyclicality: while they did not downgrade most Asian countries pre-crisis (when imbalances were developing), their downgrades in the midst of the crisis – especially when they lowered Korean, Indonesian and Thai bonds to non-investment grade – made the crisis worse. Perhaps the most damning criticism is that the rating agencies were backward-looking rather than forward-looking in their assessments. For instance, there is evidence that credit ratings of

countries exhibit a strong negative correlation with their real effective exchange rates.¹¹ This means that depreciation in the wake of a crisis typically leads to a downgrade – whereas a forward-looking approach (e.g. as applied in much of the recent work on indicators of vulnerability) would recognise a more competitive exchange rate as a source of medium-term strength, not weakness.

One particular danger of reliance on external credit assessment agencies is that developing countries that are downgraded in a crisis would be hit twice: once via higher risk-weights used by international lending banks and secondly via higher risk-weights for domestic bank lending to major corporations which also may be downgraded in a crisis. A second reservation is that making greater use of ratings could tempt the raters to be more lenient. Finally, the development of corporate ratings is quite uneven across countries – and because there may be a tendency to rate newly-rated entities conservatively (i.e. on the low side), those without a history of credit rating may be placed at a transitional disadvantage.

Nevertheless, the recent proposals represent a major improvement on present practice which is rather arbitrary. The aim should be to rely on credit assessments that have a long-term focus (i.e. “see through” economic cycles) and which can therefore exert a stabilising influence. It is possible that export insurance agencies and the official credit registers that exist in some countries do indeed have a more appropriate long-term focus. As Bonte et al (1999) have observed, an expanded regulatory use of external ratings needs to be carefully researched.

One subject for reflection is how quickly a change in credit rating should be reflected in the regulatory risk weight. On the new proposed scale, for instance, loans to the Korean government would have gone from a zero risk weight in 1997 to a 100% risk weight in 1998 only to go back to 50% in 1999 (Table 3). It is sometimes overlooked that there is nothing in the Basel Committee’s consultative document to say that changes in credit ratings have to be immediately reflected in risk weights. The need to mitigate procyclicality might suggest a case for phasing in very gradually any change in risk weights resulting from a change in credit ratings. If the phase-in period was long relative to the length of the economic cycle, then procyclicality might be mitigated. But there is of course a trade-off: such smoothing devices weaken the link between risk and capital weights – yet the whole point of the recent proposals is to make Basel Accord rules more risk sensitive. And it is not clear how effective these devices would be in practice. Expectations are important and the knowledge that a country’s “ultimate” risk weighting has gone up might have an immediate impact on banks’ decisions

¹¹ Monfort and Mulder (2000).

irrespective of any phase-in period and might, in addition, affect the market value of the exposed bank.

Perhaps an added danger of a reliance on any small number of credit assessors (e.g. a credit rating agency) in assessing risk is that it could narrow the diversity of opinions and so could increase the degree and spread of procyclicality. For instance, a downgrade by a major agency could trigger sudden and simultaneous attempts by all banks to cut their exposure. If instead very many banks are independently assessing risk, the chances of imposing progressive discipline on a country running into trouble – rather than provoking a sudden discontinuous drying up of foreign inflows – are greatly enhanced. For this reason, the fragmentation of risk assessment across many different banks and other institutions may help the market mechanism to work more smoothly.¹² These considerations suggest placing greater reliance on banks' own internal rating mechanisms. Internal ratings are of course easier to apply to corporations where there are data on credit history (so that default probabilities can be calculated) than to sovereigns. An important question about the use of internal ratings concerns the time horizon of banks' credit assessment. In most cases, banks calculate the probability of default over a near-term horizon (e.g. over one year), rather than over a full cycle. This by itself could lead to excessive cyclicality – with too much optimism during cyclical upswings and too much caution during cyclical downturns. The words “by itself” deserve emphasis: banks' risk management systems should involve more checks than simply calculating the near-term probability of default. They should also include allowance for unfavourable scenarios: a question to ask of all loans considered during a boom is, “how will it look in a recession?”

Regulatory bias towards short-term lending?

