Speech

The Role of Regulation in Global Financial Markets

Speech given by

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Introduction

1 These remarks concern regulation in a broad sense. Specifically, I want to say a few words about a major current initiative in this area, promoted by the G7, the Financial Stability Forum, the IMF and others. It involves the formulation and implementation of a range of **codes and standards** relevant to the safe functioning of individual countries' economic and financial systems and the stability of the international financial system as a whole. Some of these codes and standards – for example the Basel capital regime - are already familiar. Others – for example those dealing with the transparency of fiscal policy or with corporate governance – may be less so.

2 Codes and standards, in one form or another, have of course shaped the environment for international economic and financial relations for a long time. In some cases they have been enshrined in treaties or other formal legal agreements. But in many cases they have not - and whether and if so how they have been implemented has then been largely at the discretion of individual countries. For a number of reasons, however, the collective interest in a country's compliance with internationally-recognised codes and standards has increased greatly in recent years.

3 I will organise my comments under the headings of "Why?", "What?" and "How?". Why is this codes and standards initiative being pursued, and why is it being pursued now? What codes and standards are we talking about and which of them are most important, given the very different situations of different countries? And how in practice is it proposed that they should be implemented?

Why?

4 A number of factors have contributed to the current focus on codes and standards.

5 First, **globalisation**. National economies are increasingly interlinked, so that problems in one can have rapid and significant knock-on effects in others. Put in a slightly different way, as countries

seek to integrate themselves more closely into the global economy, the externalities associated with their conduct of national economic and financial policies increase. Other members of the "club" may understandably look for reassurance that everyone is playing by broadly the same rules or at least is not exposing the club as a whole to unreasonable risks.

6 Second, the implications of **greatly expanded international capital flows**. Over the past 15 years, according to the Bank for International Settlements, the outstanding stock of cross-border bank lending has risen from under $1trn to $6 ½ trn, ie by a factor of about 7. There has probably been even faster growth in other kinds of cross-border financial claims. This compares with an increase in nominal world GDP by a factor of about 2 ½ and in nominal world trade by a factor of about 3. The size of current financial exposures means that the transmission of shocks is likely to be quicker, and quite likely more damaging, than would arise purely from trade effects.

7 Third, an **increased emphasis on private markets**. The value of capital flows to emerging markets has risen sharply; but there has in addition been a decisive shift in the source of these flows from the public to the private sector. This has highlighted the importance of factors contributing to the efficient functioning of private markets, including especially the availability of accurate and timely information.

8 Fourth, **recent experience**. The concern about knock-on effects is not simply theoretical – over the past twenty years there have been several examples of problems affecting sizeable economies which have threatened wider systemic damage. From Mexico in 1982 through the other Latin American debt crises of the 1980s, to Mexico again in 1994 and 1995, and then the East Asian debt problems of 1997 and 1998, to Russia in 1998 and Brazil in 1999 – all have called for intervention by the international financial institutions and/or by national authorities in order to contain the potential contagion.

9 No-one believes that formulating codes and standards, and monitoring and promoting compliance with them, is a complete response to these problems. There were clearly many contributory factors. But in most of the countries concerned there were areas where policy fell short of recognised good practice, or where features of the financial infrastructure - for example the regulatory regime - left the financial system excessively vulnerable or where there was simply not enough reliable information available for lenders and borrowers to make a proper assessment of risk. The position certainly differed from country to country. But there was sufficient commonality of experience to allow some general lessons to be drawn – and the current work on codes and standards is partly aimed at capturing those lessons. What it amounts to is a broad effort to raise the quality and the transparency of public policy in the economic and financial area in all countries, including the G7. The UK and Canada amongst others have already set an example.

What?

10 In referring to codes and standards in the present context it is worth emphasising that – as has typically been the case in the past - we are not talking about legally enforceable rules. One very good reason is that little international legal machinery would be available to enforce such rules. But even if the machinery were available, a legalistic approach might not be desirable for all sorts of reasons. This of course leaves open the question of what happens when a country fails to meet a relevant standard – to which I will return in a moment. (It is worth noting, however, that in the special context of the EU, there are now many examples of trans-national legally-enforceable codes and standards, including many relating to economic and financial issues.)

11 Codes have been drawn up and standards established by all sorts of bodies. I am not going to enumerate those currently recognised in the so-called Compendium maintained by the Financial Stability Forum. Depending on exactly what you count, there are around 55 going on 65 in total. They can be classified in a number of different ways. In terms of subject, there are three main areas:

macroeconomic fundamentals; institutional and market infrastructure; and financial regulation and supervision. A list is shown in Table 1. But the list can also be divided up in other ways: between standards which are sectoral in scope (eg standards relating to banking supervision) and those which are functional (eg standards relating to corporate governance or accounting); between those which set benchmarks for the substance of policy and those which focus on the transparency of policy (ie the public availability of information about policy objectives, operational techniques, etc); between standards which take the form of broad principles (eg the Basel Committee's *Core Principles for Effective Banking Supervision*), those which spell out in more detail the intended practical application of the principles (eg the Basel Committee's *Sound Practices for Loan Accounting*) and those which set out detailed methodologies (eg the IMF's *Special Data Dissemination Standard*); and finally between those which have received formal international endorsement and those which have not.

