FINANCIAL SERVICES REGULATION

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6th IEA DISCUSSION PAPER

THIS PAPER IS THE TEXT OF THE IEA / CASS BUSINESS SCHOOL FINANCIAL SERVICES REGULATION LECTURES, 2003 HELD AT CASS BUSINESS SCHOOL, CITY UNIVERSITY

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International Standard Setting in Financial Supervision

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5th February 2003

Cass/IEA Financial Services Regulation Seminar Series 2003

WWW.IEA.ORG.UK

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Introduction

It is a pleasure to be with you for this first lecture in the Institute of Economic Affairs/Cass Business School series. The IEA has long been a significant voice in making the intellectual case for open markets. I have not always found myself in agreement with the positions taken in their publications, but I doubt whether economic thinking and economic policy in the United Kingdom would be where it is today without the IEA's advocacy.

The City University Business School, now the Cass Business School, is of newer vintage, but promises to be equally influential. Under the leadership of David Currie and with its unique location and handsome new quarters, it too should be a powerful intellectual face of modern Britain, and its financial sector. It is, indeed, an honour to be the first speaker in this series.

This evening, I would like to talk about the subject of financial stability: what it means; why it is important; why is has, arguably, become more difficult to achieve; and what can be done about it.

This topic is somewhat wider than the one advertised, though it encompasses it. The reason for the extension is two-fold. First, as the first speaker in this series of seminars, it is perhaps appropriate for me to take a broad view of some of the issues to be dealt with in later lectures. Second, standard-setting in financial supervision needs to be seen in the context of the overall goal of improving the efficiency and resiliency of financial systems.

What is financial stability?

First, to definitions. I will take financial stability to be a situation in which the *capacity of financial institutions and markets to efficiently mobilise savings, provide liquidity and allocate investment is maintained unimpaired.*

Financial stability is distinguishable from monetary stability (though the two are often complementary). Monetary stability is usually taken to mean stability in the overall value of money - otherwise put, low and stable inflation. Financial stability means the absence of strains that curtail the intermediation function of the financial system.

Note that in my definition, financial stability can be consistent with the periodic failure of *individual* financial institutions, and with fluctuations of prices in markets for financial assets. The failure of individual institutions is of concern only if it leads (as it sometimes can) to an impairment of the basic intermediation role of the financial system at large. And asset price volatility is of concern only if it leads to a severe misallocation of capital.

Why is financial stability important?

Twenty-five years ago, the dominant monetary and financial issue facing the industrial world was the control of inflation. In 1980, consumer price increases in the OECD countries, though lower than their peak, still averaged over 10%, and seemed to be headed higher. Inflation was having serious social and political, as well as economic consequences. It had proved remarkably resistant to policies adopted to combat it.

By contrast, the issue of financial instability scarcely registered as a major concern of policy makers. To be sure, there had been isolated episodes of strain, such as the secondary banking crisis in the United Kingdom, and failures of individual institutions, such as Bankhaus Herstatt in Germany and Franklin National Bank in New York. None of these, however, had created wider financial or economic consequences.

Now, a quarter of a century later, there has been a remarkable evolution. Thanks to resolute action by central banks, the battle against inflation has been largely successful. Meanwhile the problem of financial instability has moved up the policy agenda. On the face of it, this is strange. Why has price stability not yielded a "peace dividend" of greater financial stability? And why has financial turmoil proved so troublesome to manage?

To anticipate the conclusions a bit, I will be making five interrelated points. **First**, following a wave of financial liberalisation, the financial system has come to play a much larger role in the allocation of resources than was the case twenty-five years ago. The capacity of financial system weaknesses to generate strains and even crisis has therefore grown. So have the real economic consequences when the system malfunctions.

Second, there are elements in the functioning of financial markets that naturally tend to overreaction. This "fear and greed" phenomenon is not simply driven by human nature (though this should not be underestimated) but also by elements specific to the dynamics of financial markets.

Third, while a stable monetary environment helps the efficient functioning of the financial system in many respects, it may not be sufficient to eliminate these tendencies to excess. In one respect, indeed, it may even encourage them. Confidence in the power of the authorities to manage the economy can encourage excessive risk taking, if economic agents come to discount downside risks.

Fourth, greater stability can be achieved through a supervisory approach that harnesses the prudential aspects of market disciplines. This means that the behavioural norms and prudential standards incorporated in systemic oversight need to focus on providing accurate financial *information* to market participants, and a framework of *incentives* that encourages a proper weighting of downside risks.

Fifth, and last, there is a need to strengthen the macroprudential (or system-wide) aspects of the supervisory framework, including the way in which standards and codes are implemented. We must be aware of the risk that even individually rational and prudent behaviour can at times become systemically destabilising.

The growing role of financial intermediation

As I have just noted one reason for the increased importance of financial stability is the fact that the financial system now plays a greater role in resource allocation than it did twenty-five years ago. There have been many contributory factors in this development, but it is helpful to think of the main driving forces being those of liberalisation and technological innovation. Liberalisation, in turn, has been driven both by ideological trends (the ascent of the free market philosophy) and by the sheer impracticability of maintaining restrictions and controls in the face of technological innovation.

Liberalisation has affected many aspects of economic life, but the main developments of relevance to the financial sector can be listed as follows:

(i) The reduction in the role of the state in economic activity through privatisation and the lifting of administrative controls;

(ii) Removal of impediments, direct and indirect, to competition between financial institutions;

(iii) The removal of restrictions on the pricing of financial transactions, such as rates of interest paid and received by banks; and

(iv) The removal of restrictions on international capital movements and the widespread introduction of convertibility.

Technology has affected the financial sector in two ways: first, by reducing the cost of processing and communicating information; and second, through the development of new instruments for the measurement and management of financial risk. A dramatic reduction in the cost of financial intermediation has not only drawn new users into the system (ultimate savers and borrowers) but, even more dramatically, encouraged a greater *intensity* of financial intermediation (i.e., more intermediate transactions between the ultimate lender and borrower). The development of new financial instruments has enabled a quantum leap in the scope of risk management - an advance that has facilitated risk-taking as well as risk-shedding.

The impact of technology and liberalisation on the role of the financial system has been compounded by two other trends in western societies. One is growing levels of personal wealth, and the other is the aging of populations. Together, these trends have resulted in greater volumes of financial savings seeking outlets in the capital markets and in financial intermediaries.

The growing role of the financial sector in the allocation of resources has significant potential advantages for the efficiency with which our economies function. If financial markets work well, they will direct resources to their most productive uses, as measured by relative rates of return adjusted for risk. Risks will be more accurately priced and will be borne by those most willing and able to do so. Real economic activity will proceed with fewer financial uncertainties. Investment should increase in quantity and improve in quality as a result.

There is another side to the coin, however. The fact that our economies have become more dependent on their financial systems means that, if the financial system malfunctions, the adverse consequences are likely to be more severe than they used to be. The past decade or so has provided ample evidence of the costs of financial instability. At the international level, think of the Mexican crisis of 1994-95; think of the East Asian crisis of 1997-98; think of the Argentine crisis that began in 2001 and is still far from reaching its end.

At the national level, there are also examples of costly financial instability in advanced countries. These include: banking crises of Spain and the Nordic countries in the 1980s; the S&L crisis in the United States; and the financial bubble in Japan, whose costs are still being felt today. Closer to home, if one defines financial instability broadly, is the ERM crisis of 1992. And the recovery of the United States from the recession of the early 1990s was delayed by financial “headwinds” resulting from strained balance sheets.

The Stability/Instability properties of Financial Markets

The growing role of financial markets does not by itself explain why financial instability has become more prevalent. So let me now turn to a closer analysis of why open financial markets have proved vulnerable to periodic episodes of stress.

As western countries embarked on the process of liberalising their financial markets, little thought was given to the possibility that this might result in an increase in financial instability. It was generally assumed that in financial markets, as in those for other goods and services, open competition would produce stable equilibrium prices. If, in addition, low inflation could be achieved, that would further support overall financial stability.

This sanguine view did not take into account some particular characteristics of financial markets that differentiate them from the conventional model of equilibrium price determination. Let me note four such characteristics.

First, *fundamental value is extremely hard to assess*. We can define a financial asset's value as the product of its expected flow of income, a discount rate and a risk premium. But this does not get us very far. The key element in judging the value of a financial asset is how much it can be sold for in the market. A function of financial claims is to telescope into the present intrinsically uncertain cash flow streams. In assessing these uncertainties, there are strong psychological incentives to extrapolate recent experience, and to fall victim to current fashions about how assets should be valued.

Such partial vision is true of individual agents taken in isolation. It is even stronger in the social behavioural patterns reflected in market prices. Price reactions to "news" can go through phases in which, whatever the intrinsic information content, the news is interpreted as reinforcing the prevailing paradigm. The "new economy" euphoria of the late 1990s is only the most recent example of such a phenomenon.

Second, in the financial sector, the *process by which equilibrium is maintained does not work in quite the same way as in other industries*. Normally, we think of supply and demand curves as being well-behaved. The increased supply of a product exerts downward pressure on its price, thus limiting the eventual increase in supply. In the case of credit, however, an expansion in supply can, for a time, strengthen economic activity and boost asset prices. By thereby improving the balance sheet position of both borrowers and lenders, it can sustain further increases in the supply of credit. Excess capacity and risk can build up partly unnoticed. The mutually reinforcing process between perceived wealth and access to external funding masks the extent of the underlying financial imbalance, until the process, when it goes too far, at some point unwinds. The amplitude of the financial cycle is thereby augmented.

Third, *the leverage inherent in financial intermediation gives rise to fragile balance sheet structures.* The sudden and sometimes indiscriminate retrenchment of suppliers of funds can cause institutions and markets to be starved of liquidity, exacerbating price declines and impairing the functioning of markets. Bank runs are the textbook example. But there are also cases of markets functioning in a similar way. In the wake of the LTCM crisis, for example, liquidity virtually dried up for a while, and the financial system was perilously close to a full-blown crisis. In my own institution, the BIS, the value-at-risk in our securities portfolio doubled within a few weeks, with essentially no changes in portfolio composition.

Finally, *moral hazard plays a potentially important role:* the forms of official protection put in place in response to past episodes of financial instability have weakened market discipline without providing offsetting prudential incentives.

While the above characteristics are inherent in financial activity, and in the institutional safeguards put in place in the first half of the 20th century, a number of changes in the financial regime over the past twenty-five years have arguably increased the potential for financial instability. All of them can ultimately be traced back to the financial liberalisation and technological innovation that has gathered pace during the period. This process has resulted in a broader range of services, at lower prices, and more accessible terms than ever before. But these great benefits have not come for free. Let me focus on four implications of financial liberalisation and technological innovation.

First, *competitive pressures have vastly increased.* This means that the rents that licensed financial institutions could previously extract from their protected franchises have diminished, if not disappeared altogether. The cushion available to absorb mistakes or misfortune has become much thinner. Previously sheltered financial institutions have had to learn to manage risk more actively, with a smaller margin for mistakes. Frequently, they have had to compete with new entrants, not saddled with burdensome cost structures inherited from the past. Net operating margins have thus come under pressure, making it harder to earn a given return for the same amount of risk. Consequently, the incentives to enhance returns by taking on added risk have grown.

Second, *the new environment has structurally increased liquidity and the potential for leverage.* The development of new financial instruments, and financial engineering more generally, has made it easier for firms, both financial and non-financial, to realise value from assets, whether tangible or intangible. This has, in a sense, "liquefied" a wider range of income streams, and by the same token, increased the potential for leverage. Moreover, the hugely increased emphasis on stock market value has encouraged the exploitation of leverage. In a rising market, leverage is the winning formula. If the period of rising asset prices is protracted, market participants can come to forget the warning that regulators now insist be included in the small point of stock offerings: "Prices can go down as well as up".

Third, *the new environment has tended to raise the option value implicit in safety nets*. The reason is simple. Ceteris paribus, guarantees become more valuable as the environment becomes riskier. So the hidden subsidy provided by the official sector has become greater, and the danger of resource misallocation through the mispricing of risk has grown.