Under the present Accord, international interbank lending of up to one year has a 20% risk-weight irrespective of country. As interbank lending of more than one year to non-OECD countries carries a 100% risk weight, short-term lending to non-OECD countries may be encouraged at the expense of long-term lending. One possible consequence of this distinction is that bank lending to emerging markets is “too” short term, and thus more subject to cyclical forces. While a lower risk weight for short-term lending than for long-term lending may make sense for the lending of an individual bank (which is the focus of the supervisors), it makes less sense if all banks lend short-term so that the borrower is vulnerable to a sudden loss in liquidity. In other words the systemic (or macro) considerations may to some extent run counter to supervisory (or micro) considerations.

¹² A similar conclusion is reached by Morris and Shin's (1999) analysis of market mechanisms where outcomes depend on what others do, which can in simple models lead to multiple equilibria. They argue that when there are disparities in the information available to participants, the indeterminacy is largely removed.

How important this effect has proved in practice is open to question. Simple calculations suggest that the rule is unlikely to add more than 100 basis points to the charge for a long-term loan over a short-term loan.¹³ A second consideration is that a bank that holds capital above the regulatory minimum need not be constrained by officially-imposed risk weights – it may attach a lower risk weight for short-term lending on the basis of its own risk procedures. Informal enquiries made of banks and empirical studies have not resolved the question of the quantitative importance of the 20%/100% distinction.

At any event, the consultative document proposes to considerably soften this distinction. Under one option (where risk weighting depends on the rating of the bank rather than the sovereign risk rating), claims on banks of short original maturity (e.g. less than six months) will receive a risk weight one notch lower than for longer maturities.

The impact of implicit and explicit guarantees

The issue of guarantees presents a major dilemma for governments. On the one hand, the chances of a financial crisis can be increased by government guarantees because the perception of official protection leads market participants to take more risky positions. On the other hand, guarantees can serve to maintain confidence in the system and keep problems in one sector from spilling over into other areas. This is illustrated by the pros and cons for depositor protection schemes.

Most governments provide some form of protection for bank depositors (Table 4). Explicit deposit insurance schemes have become more common following the increased incidence of banking crises in the past two decades. Of 68 such schemes identified by Garcia (1999), 52 have been established since 1980 (and 18 extensively modified during this period). Deposit insurance is designed to protect small depositors who cannot be expected to monitor the soundness of their bank's asset portfolio. It may also encourage savings and the use of large-scale payments systems rather than less efficient media such as cash. It may also promote fair competition; otherwise depositors may uncritically avoid smaller financial institutions in favour of state-owned banks (which enjoy implicit protection), large banks (which may be considered too-big-to-fail) or foreign banks (which may be able to rely on financial backing in their home countries). It can also encourage timely bank restructuring by defusing political pressure or legal challenges leading to delays in closing banks.

¹³ For example, if a bank borrows at 4% and has a cost of capital of 20% (to choose a number at the high end of the range), then the additional cost of a longer-term loan is $0.08*(1-0.2)*(20-4) = 1.02\%$. (This assumes banks would not set aside more capital of their own accord for longer-term lending.) Bonte et al (1999, p24) compare the proportion of lending with maturity under one year to OECD economies with that to non-OECD economies with similar ratings. This suggested there was some effect among higher-rated borrowing economies but little among lower-rated ones (but it is based on a fairly small sample).

However, the provision of deposit insurance does raise moral hazard concerns. Demirgüç-Kunt and Detragiache (1998, 2000) and Rossi (1999) both provide econometric evidence that banking systems with deposit insurance are more likely to suffer crises. But moral hazard can be limited by properly designed coverage and pricing. One possibility is to impose a ceiling on the size of deposit covered: in this way, large depositors are held responsible for monitoring the deposit-taking institutions. The IMF suggests, as a rule-of-thumb, a maximum coverage of twice per capita annual income. Garcia's survey found insurance typically covered 90% or more of accounts by number but only around 40% of the total value of deposits. Additional limitations of coverage have also been imposed. One increasingly common practice is to limit each depositor to a single claim or to cover (a little) less than 100% (perhaps by delaying repayment significantly). Not all types of deposits may be protected. Garcia reports 27 schemes exclude all or some foreign currency deposits and 45 do not cover interbank deposits. Sixteen guarantee only, or mainly, household deposits.

However, such restrictions run the risk of eroding the stability-promoting characteristics of deposit insurance. Is a depositor's tendency to withdraw a deposit from an unsound bank materially greater if it involves losing 100% of the deposit (i.e. no insurance) than when it involves a loss of, say, 25% (i.e. capped insurance)? Furthermore, they may not be credible. In a generalised banking crisis, governments often feel obliged to offer a broad guarantee of all deposits to restore confidence, regardless of the modalities of the deposit insurance scheme.

Another possibility for reducing moral hazard is to charge banks premia related to the risks they undertake. However, while the 'best' assessment would draw on factors such as the quality of management, the premia charged would need to be based on some objective criteria (e.g. risk-adjusted capital ratios, the record of past losses; rating etc) so they can be justified to the bank, and to the courts should the bank challenge the ruling. Deriving such objective criteria is far from easy. In addition, premia set too realistically may be prohibitively expensive for institutions going through a temporary period of weakness. Nevertheless, risk-related premia have become more prevalent, and are used by a third of the countries surveyed by Garcia.

Table 4

Deposit protection schemes

	Year deposit insurance enacted	Membership compulsory or voluntary	Covers foreign currency deposits?	Covers interbank deposits?	Annual premium %	% of value of deposits covered	Coverage limit (ratio to per capita GDP)	Legal priority for depositors ?
Australia	none					0		√
Hong Kong	BC					0		√
India	1961	C	√	X	0.05	75	6.1	X
Japan	1971	C	X	X	0.05	79		X
Korea	1996	C	X ¹	X ¹	0.05			
Malaysia	none					0		
Philippines	1963	C	√	√	0.20		2.7	
Singapore	none					0		X
Sri Lanka	1987	V	X	√	0.15	very low	1.8	X
Taiwan	1985	V	X	X	0.02	45	3.3	X
Argentina	1971	C	√	X	0.36-0.72	40	3.1	√
Brazil	1995	C	√	X	0.30		3.7	X
Canada	1967	C	X	√	<0.33	40	2.1	X
Chile	1986	C	√	X			0.7	√
Colombia	1985	C	X	√	0.30	34	2.3	
Mexico	1986	C	√	√	0.30	100		√
Peru	1992	C	√	√	0.65-1.45		8.5	√
United States	1934	C	√ ⁴	√	<0.27	65	3.2	√
Venezuela	1985	C	X	X			1.9	√
Czech Rep	1994	C	X	X	0.50		2.3	X
France	1980	C	√ ²	X			2.6	X
Germany	1966	CV ³	√	X	0.03		0.8	
Hungary	1993	C	√	X	< 0.30		1.0	√
Italy	1987	C	√	X	0.40-0.80	83	6.1	X
Poland	1995	C	√	X	<0.40		0.3	
Switzerland	1984	V	X	X			0.5	X
United Kingdom	1982	C	√ ²	X			1.4	√
Israel	none					0		X
Nigeria	1988	C	X	√	0.94	21	2.1	√
Saudi Arabia	BC					0		X
South Africa	BC					0		BC

BC: being considered 1. covered by temporary government guarantee. 2 European currencies. 3. C for commercial banks, V for others. 4. Onshore accounts only. Sources: Garcia (1999); Hawkins and Turner (1999) Table 13, central banks.

Market discipline for banks

As financial markets become increasingly complex, it is inevitable that the market will play a bigger-and-bigger role in providing oversight of financial institutions. If market discipline is to function effectively, fuller and more accurate information is needed on (i) individual bank performance and (ii) the condition of the banking system. At present, the lack of consistent data, properly treating non-performing loans, on individual banks in many emerging markets makes it difficult to form a true picture for the banking system as a whole. Not even consistent data on banks' capital ratios are available for most countries. The lack of banking system indicators is a major vacuum in the statistics available at present for surveillance purposes. Putting this right deserves high priority.

Three ideas have been put forward recently as ways of strengthening market discipline: requiring local banks to negotiate credit lines with foreign banks; encouraging the establishment of foreign banks in the domestic market; and, finally, fostering (or requiring) the issuance of subordinated debt.