Finally, *financial globalisation has transformed geography*, with significant implications for the character of instability. Globalisation has heightened the significance of common factors in originating and spreading financial distress. It has done so by extending and tightening financial linkages across institutions, markets and countries; by increasing the uniformity of the information set available to economic agents; and by encouraging greater similarity in the assessment of that information.

Freedom of capital movements has exposed emerging market countries to potential volatility of access to external funding. Portfolio adjustments that are comparatively minor for institutions in the countries originating capital flows can be of first order significance for the recipients. This greatly increases the recipients' vulnerability to changes in sentiment, whether these are due to revised perceptions of economic conditions in the periphery or to developments at the core.

Some of the environmental changes I have just described are particularly acute during the transition from a sheltered to a liberalised environment. Others, I suspect, have a more permanent character. The bottom line is that market discipline alone may be insufficient to ensure the necessary degree of stability. Hence the issue of whether additional policy action is needed to protect the system against instability. But before I discuss this question, let me say something about the link between financial instability and the monetary regime.

Why has price stability not produced financial stability?

It is not uncommon for economists and financial practitioners to argue that monetary stability should yield, as a by-product, improved financial stability. There is, indeed, much validity in this contention. Inflation has always provided fertile ground for resource misallocation and facilitated the build-up of over-extended balance sheets. Inflation makes it harder to distinguish between real and nominal magnitudes. Moreover, since *high* inflation is almost invariably *unstable* inflation, the expectations on which financial judgements are based, are rendered even more difficult to form with confidence.

However, it would not be right to say that price stability is a sufficient criterion for financial stability. There are numerous counter-examples, of which the Japanese and East Asian cases are only the most prominent.

Two possible factors help explain why financial instability seems to persist, even in a world in which price stability has been credibly established. One lies in the paradox that success in taming inflation can make economies even more vulnerable to those waves of excessive optimism that breed unsustainable asset price dynamics. A danger sign is the increased prevalence in upswings of articles heralding the "end of the business cycle". In such circumstances, many may come to believe that low inflation removes a common cause of the termination of economic expansions, namely a sharp tightening of monetary policy. They may thus be tempted to accept balance sheet structures that are particularly vulnerable to changes in financial conditions.

The second possible factor is a more controversial conjecture. It is the following: in a monetary regime in which the central bank's operational objective is expressed *exclusively* in terms of short-term inflation, there may be insufficient protection against that build up of financial imbalances that lies at the root of much of the financial instability we observe. This could be so if the focus on short-term inflation control meant that the authorities did not tighten monetary policy sufficiently pre-emptively to lean against excessive credit expansion and asset price increases. In jargon, if the monetary policy reaction function does not incorporate financial imbalances, the monetary anchor may fail to deliver financial stability.

One response to this conundrum could be to modify, at least at the margin, the monetary strategies. I have addressed this controversial question on other occasions, and I do not want to return to it here today. Rather, I simply want to make the point that, if the monetary anchor is, along with conventional market forces, insufficient to produce financial stability, then additional policies may be needed to achieve these objectives. This brings me to the final part of my remarks, on the design of prudential standards and codes to enhance the stability of the financial system.

Standards and codes

In principle, a competitive financial system should eventually eliminate poorly performing institutions or market platforms, and should encourage the development of prudent and efficient practices. In other words, competition should foster convergence towards best practice in risk management. For various reasons, however, this may not happen, or may not happen quickly enough. Hence the justification for official oversight of the financial sector, to strengthen prudential management.

Prudential supervision of financial institutions has a long history. In the past, financial sector regulation tended to focus on the authorisation of financial institutions, on the definition of their permitted spheres of activity, and on required balance sheet ratios. More recently, however, growing attention has been devoted to the prudential management of risk. Several trends in supervisory standard-setting are worthy of note.

First, there is growing recognition that the most effective regulatory framework is one that works with the grain of market forces, and allows the greatest play to market disciplines. Hence the search to relate regulatory requirements to risk management practices, and to find ways to increase transparency.

Second, it is increasingly accepted that globalisation of financial activity means that prudential norms have to be internationally consistent. Otherwise, the twin risks of regulatory arbitrage and competition in laxity are likely to present themselves. The international dimension of standards and codes raises the issue of how such standards should be developed, a subject to which I will return in a moment.

Third, it is now recognised that efficient financial intermediation requires a high-quality financial infrastructure. By infrastructure, I mean the network of conventions, practices, and information that underlie market activity. This includes the system of contract law and law enforcement, bankruptcy procedures, the accounting framework and auditing standards, corporate governance practices, and requirements for transparency and data dissemination.

Fourth, and last, it has been realised that prudential standards are interdependent. Minimum capital requirements for banks are of little use if the accounting conventions used to value a bank's assets and liabilities are flawed. And accounting conventions are only as good as the auditing standards used to apply them. More generally, market disciplines require accurate information, a legal environment that provides adequate security to market participants, and a payment system that can be relied on.

These underlying trends in the prudential oversight of the financial system have come together in the international effort to develop a framework of codes and standards for the financial sector. This effort crystallised in the wake of the Asian crisis, and owes much to the forceful advocacy of Gordon Brown in his capacity as Chairman of the IMF's International Monetary and Financial Committee.

The strategy is (i) to define those areas of financial activity in which it is desirable to develop internationally agreed standards of best practice; (ii) to assign the role of standard-setting to an appropriate international grouping; and (iii) to devise mechanisms that foster convergence on this best practice by as wide a range of countries as possible.

The first issue is the scope of standards. I have just argued that the financial sector is marked by a considerable degree of interdependence and complementarity. This suggests a broad scope for standards, which can be grouped in three main areas. **First**, guidelines for supervision of the main types of financial intermediary -- banks, securities issuers, and insurance companies. **Second**, standards for the transparent disclosure of the financial information needed to facilitate the efficient performance of markets -- macroeconomic information provided by governments, and microeconomic information related to the financial position of market participants and their counterparties. **Third**, codes for the robust underpinning of market infrastructure -- standards for contract law and law enforcement, corporate governance, accounting conventions, auditing practices, safety and soundness in the payment system, and so on.

The second issue is who should set the standards. Since standards are comprehensive in scope, interdependent in nature and global in their impact, it might seem logical to have a single authority responsible for their formulation. Some, including John Eatwell, have put the case on these grounds for a "World Financial Authority" with broad powers of regulatory design and supervisory oversight.

There is some logic in this idea, but as a matter of sheer politics, it does not seem to me to be practically feasible for quite some time to come. A more promising approach is to assign the responsibility for developing standards in individual areas to groups of national experts. In this way, the relevance of the resulting standards is enhanced and their acceptability in national jurisdictions is strengthened. However, means must be sought to ensure that the resulting standards represent a convergence to best practice and not a lowest common denominator.

This leads me to the third issue, that of how standards are to be implemented. The experience of the Basel Committee on Banking Supervision is instructive in this context. The Basel Committee is composed of senior supervisors from the most advanced countries, who have issued supervisory guidance on a wide range of topics. Basel Committee recommendations have no legal force. But since they have been adopted by consensus, they have been applied in all countries represented on the Committee. Interestingly, they have also been almost universally applied in non-member countries -- a telling example of the power of peer pressure and market forces to promote the adoption of best practice and to enforce what I have elsewhere called "soft law".

The success of the Basel Committee process is not just an academic matter of securing a common regulatory approach. It has produced real economic benefits. I would hazard the view that the absence of significant difficulties in the banking systems of Europe and America in the past couple of years, despite significant economic shocks, owes much to the strengthening of risk management that has taken place under the aegis of the Basel Committee's standards.

Realistically, of course, peer pressure will not be sufficient, by itself, to secure the prompt implementation of the wide range of standards that have now been drawn up. The international institutions, principally the IMF and World Bank have an important role to play here. They are using their consultation missions with member countries to carry out Financial Sector Assessment Programs (FSAPs) and Reports on Standards and Codes (ROSCs). FSAPs and ROSCs are a key means of enabling countries to "benchmark" their current standards on international best practice, to identify weaknesses, and to devise means for dealing with them. Giving publicity to the state of a country's financial sector may, of course, be the best way to ensure that the market is able to reward progress, through greater access to finance, on more favourable terms.

Microprudential and macroprudential oversight

So far, I have been talking mainly about how to use codes and standards to strengthen the supervision of individual financial institutions. Improved risk management at the level of individual institutions can go a long way to strengthening the resilience of the system at large. Still, by itself, it may not be quite enough. My earlier remarks implied that the dynamics of financial markets can introduce inherent pro-cyclicality into market behaviour. How can this be dealt with?

The first step is clearly to understand the underlying causes of this procyclicality. In part, it lies in the short-term nature of many risk measures. Risk measurement is often based on assessments of the recent past and the immediate future. Risk comparisons are made at a point in time on the basis of how an institution compares with its peers. But risk has a time dimensional as well as a cross-sectional character. Existing techniques of risk assessment arguably pay insufficient attention to the movement of risk **through the cycle**, and the evolution of common risk exposures.

With the benefit of hindsight, we can see that risks tend to *accumulate* during the upswing of a cycle, then to *materialise* when the economy turns down. At the time, however, risks may appear to be diminishing the longer economic expansion continues. In other words, conventional risk management tools lack the capacity to identify the emerging over-extension of balance sheets at a system-wide level.

Another limitation of an institutional focus in risk management lies in the interdependence of the actions and assessments of market participants. Risk models typically treat the external environment as independent of the actions of the entity managing risk. In fact, however, not only are some players large enough to impact markets by themselves, many use similar models to guide their behaviour. What this means is that "one-way markets" can develop more easily than theory would suggest. Thus, what is sensible and rational for an individual market participant, acting in isolation, may produce a destabilising outcome for the market as a whole.

A couple of simple examples can help to make the point. When a lending institution faces a possible slowdown in economic activity, it may seek to cut back its lending activities to reduce its risk exposure. Of course, if all lenders act in the same way, they may well produce the result they are seeking to protect themselves against. A similar process can take place in markets for traded assets. If an external shock produces a downward price adjustment, the consequent increase in measured value-at-risk may produce further sales, additional downward movements in asset prices, further increases in VaR and so on.

It is not easy to find solutions for these problems. Nevertheless, some avenues offer useful prospects. **First**, it would be good for financial institutions to adopt risk-management practices that take better account of the evolution of risk over time. Techniques such as through-the-cycle credit assessment and pre-provisioning may have a role to play here.

Second, supervisors should encourage the use of stress-testing to assess the vulnerability of institutions to “multiple-sigma” events. They may also need to think about how the information from stress-tests at individual institutions can be aggregated for the system as a whole. In other words, how might endogenous reactions to exogenous shocks amplify disturbances in potentially troublesome ways?

Third, it may be desirable to develop oversight structures that enable the authorities to track emerging vulnerabilities in the financial system. Many central banks, like the Bank of England, now issue “Financial Stability Reviews” and I understand that the Treasury, the Bank of England and the FSA now have regular meetings to consider potential areas of weakness in the financial system.

Something similar has taken place at the international level. Following the Asian crisis and as part of their search for a “new financial architecture” the Ministers and Governors of the G7 countries established the Financial Stability Forum (FSF). This brings together, at very senior level, the key authorities responsible for international financial stability. They comprise: the finance ministries, central banks and regulatory authorities from the countries with the largest financial markets; the main international organisations (IMF, World Bank, BIS and OECD), and the principal standard setting bodies (the Basel Committee, International Accounting Standards Board, IOSCO and others).

The FSF has not, perhaps captured the public imagination through dramatic crisis intervention. Nevertheless, it has done much useful work in focussing attention on common sources of financial vulnerability, and in providing an impetus for tackling them. Perhaps even more important, the FSF is welding together institutions and groupings that need to work increasingly closely to promote financial market efficiency and stability. I believe it is a promising tool of international cooperation that can, and should, be further developed in the years ahead.

Some concluding remarks

We have come a long way in the past twenty-five years in understanding the way in which a liberalised financial systems works and its vulnerability to episodes of stress. There have been important conceptual advances, such as new ways to measure risk and price assets, and new insights into financial behaviour, through game theory and behavioural finance.