Banks, long required to hold liquid domestic assets to meet domestic currency liabilities, could be required to hold (or have guaranteed access to) liquid foreign currency assets. As Powell (1999) comments "if there is a crisis of confidence in an emerging country banking system, there will be an increased demand for foreign assets and reserves in domestic assets may not help". Requiring banks to establish credit lines with international banks is akin to privatising the lender of last resort function. As such facilities will be on a commercial basis, the potential lender has incentives to examine the health of the bank seeking such a line and impose conditions on it. If a competitive market can be established, the price charged should reflect the risks involved and so encourage the banks to limit their risks. There may be a problem with the home supervisors of the potential lenders being uneasy about their banks taking on a large exposure to a troubled bank. There will also be a need to ensure that such credit lines are legally watertight as the bank providing the loan may well balk when faced with making a loan to a troubled customer.

A second strategy can be to encourage the entry of foreign banks. Foreign banks offer many advantages. They are less likely to engage in connected lending. They may improve the quality and availability of financial services in the domestic market by increasing competition and applying new skills and technology. They may have faster and cheaper access to international capital markets and liquid funds (via parent banks). The additional oversight by foreign supervisors may make them sounder. Some emerging economies may be too small to have a purely domestic banking system that is adequately diversified.

Nonetheless it is entirely understandable that governments will be reluctant to have their banking systems dominated by banks from a single country, in case problems in that country lead to the subsidiaries cutting back their operations. For this reason, they may seek to

“diversify” foreign owners. Many authorities feel it is desirable to keep some banks for whom the domestic market is their prime focus; otherwise domestic lending – notably to small businesses – may be neglected.

A third possible strategy is that banks be required to issue standardised subordinated debt.¹⁴ This would generate a better market estimate of bank risk than do equity prices at present: while a simultaneous increase in risk and expected return could either raise or lower the share price, it should unambiguously lower the price of subordinated debt. Argentina’s supervisory authorities require banks to issue 2 per cent of their liabilities as marketable debt securities, with a minimum maturity of two years. Benink and Calomiris (1999), Garber (2000) and Litan (2000) discuss making the issue of subordinated debt with minimum two-year maturity (and a contingency clause terminating it in the event of a bailout) mandatory for large banks.

In Benink and Calomiris’ (1999) words, subordinated debt could be the “canary in the coal mine of bank risk”. The theory is that when a bank becomes weaker, the price of its bonds would decline, and induce depositors and investors to move to stronger banks. Hence the banking system itself is not hurt: there is merely a re-allocation from weak to strong banks. Furthermore, deposit insurance premia could be set based on the yield on the bonds or supervisors might act if it rose too much. A more radical suggestion is that banks may be forced to shrink their balance sheets if the yield on their subordinated debt exceeded (for a certain period) some prescribed maximum such as the spread on BBB paper. Setting such a ceiling would be a difficult task; if too high, it would never bind but if too low it could cripple the banking system in a crisis.

Another tricky question is who should be allowed to hold banks’ subordinated debt. Litan suggests related companies or banks who join in any syndicates with the issuing bank (in practice this might mean all large banks) would be banned from holding it to prevent collusion (such as banks just swapping subordinated debt with each other at non-market rates). Such a restriction might also be necessary to avoid a new avenue of contagion. However, this restriction would eliminate the potential buyers best placed to evaluate and trade the subordinated debt.

The subordinated bonds requirement remains as yet untested: a very sharp recession (or some other exogenous shock) would force down the prices of subordinated bonds issued by all banks and this effect may swamp the differences among individual banks. If so, the

14 In the US, the Gramm-Leach-Bliley Act of November 1999 requires the Treasury and the Federal Reserve Board to conduct a joint study of a proposal to require large insured banks to issue subordinated debt. In doing so they are likely to draw on a report by the Federal Reserve System Study Group (1999), which includes summaries of numerous proposals.

banking system as a whole will be forced to cut back credit and an additional element of procyclicality would have been added.

Developing deeper financial markets

Financial intermediation in many emerging markets is too bank-centred and financial markets are relatively underdeveloped. This has several disadvantages. The first is that credit risks are concentrated on banks. The second is that there are limited local currency instruments for banks to hedge, e.g., maturity risk. The third is that highly-rated corporations are led to borrow long-term funds abroad rather than in the domestic market.