Yet we still have much to do in applying these insights to achieving the goal of a safe and efficient financial system. The task will be to develop mechanisms of supervisory oversight that make markets work better, not by suppressing the symptoms of market failure, but by addressing their causes. Setting financial standards that attempt to harness prudential instincts and deal with the underlying sources of market failure should play in important role in this endeavour. I like to think it is an endeavour that is fully in accord with the goals and purposes of the IEA and the Cass Business School.

Priorities For International Financial Regulation

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12th February 2003

Cass/IEA Financial Services Regulation
Seminar Series 2003

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1. When I was an economist in the Treasury at the beginning of the 1970's, I spent a fascinating 18 months studying the impact on the British economy of joining the "Common Market". My colleagues and I tried to measure the effect of liberalisation, of eliminating tariffs and non-tariff barriers to permit "free trade" - in goods only of course, not in agriculture or services. We concluded that the <u>static</u> benefits of liberalisation (arising if you like, from shifts <u>along</u> existing supply and demand curves) would indeed, be significant, although offset in part by costs of EU Membership such as the CAP. That evaluation was reflected in the Government's historic 1971 White Paper, in which EU membership was commended to the Nation. I also concluded that in time there would be substantial dynamic benefits as well, as "long-run" supply and demand curves shifted in response to the enlarged market and greater competition in the trading sectors.

A. SLOW PROGRESS IN CREATING A SINGLE EUROPEAN SERVICES MARKET

2. My attention and professional interests then shifted to other areas of economic policy. It was only in the '80's when I was back in the Treasury as a Special Adviser that I began to think seriously again about the "single market". In goods trade, tariffs had gone, non-tariff barriers were under pressure and the movement to suppress competitive distortions arising from public ownership and industrial subsidy was gathering way. However there had still been little or no progress on the services front. I suspected (as did many others) that there were big static and dynamic benefits to be had from free trade in services as well as goods. So I was delighted when Lord Cockfield launched the Commission programme "Completing the internal Market" in 1985 to liberalise trade in the Community's services sector, just before I left the Treasury for the city.

3. I then worked on other policy areas. It was only in 2000, on joining LIBA, that I concentrated again on the single market in services. For a second time, I noticed how little progress had been made. For LIBA and its members, (largely investment banks and securities houses operating internationally) the creation of a well run, liberalised international market place through the Financial Services Action Plan (FSAP) and other related reforms appeared vital. Thus merely cutting margins in securities dealing to competitive levels would surely bring big benefits for savers and company finance alike. As I immersed myself in the issues, I became increasingly puzzled. The FSAP was scarcely "moving forward" at all, despite the universal pious protestations about its importance.

4. At LIBA, we were also busy with a rather different venture. The Treasury and FSA were consulting on the creation of a single regulatory system, on the Financial Services and Markets Bill (FSMB) and Act (FSMA), the 100 odd statutory instruments giving effect to it, and the thousands of pages of FSA policy papers, discussion papers, consultation papers and draft Rules. The FSA was committed from the start to a very thorough process of open consultation with market participants, experts, professionals, and interested parties generally. This experience has demonstrated that

such consultation processes are essential to success in an ambitious regulatory reform, **even inside a single country**.

B. THE LAMFALUSSY GROUP'S REPORT

5. Just as the FSMB was nearing the end of its Parliamentary voyage in mid 2000, the French EU Presidency triggered off another important train of events - which is still far from over. The EU set up the Group of Wise Men under Alexandre Lamfalussy to advise on ways of reviving the FSAP. At LIBA we were delighted. Together with others in the international wholesale marketplace we discussed and analysed our sector's experience; made major submissions to Lamfalussy and his group; and warmly welcomed its recommendations.

Process the Problem?

6. As the debate about the problems with the FSAP evolved, a number of us were struck by the following point. Try as we might to discuss the policy issues of the FSAP, our debates turned inexorably to institutions or, a most important point, process. We agreed with the Wise Men that the FSAP was stuck because the issues were being dealt with at the wrong political or institutional level; in the wrong way; with too little consultation; and so on. "So what", one may say, as some certainly did when this observation was first made. The EU is a gigantic dynamic experiment in international institutional and process design. When something goes wrong, process is very likely to be a major cause. What is so special about finding that this is true of financial sector integration?

7. I think I can now discern some of the answers to that question. There is indeed something special about financial services; and there is something systematic about what has been going wrong. Some of the reasons are obvious, some not. So today I will try to explain or at least hint to you, why **process** is so important; then to sketch some of the consequences; and then to focus on some conclusions about how to put matters right.

C. WHAT IS SO SPECIAL ABOUT INTERNATIONAL FINANCIAL SECTOR INTEGRATION?
The obvious issues

8. Let us take the obvious issues first. For whatever reasons, good or bad, we all know that the provision of financial services and the conduct of financial markets has attracted Governments' attention and actions, whether by law, regulation, formal supervision or informal oversight: by encouragement of self regulation; or by both Governmental and self-regulation. So programmes for integrating the financial sectors of a dozen or more very heterogeneous economies and societies are bound to throw up a host of "differences" (to use a neutral word) which will need somehow to be reconciled. Some of the most important **objective** factors are that:

   a. **History is a powerful influence on national attitudes**. Thus in countries which have experienced systemic disasters such as hyperinflation, or major scandals of consumer exploitation, many people may still distrust their own national Government. They may only trust an integrated EU market with a very powerful and competent central authority. At the other end of the scale, others may only trust their own Government to assure them of a trusted level of domestic consumer protection for which they have had to fight for decades. Then there are those who know little of what other Governments do as financial regulators; whom they may well suspect of one-sided and nationalistic motives and devious behaviour. Ignorance and prejudice can be a potent mixture, even in small quantities.

b. **Legal systems differ greatly**. There are fundamental differences between Common Law, and civil code countries; and between those with or without written constitutions and so on. At a more modest but still very important level, many countries do not have anything resembling trusts or trustees. Some do not recognise the legal concept (so beloved of regulators) of a safe harbour. And concepts of fiduciary duty probably differ radically.

c. **Constitutions and institutions differ**: Federal vs unitary states; more, or less, integrated domestic regulators; extensive or limited dependence on self-regulation.

d. **Attitudes differ**, too. Some countries believe in delegating regulation to a nominated authority like the FSA. Others believe (and are so organised) that their delegated regulation should be subject to the scrutiny of a national or, nowadays, European Parliament, not trusting the technicians to be independent or, perhaps, denying that "technical details" can be decided properly in a political vacuum.

Financial Market Variability

9. Weighty though all these familiar considerations are, I believe they are only part of the story. When you are sucked into the practical detail of how markets work, whether as an economist, an official, a market participant, a financier, a regulator, a litigator or industry representative (and I have been or am all seven), you come to learn that financial markets are immensely varied, very complex <u>and</u> differ very greatly in many senses. **The "same" markets can be structured in different ways in different countries; and risks and procedures which are essentially the same in differing sectors can be handled or undertaken in very different ways in the same country.**

10. I believe that such variability is generally much greater and much more significant than are differences in methods of production and distribution of conventional manufactured and industrial goods. Let me term this phenomenon **"financial market variability".** I would not claim that the factors underlying it are unique to the financial sectors. But I would claim that they are only of secondary importance in most goods markets, while they are generally central to the nature of most financial sector activity.

Ronald Coase

11. <u>Why should there be so much intrinsic variablity</u>? Let me briefly recall a famous legal and economic debate, which derives from a very profound article by the (British-born) Nobel prize-winning economist, Ronald Coase. "The problem of Social Cost" - Journal of Law and Economics. Coase 1961, (3]. It introduces the **problem of the wandering cattle and the wheat growers.**

12. Nomadic cattle herders come to an unfenced agricultural area devoted exclusively to wheat growing. They are only too happy when their cattle find excellent food in the wheat fields. But the farmers are not. If the herders have no, or only partial, responsibility for the damage they do, cattle production will thrive, but grain production will suffer badly and the community will be worse off. However if the cattle herders are

required by law or regulation to bear the full cost of the fencing and damage their cattle necessitate, then private and social costs and benefits will be equal, and society will be at a welfare optimum.

13. Consider the mirror-image case. In an area, say a "Common" hitherto devoted to nomadic cattle herding, wheat farmers arrive, who wish to keep the cattle out of their fields by erecting fences. This is to the detriment of the herders. If any wheat grower can fence off what land he chooses, albeit at his own cost, wheat production will thrive, but cattle farming will shrink dramatically and the community will be worse off. However, if the wheat growers are required by law or regulation to bear the full costs of the loss to the cattle farmers as well as the cost of fencing, then private and social cost will be equal; and society will again be at a welfare optimum.

14. We can go further. The optimum balance between cattle and wheat will be the same (for given land and cattle) in **both** cases. **Coase showed that the manner in which the law and regulators assign liability will not affect the ultimate allocation of production, provided costs and benefits are properly reflected in the legal and regulatory structure.**

15. We can go further still with this example. I conjecture that it can be demonstrated that there are **at least two other ways of getting to the same optimum, both using insurance**. First, the wheat growers are required to insure ("All risks") against damage by wandering cattle; and the underwriters specify that they must build the fences and negotiate compensation agreements with the graziers for loss of income. Alternatively, the graziers are only permitted to graze if they take out third party insurance for damage caused by their cattle; and this time the underwriters insist it is the graziers, not the wheat growers who build and maintain the fences.

16. Fifth, but not least and perhaps not last, one might imagine a **centralised regulatory authority** which owns and fences the area, subject to a duty to allocate land use "fairly", meaning in such a way as to optimise the land usage. Even if the authority levies no charges on wheat growers or cattle raisers, it could perhaps in principle model social costs and benefits accurately enough to allocate the land use and fencing appropriately. [No doubt the wags would call this regulator OFFCOW].

17. In sum, even in market interactions between such eminently physical products and factors of production as cattle, grain fences and land, we can come up with **five (and probably more) different ways of ensuring the correct, identical, allocation of resources**. What is more, many of them are or could be incompatible.

18. What happens when we leave behind the world of physical objects and turn to "pure" financial service transactions and contracts? In such transactions money passes in one direction, in exchange for some right, thus creating a financial asset - typically consisting e.g. of an obligation to pay, repay, share in profits; or contingent rights in the form of options, life insurance, sickness pay, pensions and so on. The provision and distribution of the "product" is no longer circumscribed by a physical process of production, or by the physical characteristics of the product. So for pure services, therefore, one would predict a greater variety of practices and, therefore even more scope for discrepancies when two national market places are brought together. Equally important, one would expect that many of such specific market niches are so recherché that they are understood barely if at all even, within a country, let alone elsewhere.

The Additional Influences Of Systemic Risk, Consumer Protection And Unfair Competition

19. On top of this exceptional underlying heterogeneity there will often come considerations of systemic risk; consumer protection; and mitigating imbalances in market power and information. These will draw the authorities into an all-too complex web of legal, regulatory, self-regulatory and commercial interventions. The scope for variation will be immense in these respects, too, being a function of all the sorts of obvious influence which I have already cited - historical, juridical, size of market, and so on. Typically, from the moment these procedures were first set up, they have been rich in national idiosyncrasies. At the time they were set up, few Governments knew or cared much about what other countries did, let alone wanted to imitate them.

20. So when we try to bring together separate economies in a single financial market place, it is scarcely surprising that the process is so hard and so different from, say, unifying the market in cars. [In that case there were questions of safety standards, annual inspection and the rest. In their day, these constituted serious non-tariff barriers in the EU and, once solved, they revealed a further array of obstacles in the form of complex (and questionable) agreements between manufacturers, main distributors and dealers about the distribution and servicing process. However much of this could be dealt with by classic deregulation and liberalisation]. When we come to the financial sectors, such as the securities markets, we are in the heart of this different world.

Sporting parallels

21. Let me offer an analogy or two. Imagine first, that it is desired to "integrate" (or reintegrate) Rugby Union and American Football, which broke away from Rugby rules in the late 19th Century. You would have a problem. In Rugby, you may only pass the ball **backwards**. In American football, you may pass it **forwards**. So the effort to integrate the two looks impossible.