A particular shortcoming in many emerging markets (notably in Asia) is that domestic bond markets are relatively underdeveloped. Outstanding volumes are relatively small (Table 5) and turnover is very low. In some cases, banks may be forced to buy government bonds at below-market interest rates. Developing bond markets would help extend the average maturity of debt within the region, as well as facilitating risk management by banks.

An important reason for the small size of bond markets is that Asian governments have generally not run budget deficits requiring large bond issuance. The absence of a yield curve for benchmark government bonds also makes it difficult to price corporate bonds and inhibits their issue. However, government deficits have recently risen sharply across Asia and are likely to remain high for the foreseeable future. In addition, a large volume of bonds is being issued to finance bank recapitalisation. Bond markets in Latin America have been inhibited by periodic bouts of inflation, but as low inflation becomes more established in this region, bond markets should also develop.

This raises the question of the official role in the development of a bond market. In the first place, providing a stable low-inflation macroenvironment is an important contribution but may not be sufficient. The authorities can provide, or co-ordinate, a supportive infrastructure. Important elements would be standard documents, appropriate governing legislation and an efficient registry, trading and settlement system linked into the payments system so as to allow delivery-versus-payment. Other supportive measures include removing legal, regulatory or taxation impediments to greater market liquidity, releasing information on yields and volumes traded, and promoting transparency, competition and market-making. Listing bonds on the stock exchange may make them more liquid, especially for retail investors. International linkages between national systems could further broaden and deepen bond markets.

Table 5
Emerging economies' financial markets
end 1998; % to GDP

	Domestic bonds	(of which: private sector)	International bonds	Domestic bank credit	International bank loans ¹	Equity market capitalisation
China	20	(7)	2	113	1	24
Hong Kong	18	(14)	18	162	9	248
India	31	(7)	2	25	3	28
Indonesia			20	51	25	17
Korea	64	(50)	15	65	3	31
Malaysia	84	(53)	18	107	4	146
Philippines			16	53	8	52
Singapore	18	(2)	6	110	6	124
Thailand	11	109	7	26
Argentina	21	(14)	16	21	7	13
Brazil	52	(11)	6	28	5	22
Chile			8	62	22	73
Colombia			8	25	12	15
Mexico	9	(2)	14	18	13	24
Czech Rep	38	(8)	3	71	4	20
Hungary	33	(1)	26	26	7	30
Poland	18		2	25	3	13
<i>Memorandum</i>						
G3 ²	124	(51)	13	102	4	74

¹ Loans to domestic non-banks by BIS-reporting banks. ² Simple average of Germany, Japan and United States.
Sources: BIS, IMF.

Secondly, official action to support the establishment of a secondary mortgage market would also help bond markets to develop. Liquidity could also be enhanced by the public sector concentrating on certain benchmark issues, encouraging repo markets. Encouraging the use of international credit rating agencies (and perhaps the establishment of domestic agencies) and the use of credit enhancements could also make such paper more marketable. On the demand side, the development of pension funds would create natural buyers for longer-term paper.

One cautionary note is that deeper markets may make a small country more vulnerable. International funds managers will sometimes sell in a liquid market as a proxy for selling in an illiquid market when markets in small economies tend to move closely with those in large

economies. A second consideration that may argue for caution is that bond issues could skim off the better corporate credits from the banking system, weakening the average quality of their loan portfolio. This will depend in part on how far domestic corporate bond issuance substitutes for domestic bank loans. Many large corporations already rely more on issuance of international bonds than on bank loans. For such firms, a deeper domestic bond market will tend to divert business from international markets rather than from domestic banks. The overall impact will therefore partly depend on whether it is only highly-rated large companies (already active in international bond markets) that issue domestic securities, or whether issuance will extend to other good quality entities – or even as in the US to the issue of “junk bonds”. How far (if at all) regulators should seek to influence the ‘credit-rating cut-off’ for domestic bond issuance is one important issue. A second issue is whether the authorities should somehow discourage shorter-dated issues – either to lengthen the average maturity of debt in the economy or to avoid hedge funds using the swapped proceeds of such issues for currency speculation.

Equity markets are an important source of long-term capital for firms. They also facilitate privatisation of state-owned enterprises. They tend to become relatively more active and efficient as economies develop, particularly in countries with a common law rather than civil law tradition, and there is some econometric evidence that equity market development enhances economic growth.¹⁵ But, as Rogoff (1999) comments, there are some ways in which policy (inadvertently) discriminates in favour of bank lending rather than equity markets; deposit insurance makes debt less risky and legal protection is often stronger for lenders than shareholders.

More contentious is how quickly derivatives markets should be developed in emerging economies. While potentially useful for risk management by sophisticated players, derivatives can give rise to dangerous exposures when used by inexperienced institutions. There is also often a problem generating sufficient transactions to have deep derivatives markets in small economies. A better alternative may be to use international derivatives markets for ‘proxy hedging’.

¹⁵ See Demirgüç-Kunt & Levine (1999), Levine (1997) and Levine and Zervos (1998).

International aspects

A global regulatory authority?

Practical steps to reduce contagion in the global financial system are likely to take the form of incremental reforms rather than grand solutions. Given how jealously nations guard their sovereignty, proposals for a global mega-regulator, or global central bank¹⁶ are unlikely to be realised in the foreseeable future. The single market/ single currency project among the relatively homogenous European countries is still in progress after half a century. And even within the single currency zone, financial supervision remains with national regulators rather than a Euro zone supervisor.

Nevertheless better co-operation between the existing institutions is needed to avoid costly overlaps and set priorities for dealing with new areas of financial vulnerability. To this end the *Financial Stability Forum* was established in 1999 with a small secretariat housed in the BIS. It brings together the BIS, ECB, IMF, OECD, World Bank, international committees concerned with financial stability and supervision and senior treasury officials, central bankers and financial supervisors from 11 economies with a prominent role in the international financial system (G7 plus Australia, Hong Kong, Netherlands and Singapore). The term “pragmatic multitherapy” captures this approach well.¹⁷

Transparency

There have been a number of recent initiatives aimed at improving the transparency of the international financial system, addressing both the official and private sectors.¹⁸ They cover the availability, accuracy and international comparability of data. The work of the International Accounting Standards Committee, which has representatives from over a hundred countries, is one important element in this. Parallel to this is the development of international auditing standards by the International Federation of Accountants and the International Organisation of Supreme Audit Institutions. The international financial institutions can encourage and assist these developments, perhaps certify or assess compliance with the resulting standards or even make lending conditional on countries adopting them.

The IMF’s Special Data Dissemination Standard (SDDS) establishes minimum standards for the coverage, frequency and timeliness of key macroeconomic data. The prescriptions for international reserves data were significantly strengthened in March 1999 to

¹⁶Eichengreen (1999) and Rogoff (1999) catalogue some of these proposals.

¹⁷ See Icard (2000).

¹⁸ For example, the Working Group on Transparency and Accountability’s (1998) report to the G22 (“Willard Group”) and the private sector Institute of International Finance’s *Report of the working group on transparency in emerging markets finance* of March 1999.

follow a template developed in conjunction with the Committee on the Global Financial System¹⁹. This amendment reflects a view that the data available on reserves in the run-up to the Asian crisis were misleading (in that they omitted off-balance-sheet transactions that had reduced the amount of reserves available for the defence of a besieged currency²⁰). There are various ways in which adherence to the SDDS is being encouraged. Firstly, the list of subscribers is public. It may be given greater prominence as part of the “Reports on Observance of Standards and Codes” being developed by the IMF. Secondly, it has been announced that only subscribing countries will be eligible for the IMF’s new contingent credit line.

The requirements for data on foreign debt are also being strengthened in the SDDS²¹ and international standards are being developed for its compilation. This has attracted more attention as a potential ‘early warning indicator’ since the Asian crisis. As borrower data are often incomplete, the BIS data on lending by international banks are an important source. Those data are supplemented with other components of external debt from three other international agencies (OECD, IMF and World Bank) to form consolidated statistics on the external debt of 176 developing and transition economies. These data have been released quarterly on the agencies’ websites since March 1999.

The development of the internet has greatly facilitated the international provision of data but there are few independent checks on data quality. Banks and corporations under pressure have an incentive to disguise the full extent of their problems –and this may be true of governments and central banks as well. Peer review, such as happens within the EU, may be one useful way of enhancing the quality and consistency of statistics.