22. Suppose instead we are set the more modest objective of "enlarging the single market in rugby", and that it is proposed to unite Rugby League and Rugby Union. The differences are undoubtedly less serious, and less radical. But just what they are, which ones really matter, and what would be involved in reconciling them is unclear to nearly all of us. Almost certainly they will be way beyond the knowledge of Ministers and Treasury officials. [And who can tell what the supporters will say?] There is little chance the Government could determine authoritatively whether it was feasible or, even if feasible, worthwhile.

23. The process of creating an integrated financial market place in Europe is not unlike these rather fanciful programmes of sporting harmonisation. **If there are "many ways to skin a cat", particularly in financial markets, then one would predict that integrating them would usually be very hard work, and sometimes impossible since the integrator will find so many different approaches to reconcile.** So it is not at all surprising that the 1985 Cockfield programme delivered less than expected; that the First Investment Services Directive (ISD1) of 1993 was flawed in some key respects and brought limited results; or that of the forty two FSAP measures, many of the most fundamental are still proving to be so problematic.

. **Misjudged Attempts To Integrate Markets**

24. If there is something special about financial services, what, then, should one do to promote EU or international financial market integration, regulation and liberalisation (more) effectively? Whatever else, one should not maintain the recent approach of EU Member Governments. At the risk of parody and unfairness, one rather fears that when the EU's Governments and institutions put together a portfolio of measures under a label such as the FSAP, it is rather like designing a menu of dishes from a recipe book with those very flowery descriptions favoured by some of today's chefs. [The Ministers and senior officials involved chose between items such as a light dish of Collateral served on a bed of mature master product agreements; followed as entrée by a Single Passport for all markets, with a sauce of fortified national stock exchanges of at least four kinds; followed as dessert by a Pension Bombe Alaska; all washed down with a …]. Yet almost no one has any idea what these fine-sounding and seductive titles mean, let alone whether they are attainable, beneficial, or can be put into effect on a sensible time-scale.

D. SYSTEMATIC ERRORS AND PATHOLOGICAL OUTCOMES

A Taxonomy of problems

25. If policymakers commit themselves in such a way to integrating and regulating parts of the market where common policies are in truth hard or impossible to achieve - and typically to vast programmes with rigid deadlines - then there are a number of standard problems which will regularly arise. For example:

a. The **technicians and negotiators cannot reach agreement**; perhaps the least bad outcome in some cases. Thus in ISD1, there was no agreement about how to harmonise Conduct of Business Rules. So the politicians left the responsibility with host states.

b. The **technicians and regulators agree a common policy**. But the regulatory solution **is deemed politically unacceptable**, so another solution is imposed through the "political" rather than technical part of the consultative process. This could be by the Commission, as in the final decisions on the ISD proposed in November '02; by the Council of Ministers, or by the Parliament [e.g The Take-over Directive]. This is not a guaranteed recipe for disaster, but it is a reliable route to very indifferent policies and very poor results.

c. The **technicians and negotiators can agree, just**. But in so doing, have to **overcome the deep distrust** felt by many members vis-à-vis other members; whether for the quality of law enforcement and regulation, the morals of public servants, politicians and legislators; or the effectiveness of the European Commission in ensuring that Directives are implemented consistently and effectively. So to reduce the scope for such deviant behaviour to the minimum, the Directive Text is exceptionally specific, lengthy and, perhaps worst of all, rigid and prescriptive. [e.g. The Prospectus Directive implementation proposals being developed by the CESR since late 2002).

d. **Technicians & negotiators reach a "politically correct" consensus**, defined as giving everyone a part of what they asked for. But the outcome may make little operational sense [e.g UCITS.2, ISD2].

e. A fifth possibility arises when technicians and negotiators, recognising little movement is possible, agree to construct what is termed a **common policy; but in reality it is little more than a patchwork of members' existing national practices,** stitched together with the thread of communautaire rhetoric. This is good, of course, if the issue calls for subsidiarity or mutual recognition anyway. But it may immobilise policy development at EU level for many years.

f. Then there is a sixth case, when a member fears exploitation (e.g. of its consumers by businesses in other members); when it sees in a Community initiative an opportunity to protect its own producers and markets or, better still, to reverse the effect of competition and to "repatriate" once-domestic business which has gone elsewhere. In such circumstances the **rhetoric of market integration**, a level playing field, etc, provides **excellent camouflage for the re-erection of barriers to competition, and mercantilism of many kinds**. [e.g. Prospectus Directive, ISD].

26. This is not the time to develop this taxonomy further, or to give more chapter and verse. What I can do now is offer you five propositions.

- **First, outcomes such as these are to be seen in many major FSAP measures.**
- **Second, the elaboration of Community institutions in recent years has made it harder to handle FSAP measures.** It has created more opportunity for political interference through co-decision; more scope for discriminating against minorities through qualified majority voting; and, I fear, could tempt members of the CESR to unpick the political decisions embodied in a Directive, for protectionist and nationalistic motives.
- Third, what is more, such **problems will obviously be more serious** and will affect more of the proposals under review if Ministers decide to **introduce new regulatory policies very rapidly.** Matters are made particularly difficult if the deadlines for completion are inflexible and arbitrary as well as very short.
- Fourth, such **difficulties are entirely predictable**, and they **will recur repeatedly** in international financial regulation, unless we recognise and do something about them.

Do what? This is where Process is so fundamental. Getting it right will not conjure up agreement out of contradiction. But it will help us to find common ground if it is to be found; or warn us off when there is no consensus to be had.

E. INTEGRATING FINANCIAL MARKETS & REGULATION WITHOUT PATHOLOGICAL OUTCOMES: LOOK BEFORE YOU LEAP

27. The most important answer to this question is "Look before you leap". What might it mean in this context?" Do five things, whatever else.

Clarify Objectives & Constraints

28. Political leaders and their advisers should look beyond the platonic attractions of sound-bite programme labels like the Single Market or Financial Services Action Plan. From the start it is essential to define the specific, concrete goal to be achieved, and as far as possible by what practical means. In that light, are each nation's political,

institutional legal regimes compatible or contradictory? Is the goal only worth pursuing if everyone goes all the way? Or would it still be worth doing if some drop out, [shades of "Variable Geometry"]. How important is it to implement "all" the policy or to take it "all the way"?.

Apply the Appropriate Tests Of Costs & Benefits Before Finally Deciding To Proceed!

29. Will the concrete policy finally recommended bring material benefits? Will the costs be justified? Will both costs & benefits be acceptably distributed, even if the policy proposals are acceptable?

Consider all the alternatives available for meeting the policy goal

30. There may be several policy methods to consider. There may also be an option of deregulation and true liberalisation, which should not be ruled out. Since policies and institutions tend to become rigid, it may be that two (or more) regulatory methods or policies could be pursued together, which will inject the vital element of competition. Particularly where such competition is not possible and a single harmonised policy is pursued, then some regular review process should be set up. If the policy looks irreversible and risky, one should consider the possibilities of experimenting with pilot projects before taking the plunge.

Quality not speed

31. Integrating markets is a vast, momentous exercise which has to be got right. Because it is so complex, meeting the tight timetables for which all interested parties have clamoured till recently - Ministers the Commission, Consumers, the private sector alike - is much less important in most cases than introducing measures of high quality which do the job, even if deadlines are missed.

Consultation essential

32. Another blinding flash of the obvious, to which I return at greater length later.

F. THE PARALLELS WITH MONETARY INTEGRATION

33. There are interesting parallels to be drawn here with the technical, economic debate about Monetary Union and the introduction of the EURO. We have been treated to numerous studies of this family of issues. Some fascinating broad propositions emerge from them.

Optimal Currency Areas

34. First, theoreticians have long underlined that the case for two or more countries integrating their currencies depends on the characteristics of the countries involved. The candidates should constitute an "optimal currency" area to justify their monetary union economically. In such optimal areas, certain relationships should prevail between each potential member, for example:

- a high degree of mobility of capital and labour;
- high levels of reciprocal trade;
- reasonably consistent or convergent expections.

By the same token, countries which do not meet such conditions would do better if they retained separate currencies.

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Other Optimal Areas

35. Second, regional economists have recognised for decades that within broad geographical zones, optimal areas for uniform policy or integrated regulation may differ widely depending on the product, service, function or process under examination. Thus it would be inconceivable that the optimal areas would be identical for each of telecom regulation, controlling the press, physical planning, conservation of fish stocks, air-traffic control, public health administration…..Optimal areas will vary widely for different financial services in the same way.

Step by Step

36. Third the debate about EMU and policy for adopting the EURO was taken forward in a measured way, step by step. Indeed it took the best part of two generations. It was generally recognised that some states would not want to join at the start, or perhaps at all; while others should join at different dates determined above all by centrally determined conditions.

Integration should bring benefits

37. At least one country, the UK, has gone further, and has indicated that she should not try to join unless doing so could be shown to be in the national economic interest - at present by the findings of the Chancellor's famous five tests. However the tests may turn out when revealed to the world this summer, they have been very properly envisaged as constituting a **substantial and well-researched study of the pluses and minuses of EMU for the UK**.

Differences from the FSAP

38. The EU proposals for regulating a single market have evolved very differently. There has been little or no serious public debate about an optimal regulatory area or areas; nor about what to do when they are likely to be inconsistent economically, or unacceptable politically. There has been little or no analysis of the impact on individual members of individual measures or of the total FSAP package, whether of costs or of benefits. Of course there have been some interesting studies of the aggregate impact on the EU as a whole of truly integrated financial markets - e.g. by the Gyllenhammar Group (2002) and London Economics for DG Market (2002). However these are not studies of the effect of the FSAP measures as such. With few exceptions there has been no suggestion that EU members would have to meet certain minimum quality of standards (a la Maastricht) before they would be allowed to adopt a single financial market policy or policies. There has been no public debate about whether it would be best to let individual countries "join the FSAP" (as it were) at different times - "when the time is ripe"; or in some sectors only. There has not been much discussion of the scope for allowing two policy regimes to continue in order to see which regime markets prefer (if they do), or which works best.

39. The decision to adopt the FSAP as a programme was taken as being self-evidently desirable, before its possible form was sketched out at the Union-level, let alone its

impact studied sector by sector. As far as I am aware, in the UK neither the Treasury, the City, the Chancellor, Parliament the FSA or the economics profession have suggested publicly that any rigorous tests be applied to decide whether the Plan as a whole or its specific ingredients are beneficial. As far as I am aware, the same is true of our 14 partners. So, **the members of the EU have not looked before leaping into the FSAP"**. Therefore we should not be surprised if implementing such measures proves to be difficult, unpopular and, in some cases, impossible.

[A digression on the hard ECU

40. Interestingly, the earlier UK debate about EMU in the early '90s also illustrated another interesting feature: the scope for changing monetary arrangements gradually by consent and competition rather than by imposing a top-down and comprehensive replacement for the old regime overnight. The proposal to introduce a hard ECU was put forward by some as an elegant alternative to EMU. The EU authorities would introduce a "Hard ECU" which was to be run as all times at the best behaved currency within the Union. The sentimentalists could cling to their preferred currency as it inflated, fluctuated; and was gradually replaced. Practical realists would progressively switch to the hard ECU. The generic approach obviously relates very closely to the debate about the advantages of permitting competing regulatory policies or jurisdictions.]

G. CONSULTATION STANDARDS

41. Last of all, looking before you leap obviously means consulting. More and more institutions and governments recognise this - and not just in the financial sector. The details of how it should be undertaken need not concern us much today, with one vital exception. There are several excellent models to consider. Amongst those worthy of note are:

a. **The Financial Service and Markets Act Norms**

The British Treasury and FSA developed a robust procedure in the enactment and implementation of the Financial Services and Markets Act, some of that procedure is, indeed, now embodied in the Act itself. This involves informal consultation with experts; perhaps leading to (non-committal) discussion papers; published policy or discussion papers with a minimum comment period of three months (which process may be repeated if needed when the first concrete proposals are substantially revised); then concrete proposals, draft laws, rules, statutory instruments with <u>another</u> 3 months consultation period. And then only the definitive law rule or whatever.

b. **The CESR Statement on Consultative Practices**

The same kind of procedure is embodied in the CESR's recently adopted statement.

c. **The EU Commission Proposals on Governance**

The latest and improved version of these proposals was published late in 2002 and follows good practice in some respects, though not all.

d. **The International Council of Securities Associations**

This body, which groups together 16 of the principal Associations representing the Securities industry world wide has just completed work on a "Statement on Regulatory Consultation Practices" which is in many respects the most thorough treatment of the issues. Though it is particularly directed at Consultation by regulators, it is equally applicable to other bodies, involved in developing regulatory policy be they individual Governments, supranational or international bodies.

e. **The British Cabinet office - Code on Consultation**

The Cabinet office has laid down a code for all Ministries and Departments which also has some application to detached Government agencies. This code is not mandatory, but is taken very seriously.

H. "CONSULTATION ON IDEAS" BEFORE FIRM PROPOSALS

42. Such codes are all very well. However if embraced too enthusiastically they could well become bureaucratic, expensive and politically correct if we are not careful. So, we must beware lest their details divert us from the fundamental, almost, banal issue at the heart of the consultation process.

a. **Consultation must start before minds are made up.** Do not start on your journey until **after** you have decided **where** to go and **how**. Consult on ends and get clear about that before plunging into a discussion of possible means; and do so as far as possible with a genuinely open mind. The early stages of policy-making are in reality a voyage of exploration and reconnaissance, not - save with rare exceptions - a committed journey to a definite goal, come hell or high water.

b. The **process of true consultation, then, is fundamentally cooperative and tentative**: putting forward preliminary ideas; considering responses; modifying objectives; offering reasons and inviting them from others; testing acceptability; researching costs and benefits; solving administrative complications, and so on. Quite frequently this preliminary cycle will need to be repeated, as the FSA has done. Key proposals are best kept malleable for sometime, rather than being solidified at the outset.

c. There will be a **trade-off between speed and quality**. Politics calls for speed, sticking to deadlines, saving face. Wise legislation often calls for the opposite.

43. These are not novel principles. Successive British Governments have done much to "pre-consult" - not least G Howe and N Lawson. Lamfalussy's Wise Men recommended this very specifically; and Lamfalussy himself returned to the fray only a few weeks ago in an important public lecture in London on January 22nd.

I. LEGISLATING FOR CONSULTATION ON IDEAS

44. Eloquent though the Wise Men may be, the response to their report has been inadequate. The EU's response to the Wise Men has been to provide for a substantial measure of guaranteed transparency and consultation **once Directives are agreed**,

but the commitments to consult on ideas in the formative stages are very limited. Thus:

a. A key European text - the EU Governance White Paper - does not require automatic transparency and consultation **in levels 1 and 2 and for comitology** - even if it sets sensible standards for it at later stages in the legislative process.

b. As far as I am aware, the convention on the future of Europe has not discussed this fundamental aspect of good government, nor thrown up any proposal to embody it in a Treaty Amendment.

45. Guaranteeing **Consultation on Ideas** at the start of all intended policy initiatives (save of course in emergencies) is not a sufficient condition for wise Government or Policy making in the EU, the OECD or any where else. However the case for its being a fundamental **necessary** condition in **international** financial policy making even more than in domestic is surely exceptionally strong. As well as favouring rational debate, Consultation and Transparency much reduce the scope for concealing discreditable decision-making behind a smoke screen of finely spun public relations. At this of all moments - when the EU is about to embark on a Treaty revision which may be the last for many years - it is time for the Convention to commend, and the IGC to adopt, a **Treaty Amendment requiring mandatory pre-Consultation except in emergencies**, that is **Consultation on Ideas and the transparency appropriate to it.** In the meantime, we should all devote what other firepower we have to inducing the present Community institutions to require such consultation in their Governance procedures.

POST SCRIPT

46. When I was considering what lessons to draw out for you from my and LIBA's recent EU policy-making experience, I intended to go one stage further: to examine at length some of the harmful biases inherent in the international regulatory scene. There is no time for that today. But there is one last point to note. If our ultimate goal is free(?) trade in services, **rather than regulatory architecture per se, we are surely looking for de regulation; for simplification and removal** of obstacles. Markets flourish when tariff and non-tariff barriers are cut back and irrelevant political and institutional burdens are stripped away. **The key, in other words is liberalisation; removing bureaucracy**. If you require the world's regulators to reconstruct markets internationally at white hot pace, they will, being regulators, look for their answers in regulatory **constructs**. Do we really want that? I think not. Perhaps a good whiff of openness and consultation will help in that respect, too. But these, of course, are topics for another lecture.

Creating An Integrated European Market For Financial Services

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19th February 2003

Cass/IEA Financial Services Regulation Seminar Series 2003

WWW.IEA.ORG.UK

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Wednesday February 19 2003

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1. By agreeing to the title of my presentation the organizers of these seminars have been generous enough to grant me a high degree of freedom in picking the precise issue to be addressed tonight. I hope that you will not consider that I abuse of this privilege if, instead of sharing my thoughts with you on the chances of success (or otherwise) of the four-level approach designed by the Committee of Wise Men on the Regulation of European Securities Markets, I stand back a little and try to answer a question which is very much in the minds of most of our fellow citizens.

2. The question is this. In the light of what has been happening in financial markets in general, and in the United States in particular, are we still as sure as we were three years ago that the development of liquid, transparent, innovative, well integrated – and therefore efficient European financial markets should be a priority policy objective? My answer will be yes, but a yes conditional on our ability to draw the lessons from these past three years' experience.

3. Let me start by recalling what was the state of mind of most of us in the late 1990s, when the broad objective of European financial market integration was firmly put on policy makers' agenda, which then led to launching the Financial Services Action Plan and at a later stage to the mandate given to the Committee of Wise Men to review the regulatory process prevailing in the securities markets.

4. One strong motivation was that the single market cannot become a reality, and therefore yield the expected dividends, without it being extended to cover the market for financial services. So was the realization that EMU was about to lift a major non-tariff barrier to the exchange of goods and services, which raised the expectation of an upsurge in cross-border financial flows inside the euro zone.

5. But in addition, I submit, there was also the US example. By that time it became obvious that there had been a marked upward shift in the rate of growth of US labour productivity the size of which was (and still is) debatable, but not the fact itself. More generally, the growth performance of the US economy, with fast productivity increases going hand in hand with job creation and declining inflation, was regarded with admiration. A widespread belief took hold that the efficiency of US financial markets in general, and of equity markets in particular, played a major role in achieving these results. It did so by generating innovative financial instruments and techniques, by responding to the need of surging entrepreneurial initiatives, by diversifying the range of products available to savers – in short, by improving the allocation of resources. Much of this was supported by an impressive flow of academic research.

6. This widely accepted view spilled over into more specific manifestations of admiration of the "American model" which were perhaps less generally shared but still attracted a growing audience. The market-centric nature of the US financial system was given

high marks in comparison with the bank centric European system of financial intermediation. The seemingly endless bull market and the resulting extraordinarily high rate of return on equity investment were attributed to the high (actual and expected) profitability of US firms which in turn was thought to be stimulated by the efficiency of US corporate governance and not the least by the incentive provided by stock options.

7. By contrast, many Europeans were deploring the lack, or the far too slow development, of "equity culture" in continental Europe, the only slowly emerging interest of management in "value creation", the inability of European corporations to take swift policy decisions in response to the challenges raised by globalization, and the low level of profitability of many European corporations in comparison with their US competitors.

8. Admittedly, there were signs of change in Europe. Stock options were beginning to be considered as part of normal management incentive schemes. A number of corporations decided to set themselves the target of raising their far too low ROE - even of achieving as much as 15%. Traditional stock exchanges were being challenged by "new markets". Thousands of internet companies were set up in most European countries. But all this was still far from even beginning to bridge the gap between the "US model" and European reality. Moreover, the performance of Europe's "real" economy continued to lag well behind that of the United States. Hence the insistence to speed up the implementation of the Financial Services Action Plan and to reform the creaking European regulatory process with the explicit objective of enhancing, via integration, the efficiency of European financial markets.

9. Where are we now in comparison with, say, the autumn of 1999? Well, we are more than three years older, and a number of things happened during this time space which in the eyes of many raise doubts about the wisdom of putting the financial integration process so firmly at the top of the European policy agenda. I know of course that few of the financial market participants (and I guess only very few among this audience) would share these doubts - and as I told you right at the outset I have not turned myself into a doubting Thomas either. Nor do I perceive any signs that our political leaders, the Commission and Euro MPs are having second thoughts about the initiatives taken some time ago. As a matter of fact I believe that the implementation of the FSA is proceeding reasonably well within the framework provided by the new four level regulatory process. But it would be foolish to ignore the growing disenchantment of the wider public opinion with the working of financial markets and with much of the arguments that we put forward in favour of creating an integrated financial services market in Europe.

10. What has gone wrong during the past three years? I would like to point out three interconnected groups of events: the collapse of the equity market bubbles; the loss of confidence in corporate governance, corporate reporting and, more generally, the checks and balances supposed to ensure a smooth, fair and efficient working of financial markets; and the large scale misallocation of resources revealed by the boom and bust cycle.

11. We now have had three years of a bear market and, to put it mildly an inauspicious beginning to the year 2003. This has amounted, roughly speaking, to halving the broad stock market valuations in comparison with their peak values – somewhat less in the United States and more in some European countries. In those sectors which were supposed to be the driving force behind the so called "new economy" the collapse of equity prices has been significantly more that 50% on both sides of the

Atlantic. I do not have to dwell on what this has implied for those life assurers which had been heavily invested in equities, or for pension funds, and via these funds, for corporate liabilities. All this is well known. But regarding Europe, consider two facts. One is that as a result of the only recent interest of households in equity investment (often stimulated by the wave of privatizations) the share of newcomers in households' equity portfolios has been substantial. These newcomers derive no consolation from the fact that those who started buying equities before the mid-ninetees have still registered positive rates of return until now. The second fact is that the political impact of these developments on the ongoing debate on how to reform our pension systems is disastrous.

12. Is loss of trust an essentially US phenomenon? Given the large numbers of "Enrons" across the Atlantic, and the numerous examples of outright criminal behaviour, it is often argued that this problem is more serious in the US than in Europe. This maybe true to some extent but surely not entirely. Even in my small country we have had one spectacular case involving a high-tech company that had been regarded as a textbook case of entrepreneurial success, (which was well reflected in its capitalization) the bankruptcy of which has led to criminal proceedings; and I could name a dozen other instances across Europe – although it is probably true to say that the main cause of these horror stories seems to have been "sheer" mismanagement rather than criminal misbehaviour. I am however not convinced that those who lost 90% of their investment regard this distinction as very relevant. Be that as it may, investors lost their trust not only in corporate management, but also in the functioning of internal and external audit, in the behaviour of investment banks, in the investment advice given by financial analysts and even in the trustworthiness of the legal profession or the professional capability of the supervisory authorities.

13. The third piece of bad news has been the truly monumental misallocation of resources, which has been revealed~~leved~~ during the past three years – a misallocation which found its origins ~~with fund~~ in the exuberant or "extrapolative" expectations ~~in the~~ formed during the boom years. Let me point to a few examples of resource misallocation. ~~t~~The internet boom is, of course, the most striking example. ~~a~~ A very large proportion of the internet ventures, which had attracted tens of thousands of talented and enterprising young people and led to sizeable IT investment, went bust. , ~~a~~And some of them were ~~won~~ very large enterprises. Just recall the recently announced largest ever loss in US corporate history – or for that matter, in human history. The degree of indebtedness of a number of prestigious telecom companies reached stratospheric levels, reflecting excess investment, large scale acquisitions and purchases of third generation licenses. The sale of mobile telephone handsets has not collapsed, but investment in network equipment has. Moreover much beyond these industries, we witnessed a genuine merger and takeover mania motivated by over optimistic evalutions of synergies and the far too easy financing facilities provided by the bull market. A large proportion of these mergers and acquisitions have turned out to be genuine failures which is now prompting a global revision of corporate strategies - "back to core activity". With the appearance of ample excess capacities in large segments of both manufacturing and service industries, cost cutting, in practice lay-offs, has become the central preoccupation of management. And here is the embarrassing question: how can human, financial and physical resource misallocation on such a large scale be reconciled with the basic proposition that well functioning financial markets lead to a better allocation of resources? And do not forget: this

happened at a time when financial markets, in particular in the United States but also in a less spectacular way in Europe, were becoming more rather than less innovative, more rather than less competitive, more rather than less liquid, when the flow of information was improving rather than deteriorating - in short, when markets were becoming more rather than less efficient both in the common sense meaning of the word and in the sense given to it by economists.