Even so, it should not be thought that providing more information will prevent future crises. It was notable in the Asian crisis that little attention was paid to data about foreign debt that were readily available.²² Those who advocate more extensive statistics must remember that excessive reporting burdens are costly for the private sector and that a surfeit of data can dilute observers’ focus.

¹⁹ A committee of G10 central banks meeting under the aegis of the BIS.

²⁰ The Working Group on Transparency and Accountability (1998, pp15-16), comment “following the flotation of its exchange rate on 2nd July 1997, Thailand revealed that although the central bank held gross reserves of US\$32 billion at the end of June, outstanding forward and swap liabilities totalled US\$29 billion. In Korea, the central bank reported that gross reserves totalled US\$24 billion at the end of November, but almost two-thirds of this amount was not readily available to the Korean authorities because it had been deposited with overseas branches of Korean banks to assist the banks in meeting their external obligations.”

²¹ External debt data are required under the ‘international investment position’ category of the SDDS, but given the difficulties of compiling those data, subscribers have until the end of 2001 to disseminate it.

²² See Hawkins (1999).

International rules of the game

Particularly since the recent financial crisis started in 1997, there has been considerable discussion about “bailing-in” private sector creditors into the resolution of international financial crises, rather than just using taxpayers’ money (often distributed via the IMF). Recent reports²³ have suggested all international bond issues follow UK practice and incorporate provisions enabling a more orderly debt rescheduling without the process being held hostage by a small minority of lenders or bondholders. Majority voting (perhaps requiring a three-quarters or higher majority) and collective representation clauses and standing committees of creditors would expedite matters.

Buiter and Sibert (1999) have proposed every new foreign currency loan or bond should be required to have attached an option entitling the borrower to extend performing debt for a specified period (the authors suggest three or six months would be enough to get past a disorderly or crisis period) at a penalty rate.

Sachs (1995) has gone further and proposed an international bankruptcy code/court. This is likely to be impractical, at least in the medium-term, for the reasons discussed above. The analogy with a domestic bankruptcy court is far from perfect. As Rogoff (1999, p17) comments “it would seem unlikely that an international court would have the right to enter a debtor country and seize physical assets, much less fire the ‘board of directors’—in this case the country’s government”.

Soros (1998) has suggested a new international institution, the International Credit Insurance Corporation that would guarantee international loans for a fee. But the authority would have a ceiling, set based on debt and macroeconomic factors in conjunction with the IMF, beyond which it would not offer such insurance. Under Soros’ plan the IMF would not aid countries having difficulties servicing uninsured (excess) debt. Making such a statement credible would not be easy given that a default on uninsured debt could still trigger a crisis in international financial markets. There are also practical questions that would be difficult to address, such as how to choose which loans to insure and how the IMF should respond if macroeconomic conditions or policies deteriorate (revoke some existing insurance?).

There is a trade-off in reforming the rules of the game. On the one hand, to get as much international consistency as possible argues for involving a range of both advanced and emerging economies in their formulation. On the other hand, amending them in a timely fashion to keep up with the rapidly evolving financial markets would be easier if only a small group are involved.

²³ Such as the Rey Report to the Group of Ten (1996) and the Working Group on International Financial Crises (1998).

International organisations have also sought to address legal problems. The United Nations Commission on International Trade Law has developed a model law to deal with cross-border insolvencies. The International Organisation of Securities Commissions has encouraged multilateral agreements to deal with fraud cases crossing national borders.

Regulatory gaps

The imposition of taxes or controls on short-term capital flows by recipient countries is covered by Chang and Majnoni (2000). However, there is also a case for some control on such flows by the regulators in the source countries. This is already done to varying degrees for banks but mutual funds, and more particularly hedge funds, are largely unregulated. (Furthermore, hedge funds stand accused of not just herding but deliberate market manipulation.)²⁴

Griffith-Jones and Kimnis (1998, p199) suggest “it seems important to fill this regulatory gap and introduce some source country regulation that will both protect their domestic investors (especially the less informed retail investors), but also discourage excessive surges of portfolio flows to emerging markets. This could perhaps be best achieved by a risk-weighted cash requirement for institutional investors.” This could help competitive neutrality if it was set at a comparable level to the banks’ capital adequacy requirement. Furthermore, by tying such a requirement to a weighted measure of some macroeconomic fundamentals in the countries in which the fund invests, it might mean a deterioration in an economy’s fundamentals was followed by a gradual reduction in the flow of funds to that economy (rather than an abrupt reversal later). It is also desirable for bank supervisors to limit, or at least closely monitor, the funds advanced by banks to highly-g geared speculative players such as hedge funds.²⁵