14. I do not believe that these events should lead us to fundamentally revise the views held some three years ago on the major contribution to growth we could expect from financial market integration in Europe; but these views should be qualified by our recent experience. Let me expand on this. A useful starting point is to recall two facts which support my relatively optimistic stance.

15. The first is about the course taken by US labour productivity. We now know that some of the initial estimates regarding the pick-up of productivity growth in the second half of the 1990s were exagerated. But even with a downward adjustment there can be no doubt that there was a quantum jump in the rate of growth of labour productivity from the mid- nineties onwards. Moreover, productivity has continued to grow during the past three years (and quite spectacularly in 2002), which is an unusual experience in a recessionary or a slowing economy. This augurs well for further growth.

16. The second fact is that despite the sizeable equity melt-down, "Enron" and September 11, the financial system of the developed world, and notably that of the United States, has not been driven into a genuine financial crisis. A great part of the merit goes to Basel I which was instrumental in allowing banks to enter the period of turbulence with a strong capital base. Most banks' capital in 1999-2000 was well above the minimum requirements which suggests that bank management had adopted on the whole a cautious policy stance; but there is no doubt that the regulatory-driven Basel I initiative played a major role in shaping the attitude of managements. A number of banks also made ample use of credit derivatives in unloading a substantial part of their credit risks on willing risk takers. Given that banks still retain their key position as providers of liquidity and as major players in the payments system, the global effect of this redistribution has very likely been a positive one from the angle of systemic stability, even though the cost for institutional investors has been substantial. The same applies to the rising share of bond financing in corporations' total debt. Last but not least, credit should be given to the swift and radical interest rate cuts by the Fed which among other influences allowed consumer spending to sustain the US economy. But on this last point I shall make some additional remarks in a few minutes.

17. What about the nasty experience of dysfunction in the world of corporations? Far from me to minimise its importance, but we should keep a sense of proportions. Listening to some of the media one gets the impression that there has been a collective misbehaviour of all corporations, especially in the US, but perhaps also in Europe. This, of course, is nonsense. What remains true, however, is that there have been enough cases of dysfunction to warrant serious action. You would not expect me to go into this matter in detail, but I venture to make four points. The first is about priorities. If I had to pick my own, I would give accounting standards the first place, issues of corporate governance the second, and sorting out the mess of conflicts of interest the third. My second remark is about how to proceed. Some oppose spontaneous market-led reforms to regulations. I do not think it would make sense of launching a debate on a priori grounds. In a number of instances, regulation by competent authorities is unavoidable, but even in these instances market participants and all interested parties should be given the opportunity of having their voice heard.

The key point is that any such consultation should start before embarking on a legislative process and should continue when it comes to writing out the specifics of implementation. This takes time, but given the complexity of the issues at stake, we should take our time. Taking speedy action when the stories of misbehaviour are still unfolding may be thought to be politically rewarding, but the end-result will be poor quality. Third, I would insist on the absolute necessity of multilateral agreements- on global agreement when it comes the accounting standards, and on (at least broad) agreement within the EU on issues of corporate governance and conflicts of interest. That the US takes speedy and tough legislative action without seriously consulting anybody is not a novel experience even though the fact is regretable. But that European governments take the initiative of revising their company laws or that regulators edict new corporate rules of behaviour without systematically consulting each other is beyond my comprehension. Fourth, we have to try to understand what lies behind the surge and multiplication of instances of corporate dysfunction. The answer, I submit, is quite simple: the long period of economic upswing combined with the exuberance of equity markets. Could you imagine Enron or Vivendi happening in an environment in which the main equity price indices would be increasing on average by 5 to 10%? The uncomfortable conclusion is that, while reforming accounting rules, improving corporate governance, eliminating obvious conflicts of interest are worthy objectives to be pursued in any event, we should harbour no illusions: even much improved rules will be overcome by the deleterious effects of the kind of equity market bubbles that we experienced during the last years of the 1990s.

18. This leads me straight into submitting to you what I regard to be the major lessons to be drawn from the experiences of the past three years, namely

    a. that the contribution of well functioning financial markets to growth cannot be assessed otherwise than by looking across cycles – a proposition that should clearly lay to rest whatever still remains of the “standard” or “minimal” ROE objective of 15% ;
    b. that business cycles and their corollary of financial exuberance followed by financial distress have been, and remain, integral to the working of capitalist market economies;
    c. that such cycles are part and parcel of the adjustment mechanism which corrects the misallocation of resources generated during boom periods;
    d. that the longer and the more violent are the periods of exuberance, the more likely is the build-up of unsustainable financial imbalances and the emergence of large-scale resource misallocation - and, therefore, the more painful will be the unavoidable correction;
    e. that, while it would be neither feasible nor indeed desirable to “abolish” the business cycle, there are good reasons for trying to moderate its excesses;
    f. that one of the key questions we should ask ourselves is whether financial globalization aggravates, or on the contrary alleviates the propensity of our system to produce asset price cycles or short term volatility.

19. I do not know the answer to this last question, and my suspicion is that the jury will remain out on this question for quite sometime. But if we have any doubt, we should be well advised to look carefully into the policy challenges raised by this issue.

20. A short parenthesis: what I have just said is not very different from what our Committee of Wise Men said in its final report two years ago:
“while the Committee strongly believes that large, deep, liquid and innovative financial markets will result in substantial efficiency gains and will therefore bring individual

benefits to European citizens, it also believes that greater efficiency does not necessarily go hand in hand with enhanced stability"…

"Increased integration of securities markets entails more interconnection between financial intermediaries on a crossborder basis, increasing their exposure to common shocks" … "Given the growing interlinkages between all segments of the securities markets and the full range of financial intermediaries, the Committee believes that there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and micro prudential supervision".

We said this in our final report despite the fact that one of the few parts of our initial report which triggered adverse comment, by some weighty market participants had referred to the potential risk of increased asset price volatility. It was politely but firmly suggested that we drop the subject.

21. In what follows I propose to briefly explore two broad courses of action that policy makers could take to alleviate the financial hardships caused by the boom and bust sequence – the purpose being, I repeat, to moderate the consequences of this sequence rather than trying to suppress them.

22. The first is the prudential route which in essence (though not necessarily in all of its practicalities) is receiving broad support. To a very large extent this is about bank regulation and supervision – more specifically about increasing the crisis-resistance capability of banks <u>and</u> keeping a rein on their crisis-generating proclivities. But why to concentrate on banking rather than on the whole range of financial intermediaries? Is it not true that there has been a blurring of demarcation lines between traditional commercial banking and other financial intermediaries? And do we not observe the declining importance of banking intermediation relative to the role played by market transactions? Yes, but despite these undeniable developments banks have so far continued to play a central part in the potential emergence of a systemic crisis as much as in its prevention. Via their deposit base and credit granting activities, they are the providers of liquidity to the system: it is through the banks that the central bank's ultimate liquidity creation affects other financial intermediaries as well as the real economy. In addition, they play a key role in the payments mechanism which is <u>the</u> channel through which specific crisis manifestations are liable to develop into a full-blown general crisis.

23. I shall limit myself to short remarks on two issues that have a bearing on bank supervision and regulation at present. The first is about Basel II which is supposed to replace Basel I in the not-too distant future. For reasons that are well known Basel I which made a major contribution to preserving systemic stability has outlined its usefulness. There seems to be broad agreement on the basic philosophy of Basel II and on a host of specifics as well. But there are serious concerns about the potentially pro-cyclical impact of Basel II. When all major banks use similar risk assessment methods, and when all of them apply these methods at the same time in the presence of similar adverse developments, and when marking to market is universally practiced, pro-cyclical developments seem to me to be likely to occur. But I know that this view is not shared by everyone.

24. My second remark is on the role of central banks in bank supervision and regulation. The issue has arisen in connection with the extension of the four level approach proposed by the Committee of Wise Men on the Regulation of European Securities Markets to the banking industry - indeed to the whole of the financial industry – an

extension which has been decided by ECOFIN and the implementation of which is under active discussion. I am broadly sympathetic to this initiative if only because I just cannot see how Basel II could effectively be implemented in Europe (and after the implementation swiftly adjusted to changing market circumstances) without making a clear distinction between the first three levels. But I have some concerns about the way in which the role of central banks is handled.

The issue is not whether central banks should or should not, act as bank regulators and supervisors. The ECOFIN initiative accepts the fact that in some European countries central banks act in this capacity, while in others they do not.
The issue is about the place given in the new regulatory and supervisory structure to those ESCB members which fall in the second category and, by implication, about the place given to the ECB.

Nor is there any disagreement on the crucial part to by played by <u>all</u> ESCB members, and therefore by the governing council of the ECB, in crisis <u>management</u>. Everyone agrees, I hope, that when there are accumulating signs of an impending crisis, two courses of action have to be taken as a matter of priority. One is to pump central banking liquidity into the banking system; the other is to ensure the smooth functioning of the payments system. The primary responsibility for undertaking these actions lies with the Governing Council of the ECB. But in addition to "global" liquidity creation, crisis management may have to entail specific actions aimed at preventing the collapse of individual institutions. In some instances bail-outs will have to imply the actual (or potential) use of public money and at that stage the primary responsibility for running these operations will have to shift to governments. The demarcation line between global liquidity creation and bail-outs committing taxpayers' money will in most cases be fuzzy – crisis management will always be a messy business – hence the absolute necessity for well designed procedures for communication and cooperation between central banks and governments.

But what about crisis <u>prevention?</u> It would seem to me advisable to involve institutionally <u>all</u> central banks also in crisis prevention arrangements, for two good reasons. One is that it is well – nigh impossible to define where crisis prevention stops and crisis management begins. By the same token it is hard to make any operationally clear distinction between micro and macro prudential concerns. We badly need cross – fertilisation among all institutional players.

25. Satisfactory prudential arrangements (and despite some of the concerns I have just expressed I believe we are moving in that direction) coupled with prompt end skillful liquidity creation by central banks are likely to diminish the risk of a full blown systemic crisis and therefore eliminate the most dramatic consequences, of an equity market "bust". But this success is not without a price. This price is moral hazard. And the price may remain high, even if both governments and central banks make it clear that their crisis fighting commitment is in favour of the system rather than specific institutions: the "system", unfortunately, is the sum total of specific institutions. Hence the question as to whether we should not also try to moderate the "boom". Admittedly, some of this may be achieved if bank regulations are designed in a way which tend to rein in the banks' inclination to abandon caution and prudence when things appear to be going only too well. For instance mandatory - and very demanding – stress testing may go in the right direction. But this may not be enough, for the simple reason that banks' risk-taking activity can hardly be regarded as being the dominant, and certainly not the exclusive factor in the development of asset price bubbles.

26. Hence the need to look for other ways and means of trying to moderate manifestations of exuberance, and quite specifically the emergence and persistence of asset price bubbles.

27. In the wake of the 1987 Wall Street melt-down we saw the proliferation of inquiries into investment and trading techniques which may have played a part in creating excessive asset price - mainly equity price - volatility. As far as I can see this research, which still continues, has not yielded so far convincing, and widely accepted conclusions. In any event, I have some doubts about the possibility, indeed the desirability, of trying to regulate such techniques with the objective of limiting their volatility-creating effects. The main reason for this doubt is that most of these techniques provide risk-averse market participants with hedging devices, and by tinkering with them you would or could, destroy their hedging capabilities. But I do not hold strong views on this matter – so I just plead in favor of caution.

28. But what about assigning monetary policy the duty of trying to moderate asset price bubbles? Central bankers' reluctance to accept such an assignment are well known and understandable. Two main arguments are put forward. First, equity price levels, let alone real estate prices, cannot be "targeted", for (as opposed to the rate of inflation as measured by the CPI) there can be no meaningful discussion about the "right" level of asset prices. Second, the transmission mechanism of monetary policy in the direction of asset prices is, to say the least, uncertain - and there is a genuine risk of recessionary "overkill". In addition there is the "political" argument that, while targeting price stability may receive broad popular support, it would seem hard to muster popular support for deflating excessive asset prices.

    While all this is eminently reasonable, the problem remains: asset price bubbles do have nasty consequences, as anyone can experience today. Could or should central banks try to rein in the markets proclivity towards irrational exuberance? If not, could or should anybody care about it?

    You may argue that the reappearance of over-optimism akin to what we saw at the end of the last century is, to put it mildly unlikely to become a major concern in the short run. To which I am tempted to reply that we should precisely use this opportunity to look into this matter carefully.

Managing Financial Crisis

Sir Howard Davies
Chairman of the Financial Services Authority

26th February 2003

Cass/IEA Financial Services Regulation Seminar Series 2003

WWW.IEA.ORG.UK

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Introduction

My term as Chairman of the Financial Services Authority is now approaching its end, but I still have a few months left to serve. So it would be tempting fate to suggest that my time has been thankfully free of financial crisis.

Indeed some might regard that as an odd claim to make, in any event. Policy holders in Equitable Life, or investors in split capital investment trusts may, with some reason, consider that their financial affairs have been thrown into crisis by the failings or failure of individual financial firms. Indeed, at present, anyone with a sizeable stock market investment, whether direct or indirect, is aware that financial markets are going through an extremely difficult period.

However, on the definition I will use this evening, there has not been a financial crisis in recent years. When I talk of a crisis, I mean a situation in which confidence in financial institutions or markets generally is lost, where there is an actual, or a serious risk of collapse in the whole financial system, which generates collateral damage even for savers and investors who are not directly linked to the institution or institutions which are the source of the crisis.

On that definition, it is some time since we experienced a full blown financial crisis in the United Kingdom. Neither the collapse of BCCI, nor of Barings, damaged confidence in the banking system as a whole. The secondary banking crisis of the early 1990s was perhaps a more direct, though little apprehended threat to the stability of the system at the time. But there has been no need for the UK authorities to intervene on any substantial scale for some decades, and the losses to the various safety net protection schemes – the Deposit Protection Scheme etc. – have been extremely modest.

But I do not say this in order to suggest that we should be complacent, or that "it could not happen here". Indeed very much the reverse. Many people, when the term financial crisis is used, conjure up scenes of demonstrations by housewives banging saucepans in Argentina, hyperinflation in Brazil or Turkey and wholesale bank failures in Russia.

But the Scandinavian banking crisis of the late 1980s/early 1990s, Japan's decade long slow-burn financial sector melt-down and especially the late-1990s failure of Long Term Capital Management, which caused the Federal Reserve Bank of New York to promote a market-financed bail-out on the grounds of possible systemic threat, remind us all that financial crises are not confined to emerging markets. The LTCM case also alerted us to the possibility that a systemic crisis might emerge from outside the banking system. I am increasingly persuaded that crises can arise in non-banks, which is a powerful argument for an integrated approach to financial regulation.

So my aim this evening is to reflect a little on recent crises and, in particular, to draw some conclusions for how regulators should behave both before, during and after a crisis. I will, first, offer a few thoughts on what can be done in the area of crisis prevention, and on managing crises once they have crystallised. Then I will say a little about the kinds of changes that have been implemented internationally in order to improve our ability to handle crises. Finally, I will suggest one or two additional steps that might be taken, and which I believe could be both helpful and politically feasible.

Preventing Financial Crises

The first point to note is that we cannot hope to eliminate international financial crises entirely. That might seem a depressing conclusion, but it is a realistic one. Liberalised global financial markets and the free flow of capital across borders bring with them the risks of overshooting, greater volatility and imbalances which can exacerbate or amplify poor policy decisions. The result may be a currency crisis, a banking crisis, or, worst of all, both. Reducing currency volatility by a return to fixed exchange rates, or even a gold standard, as advocated by some, and tighter control of cross-border financial flows, might reduce the occurrence of international financial crises. Domestic crises could, however, still arise from poor fiscal and monetary decisions and such crisis reduction would be at the cost of access to external finance and ultimately to economic growth.

Should we conclude from this that the answer is to turn one's back on open global capital markets? I do not think so. Financial liberalisation does certainly mean that, if you throw a rock in the global financial pond, the ripples spread more quickly than they would need to: the viscosity of the water has reduced. But the upside is that the pond is larger, the opportunities for risk-sharing are greater, and enhanced transparency makes it harder for countries to persist in imprudent policies: the bubble is now pricked sooner. But whatever the regime, I take as a given that we will never entirely eliminate international financial crises.

There is an analogy here with our insistence at the FSA that we are not running a "no-failure" regime. Failure is an inherent part of a flexible, competitive, innovative capitalist system. We should not aim to oversee a race in which all shall win prizes. Eliminating the possibility of failure would distort incentives and in effect, penalise success. That is not, however, to say that we should not attempt to reduce the number of failures, or deal properly with their consequences. Quite the contrary. We devote considerable supervisory resources to attempting to reduce the number of firm failures, and on mitigating the consequences of failure when it occurs, all in the full knowledge that companies which follow inappropriate business strategies, suffer from management incompetence or the lack of effective internal controls will and should fail – despite our best efforts.

So too for financial crises. While we cannot eliminate them, we can attempt to reduce their number, duration and spread, and to mitigate the immediate consequences, particularly for innocent bystanders. In this task we have four principal tools at our disposal: i) international macro-economic surveillance; ii) market discipline; iii) corporate governance; and iv) prudential supervision. We might think of macro-economic surveillance and market discipline operating at the macro level, while corporate governance and firm-specific prudential supervision operate at the micro level. But such distinctions are hardly waterproof and, properly used, each individual tool reinforces the others.

International Macro-Economic Surveillance

The Asian financial crisis of 1997-98 exposed some serious gaps in our global system of macro-economic surveillance. How could a group of "tigers" with good growth rates and relatively solid public finances suddenly fall like flies to financial speculators?

We now know that a combination of fixed and rising foreign exchange rates, imprudent unhedged short-term dollar borrowing and long-term domestic currency lending (largely on real estate during a burgeoning asset bubble); combined with weak prudential oversight and corruption/cronyism produced a lethal brew. How did the institutions tasked with international economic surveillance miss this explosive concoction?

I am sure this question will continue to be a fruitful source of PhD theses – many of them at the LSE – for some time to come. So far, the preliminary analysis suggests that, for one thing, macro-surveillance overlooked the possibility that structural vulnerabilities like poor regulatory structures could provoke or aggravate nascent financial crises. Institutions such as the IMF, while always very strong on high-level macro-economic analysis, lacked both market and regulatory expertise. Partly as a result, they failed to spot the pressures and imbalances that ultimately produced the Asian crisis. This failure provoked a considerable amount of soul-searching on the part of the Fund and the World Bank, in particular, which has generated some significant action.

Two institutional responses are worth highlighting. First, the G7 political leadership realised there were gaps in our global surveillance structure. Following a report drafted by Hans Teitmeyer, formerly head of Germany's Bundesbank, they established the Financial Stability Forum which brings together high-level financial ministry officials, central bankers **and** regulators with a remit to both identify risk and vulnerabilities in the international financial system and set out mitigation strategies. The inclusion of regulators was a significant step, recognising the role of regulation in maintaining financial stability. The FSF is still perhaps, finding its feet in the international financial architecture, but we in the UK have put a lot of effort into making it work, and the signs are positive.

Second, the IMF, recognising its own lacunae, has set out to improve its market and regulatory expertise. It has established a new Capital Markets Department under a former commercial banker - Gerd Häusler of Dresdner - and has begun publishing a Global Financial Stability Review. I commend that useful publication to you. It has a significant influence on our own assessment of financial market risks. In addition, through its exhaustive Financial Sector Assessment Program (FSAP), the IMF is gaining a knowledge of regulatory standards and structures which will be disseminated throughout the rest of the organisation.

The FSAP team carries out reviews of the financial sectors of individual member countries of the IMF, and indeed of some Offshore centres as well. The aim is to assess the extent to which each country is meeting international best practice standards of regulation and financial management. I can speak with some authority about the rigour of this process. A team of twenty or so experts descended on the FSA three times last year to carry out the UK review, whose results will be published in the next week or two. I cannot foreshadow the assessment this evening, but I can tell you that it was a thorough and sharp pencilled process. I hope and believe that the same is true elsewhere.

I should note that financial stability is also now on the European agenda, with heightened awareness of the linkages between financial firms and markets and developments in the real economy. Some have argued that the EU needs its own version of the FSF. The institutional structures are still being discussed. The outcome remains in doubt, partly because national arrangements for handling these issues remain very diverse. It is a challenge to create appropriate representative bodies at the EU level which accommodate this regulatory biodiversity. Something concrete will no doubt emerge in due course, but exactly with what participants and with what scope, role and influence, remains unclear. In my view there is a gap which should be filled.

Market Discipline

It would be wrong to think, however, that the regulators or the IFIs are the front line of defence against crisis. In reality, markets are usually their own best regulators. This remains true despite their tendency to over-react and overshoot. To perform this regulatory role, however, markets and market participants need timely and accurate information. Here we enter the complex realm of accounting standards, transparency and disclosure standards, effective implementation and enforcement mechanisms.

Accounting remains the foundation upon which our entire financial system rests. If we cannot get our accounting and auditing standards right, then transparency and good quality disclosure are meaningless (and indeed supervision is also seriously challenged). Internationally we are struggling towards internationally accepted norms, through the work of the International Accounting Standards Board, chaired by David Tweedie. The European Commission have already agreed that International Accounting Standards should be adopted by all listed European corporations by 2005. We hope, through trans-Atlantic convergence with American GAAP, that ultimately we will have an agreed basis upon which to assess companies, regardless of the location of their headquarters, or of where their stock is traded. There are some fundamental disagreements, often between national agencies, on key issues such as the use of fair value accounting and expensing stock options, but I am cautiously optimistic that this work will eventually produce an acceptable result.

More generally, there has been considerable work internationally on developing, refining and implementing the various codes and standards that markets, ideally, will use to assess firms and countries. The Financial Stability Forum has blessed a core list of 12 key Codes and Standards which stretch across banking, securities, insurance, fiscal transparency, payments systems, money laundering and off-shore centres, etc. The sectoral standards-setters have increasingly realised that the key issue is not the standard-making but rather its effective implementation. So in organisations such as the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), effort is focussing on methodologies to help members implement good practices in their countries.

In the end, however, little will be gained if market participants themselves do not actively use the internationally agreed standards in their day-to-day judgements. Here we face the difficulty of transforming a qualitative standard into a useful quantitative reference point. The IMF has recognised this challenge and, assisted by the Bank of England and ourselves, has embarked on a programme to ensure that codes and standards are increasingly “user friendly”.

Corporate Governance

As for markets, so too for firms. There is much overlap in the development of codes and standards for markets and standards which firms should use in their internal control systems. The recent scandals in the USA, in particular, have exposed some serious gaps in areas such as auditor oversight and independence, the role of boards in overseeing management, corporate disclosure, conflicts of interest, etc. The controversial Sarbanes-Oxley Act in the USA is meant to address some of these shortcomings. On this side of the Atlantic, we continue to stress the responsibilities of senior management for the correct and timely disclosure of pertinent information and the necessity of establishing robust internal control systems to ensure that problems are caught before they become unmanageable, with possible catastrophic effects for the firms, its employees, investors and perhaps the larger financial system.