Regional co-operation

Regional co-operation to limit contagion may take many forms. One aspect is regional fora to discuss and share experiences. These meetings include both regular formal occasions and more informal ad-hoc meetings. Some are organised under the auspices of international agencies such as the BIS and IMF. Others are organised by regional groupings such as

²⁴ Hedge funds is used here to cover a range of “highly-leveraged financial institutions”, proprietary trading desks of investment firms and even treasury desks of some banks which make speculative plays. There is debate about how active and damaging has been the role of hedge funds in international financial markets. Grenville (1999, p47) describes their activities as “part of a concerted effort at market destabilisation. Some of the players themselves told us, at the time, that their objective was to push down the yen to the stage where the renminbi was under irresistible pressure to devalue, which would have broken the Hong Kong dollar peg.... As the hedge funds cut their short positions in yen to cover their disasters in the rouble, the yen rose 15 per cent in a little over a day, driven by events unrelated to any Japanese fundamentals.”

²⁵ See the papers by the “Brockmeijer Group” – BCBS (1999a, 1999c, 2000) – for further discussion.

CEMLA, EMEAP, SAARC, GCC and SADC.²⁶ Some regional groupings may conduct regional surveillance and peer review (e.g. Manila framework).

Taking co-operation a step further is the sharing of information on the operations of individual banks between national supervisors. This may require the exchange of memoranda of understanding to avoid breaches of privacy commitments covering information gathered under statutory authorisation. The G7 Principles for Information Exchange provide a possible template for this. As well as prudential aspects, information exchange may cover monetary policy matters. Information about the activities of hedge funds etc could help defend exchange rates in the face of speculative attacks.

The next stage of co-operation is regional agreements to provide financial assistance. An example of this is the ERM under which, in the event of a speculative attack driving a pair of currencies to the maximum allowed deviation from the central parities, the central banks of both the strong and weak currency were obliged to intervene in markets. Among emerging markets, a network of repo agreements had been instituted within a number of Asian economies. This did not involve them in any credit risk as the funds they agreed to advance to each other were to be fully collateralised by US treasury bonds. However, it was hoped the arrangement would give access to finance in a crisis on faster and more confidential terms than would simply selling the treasuries in the market. It did seem for a time that the scheme boosted confidence in the Asian currencies, but it proved unable to withstand the massive selling pressures that developed in mid-1997. Regional agreements to provide liquidity are problematic if contagion is regionally based as many countries in the same region will want assistance at once.

Conclusion

This paper has sought to raise some prudential issues at the heart of the debate on international financial reform. There are no settled or generally agreed answers to many of the questions. Moreover, any answers are likely to change as conditions evolve. Prudential oversight can no more stand still than can markets. One of the most difficult tasks the official community faces is to ensure that approaches that make microeconomic sense (i.e. for individual institutions) also make macroeconomic sense (i.e. in aggregate). This applies to capital ratios, the use of credit rating agencies, the risk weights for short-term as opposed to long-term lending, the use of mark-to-market accounting and to many other key questions. Because the nature of systemic stability remains ill-understood, such questions will continue to be controversial. A second set of dilemmas arise from the fact that several distinct public

²⁶ These refer to the Centro de Estudios Monetarios Latino Americanos, Executive Meeting of East Asian and Pacific central banks, South Asian Association for Regional Cooperation, Gulf Cooperation Council and Southern African Development Community respectively.

policy interests share a stake in the financial system and proposals that may make sense to one interest may not appear so attractive to another. The attitude of the tax and securities authorities to precautionary provisioning is one case in point. A final question lurking behind many of the debates is how quickly do we want the financial system to respond to changes in perceptions of risk. The desire that risk be better priced suggests the need for faster and fuller responses. But at the same time we do not want to introduce more pro-cyclicality into the financial system. Balancing these two objectives is not always easy.

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