Internationally, the OECD is currently working on a revision of its Guidelines for Corporate Governance which, although only guidelines, spell out basic acceptable norms. Corporate governance issues do have a particular political resonance, especially in light of some of the salary excesses and performance failures exposed by recent scandals. I, therefore, expect to see corporate governance issues figure quite prominently in this year's Economic Summit process as our political leaders seek to regain investor and consumer confidence.

Prudential Supervision

But in spite of the emphasis I place on the role of market discipline, robust prudential supervision of both firms and markets is essential. Here I would make two points, based on my experience at the FSA. First, supervision must be risk-based, that is to say resources, which are always finite, must be allocated to those areas of the greatest risk and the greatest impact. This approach has implications for both investors and consumers, the most basic of which is investors and consumers must take greater responsibility for their financial decisions. I have said that we do not attempt to run a “no failure” regime. Our risk-based approach means attention is, or should be focussed on those key institutions or interfaces that have the most impact. We cannot hope to cover everything. This requires smart and educated consumers and investors, and consumer education is an area where we are investing considerably more resources than most of our regulatory counterparts, though both the US and Australian regulators have already done a lot to raise consumer understanding of financial issues.

And second, we are an integrated regulator covering banking, insurance and securities. In a world of accelerating cross-sector, cross-border financial innovation, universal banks, bulge-bracket investment banks and insurance company-owned banks, we believe this is the right place to be. It allows us, almost naturally, to practice consolidated supervision, i.e. a comprehensive approach to the firms we regulate and all their sub-entities.

In theory, and increasingly in practice as we develop our integrated approach, we are able to get a better handle on the interaction between different types of risk in different sectors of the market. We can better understand the overall risk dynamics of complex diversified institutions. One of the key tasks which all our line supervisors are required to undertake in relation to the larger firms within our care is to assess the potential impact of the failure of that institution on other firms, on its customers and on the markets more generally. This impact assessment could not be carried out effectively by the previous sector based regulators.

In all these ways, I think it fair to say that the regulatory community has made some progress in understanding the sources of financial instability and in setting up mechanisms to allow that information to be more effectively shared across borders.

But problems will slip through the net, inevitably. So it is appropriate also to ask whether corresponding progress has been made in our ability to manage crises when they arise.

Managing Financial Crises

I suspect the honest answer is that is we are still better at identifying financial crises, especially when they are about to burst upon us, than managing them, both in terms of intensity and duration. Indeed some say that the regulators are now likely to forecast a dozen of the next 3 crises. We may, however, be on the verge of seeing evidence that some progress has been made.

If the current Argentinean debt default had occurred five years ago I would hazard that the contagion effects on Argentina's neighbours and global financial markets would have been much greater. To a degree this reflects better risk management by the major international banks. They saw an unsustainable position and lowered their exposure. But it also, to some degree, reflects improvements in the "plumbing" of the international financial system. This may not be much comfort to the man on the street in Buenos Aires whose US dollar per capita income is today lower than it was in 1900. But greater sophistication and differentiation between markets has led to implicit "tiering" by investors which will reduce contagion at the cost of making it harder to those with a poor policy mix to borrow money on global capital markets.

Still, the management of financial crises is a chaotic and painful business. My sense is that we can, and should, do better. The Mexican, Asian, Russian and Brazilian experiences of the late 1990s have provoked a series of reform proposals which range from a supranational World Financial Authority to making the IMF the global lender of last resort, or transforming it into the overseer of an international bankruptcy court modelled on USA-style Chapter 11 proceedings.

The arguments behind some of these suggestions are at times persuasive but, to date at least, they all lack one essential ingredient – political feasibility. For the moment, or at least until the next major international crisis, national governments will remain unwilling to cede even greater powers to international institutions. We are therefore stuck, for better or worse, with the post-Asian crisis institutional structure and division of responsibilities. The debate over some form of international bankruptcy process is not yet concluded and may yet produce something new, but the grander schemes are unlikely to get the political support necessary to take them forward.

This reality check should not, however, be interpreted as saying that nothing can be done to improve our ability to manage financial crises after they have broken out. And some meaningful improvements have been made in recent years.

Steps Taken To Date

It is fashionable to argue that the international response to the Asian financial crisis has been woefully inadequate, and indeed that the reaction to the gaps highlighted by the Enron and WorldCom scandals has been slow and insufficient. I do not take such a pessimistic view.

At the institutional level the Financial Stability Forum is now actively engaged in vulnerability, risk, gap and underlap identification and increasingly in developing strategies for risk mitigation. The IMF and BIS have attempted to counter the perception of Eurocentrism by establishing offices in Tokyo (IMF) and Hong Kong and Mexico (BIS) respectively. The IMF, through the creation of the Capital Markets Department has consciously set out to improve its market and regulatory capabilities. Better co-ordination between international financial institutions, another flaw underscored by the Asian crisis, is now on everyone’s agenda.

In terms of policy, crawling currency pegs are largely discredited. One of the understandings to emerge out of the Asian crisis is the need for well thought out, sequencing of reforms intended to liberalise financial flows, and that those reforms in turn must be combined with solid regulatory structures. More recently, the latest bout of chaos in Argentina has demonstrated that even currency boards cannot hold back speculators if policy choices are fundamentally flawed.

At a less exalted level, but probably more importantly, we are cleaning up, or flushing out, a lot of our international financial plumbing. A few examples will have to suffice. At the international committee level, following the collapse of Enron, IOSCO was quick off the mark in proposing new principles on auditor independence and oversight and corporate transparency which are likely to become the global standards. We at the FSA have just published a consultation paper on financial market conflicts of interest and the UK Listing Authority, now a division of the FSA, will be looking at various corporate governance issues as part of its current review of the UK listing rules.

As an integrated regulator, we are particularly cognisant of the increasing complexity innovation has brought to the financial sector. Recent advances in debt securitisation and risk transfer, particularly between the banking and insurance sectors, has raised the linked questions of where certain risks are lodged and whether they have been correctly priced. As issues like credit risk transfer appear on our radar screen, we work both directly with the financial industry, and through appropriate international committees such as the FSF and the IAIS, to get a better handle on the extent of any possible problems. So far, there are signs that credit risk transfer has, overall, been a stabilising factor, but there are concerns about whether some of the buyers of risk have properly assessed what they have taken on.

Similarly, recent financial developments have resulted in the creation of very large, very complex financial firms, known in the trade as LCFIs, which are not necessarily all American. A regulator’s nightmare is if ever one of these firms got into serious trouble and had to be unwound. My devout wish is that this never happens, but to prepare for any eventuality we and other regulators have expended considerable effort improving our understanding of LCFIs, their structures and risk management and control systems. This is still very much “work in progress” but at a minimum, I believe we have a better understanding of the challenges we regulators would face if things were to go wrong and we were to be obliged to attempt an orderly run-down. In this game there are no simple, neat answers.

The European Financial Groups Directive will bring a measure of consolidated supervision to all financial conglomerates operating in Europe when it is implemented in 2005 and I have already mentioned Europe's commitment to implementing International Accounting Standards during the same year. The conclusion of the Basel Committee negotiations on capital adequacy, which will be transmuted into European law through a new capital adequacy directive, will introduce a greater risk-based element to the calculation of bank capital. Through its FSAPs and its Off-shore Centre assessments, the IMF is both assessing jurisdictions against minimum standards and gaining for itself a much more refined view of where structural pressures could manifest themselves. IOSCO and the Committee on Clearing and Payments Systems (CPSS, a sub-group of the Basel Banking Supervisory Committee) have just published a useful joint study on where problems could arise in the international payments system.

Is this enough? Has the international community responded adequately to the challenges, or is there more to do? We will not be able to give wholly convincing answers to those questions until the next crisis presents itself, at which point it will be too late.

Looking Ahead: What More Can Be Done?

So the jury is still out on the effectiveness of the most recent spate of reform in the following the Enron and Argentina crises. Some useful steps have been taken in response to the exposure of corporate excesses or tensions within the international financial system. More time, however, is needed to determine if they will be fully effective. For their part, the French have made it clear that socially responsible markets, corporate governance and excessive volatility will be a central part of the agenda for their presidency of the 2003 G7/G8 Economic

Summit process. This year, regulatory issues will be highlighted as never before by both heads of government and finance ministers at the Evian Summit.

But what useful outcomes could there be, if one accepts that there is no political consensus for any significant new international institutions or even for any significant increase in the powers of existing institutions?

My view is that even within those constraints more can be done to reduce the occurrence of financial crises, lessen their impact and speed up their resolution. First and foremost, I believe that we have to push forward convergence on a single set of international accounting standards. There are some difficult problems to be addressed including issues such as the treatment of financial instruments, the expensing of stock options and the disclosure of pension fund deficits. These are knotty questions that have bedevilled national standard setters for years and will be even more difficult to agree on internationally. And yet, recent events which suggest that US standard-setters have no monopoly of wisdom, have created an environment where real progress can be made towards a single set of standards which would allow cross-border comparisons. There is a new willingness in the US to consider compromises. I believe that we must seize this opportunity. I hope that the G7 finance ministers and leaders unanimously and enthusiastically give this a push at this year's summit. Political support for the process is required.

There are other actions which would help manage financial crises. One example is the inclusion of Collective Action Clauses (CACs) in all sovereign bond contracts, which would prevent a rump of disaffected investors from holding up debt restructuring. We already do this in London for 30% of the sovereign bond market and it seems a pity that extension globally is delayed because of post-Depression attitudes enshrined in US domestic bankruptcy legislation. More work also needs to be done on options for international debt restructuring, including standstill arrangements that would contribute to orderly dispute resolution. In addition, recent work on financial stability indicators has begun to bear fruit.

Such devices could provide both national governments and international agencies a useful early warning before pressures build up to the explosion point. I am encouraged that last weekend's G7 Finance Minister's meeting in Paris encouraged both private and public sector interests to adopt effective Collective Action Clauses at an early date.

On the policy front, we need to go further on both crisis prevention and crisis management. Those organisation such as the FSF and IMF that have been tasked with surveillance responsibilities should be willing to speak out on vulnerability issues **and** on mitigation strategies, regardless of the sensibilities of powerful members who might be inconvenienced by such analysis. Only then will they meet their full potential. In this vein, greater clarity in the mandates of international organisations identifying vulnerabilities, setting standards and assessing and, if necessary, enforcing standard implementation needs to be fostered. Institutions and their national members have to be willing to transform their judgments into concrete actions. Work towards this end is progressing in IOSCO, IAIS and elsewhere, but it has to be still further encouraged.

Work on upgrading and implementing internationally agreed Codes and Standards will continue. What is required, however, is a far greater emphasis on effective implementation. As noted above, for this to happen, our various standards must be made more market user friendly. Wearing my regulator's hat, I would even go one step further. The IMF is gathering a mass of information and experience on how these standards are being implemented through its FSAP and Off-shore Centre assessment programs. To date, these programs remain entirely voluntary and, for the moment, are not supposed to influence either the IMF's or the private sector's lending decisions. To change this is sensitive and controversial, especially for emerging markets, but somehow a means must be found to draw on information related to adherence to internationally agreed codes and standards to influence both public and private lending practices. It is not unreasonable to expect that jurisdictions participating in and benefiting from global financial flows meet and continue to adhere to minimum financial sector standards and, ideally, best practice. As a first step, the FSAP country assessments should routinely be published. The UK will shortly set an example and make the full IMF assessment public. Publication will help market participants draw their own conclusions about financial stability, and the integrity of the financial sector, which could itself enhance market discipline.

Conclusion

My conclusion will be brief. A stable international financial system is merely a means to an end. That end is sustainable economic growth and rising prosperity. Stable domestic and international financial markets are therefore necessary but not sufficient conditions for continued sustainable growth. Recent financial crises have starkly shown the damage that poor regulatory structures and oversight can do to countries with ostensible positive growth rates.

We have come a long way since Mexico in 1995, the first of the "new round" of financial crises. We still, however, have a way to go before we have in place the systems, institutions, policies and levers that will minimise the number, duration, fall-out and complexity of financial crises. Elimination of financial crises is beyond our reach; but we can realistically aim to do a better job of preventing and managing them in the future.