12 I rehearse all this not because I intend to go further into the specifics but simply to illustrate the diversity of the approaches reflected under the general heading of codes and standards.

How?

13 The length of the list also indicates that it would be a tall order indeed to try to make progress on implementation uniformly across the whole range of codes and standards. There is an obvious need for prioritisation. But prioritisation is not straightforward because different standards have different priorities for different countries, and moreover these priorities are likely to change over time. In some cases there is also a sequencing implicit in the standards themselves – it would for example be foolish to put a lot of effort into the more esoteric aspects of prudential banking supervision in the absence of a proper accounting framework for the measurement of asset values, capital and so on. This issue has not been, and perhaps cannot be, completely resolved. But it has nevertheless been possible to reach broad agreement on a smaller group, of twelve, "key" standards (Table 2) - which are key in the sense that the aim of meeting them would make sense for many, even if not all, countries.

14 The second point to make under the heading of "How?" is that, without someone to orchestrate and monitor the process of implementation, there is a risk that momentum will be lost. Even if everyone accepted in principle that all the codes and standards were sensible – and at present that would be an optimistic assumption – the difficulties involved mean that implementation could well run into the sands. Who should this orchestrator be? No institution has an operational remit which runs across all the areas covered by the various codes and standards. But the IMF probably comes closest – *pace* those who would curb its role – and we believe that the IMF is the appropriate body to take on the task. But just to be clear, "the task" is to monitor and coordinate, not to be responsible for each of the individual parts. As the IMF aptly describe it, they would maintain the "loose leaf binder" into which reviews and assessments of progress, produced in some cases by the IMF but in many cases by others, could be slotted. The so-called ROSC process – the Reviews of Standards and Codes - and the work on Financial Sector Assessment Programmes, are elements of this approach.

15 A third important but contentious aspect of implementation is the question of incentives. Why should a country commit to observe the codes and standards? The general incentive, if the codes and standards are well formulated, should be that compliance will improve national economic performance. But there is an issue whether, beyond that, there are specific incentives which the private sector or the public sector might provide. I am not going to enter into the detail of the arguments here, but one approach is to look at the question from the point of view of the identification, measurement and management of risk. It would be quite reasonable for private lenders and investors to take into account compliance with relevant codes and standards if they thought it affected the credit risks they were running. For the same reason, public sector lenders could be expected to take these considerations into account. But the public sector also needs to have in mind "systemic" externalities ie that the failure of a country to meet its obligations may threaten the financial system generally and require their intervention to contain the consequential systemic damage. To that extent, the public sector may put more weight than the private sector on compliance with codes and standards as providing some protection against this risk.

16 A final, and again important, consideration under the heading of "How?" is that of technical assistance and training. Whatever the incentives, there are bound to be limits for many countries on their technical capacity to implement codes and standards; and there may also be constraints on the capacity of the IFIs and /or standard setters to monitor implementation. In turning the codes and standards programme into reality, it will be necessary to address these resource issues – which in practice probably means that regulators and the public authorities generally in the more developed economies will have to be prepared to commit staff and other resources in support of the implementation process.

Concluding comments

17 I hope these comments give a flavour of some of the issues which have arisen in the current discussions on the formulation and implementation of codes and standards. Overall, the setting out of these standards, and transparency about their implementation, could make a significant contribution to strengthening the international financial system.

18 Let me conclude with three further points.

19 First, better information from borrowers is only half the story. The counterpart is the need for lenders and investors to make proper use of that information. The evidence on the extent to which they do this is patchy but it certainly cannot be taken for granted that all lenders, even all major lenders, give due weight to the information which is available. I believe there is an important challenge to find incentives which can be applied to lenders so as to encourage them to pursue improved risk management practices in this area.

20 Second, effective implementation of the codes and standards programme involves many different parties. The official interest is reflected in various international committees; but it is important also that the private sector should be engaged. For that reason, a number of initiatives under the general heading of "outreach" are underway, aimed at telling private market participants what is going on, seeking their views on what information and in what form they would find most useful, and encouraging them to make use of it. The IMF, the G20 and the Financial Stability Forum have been particularly active in promoting such dialogue.

21 Finally, it is important to have a realistic timetable for carrying through the codes and standards programme as it has now been set out. It is not something which can be delivered overnight, within a few months or even within a year or two. It is bound to be a long term exercise. But that does not mean we should delay making a start or slacken our effort now.

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TABLE 1: STANDARDS FOR SOUND FINANCIAL SYSTEMS

Macroeconomic fundamentals

- Code of Good Practices on Transparency in Monetary and Financial Policies
- Code of Good Practices on Fiscal Transparency
- Special Data Dissemination Standard (SDDS)
- General Data Dissemination System (GDDS)

Institutional and market infrastructure

- Principles of Corporate Governance
- Core Principles for Systemically Important Payment Systems
- Settlement Risk in Foreign Exchange Transactions
- Real Time Gross Settlement Systems
- Report of the Committee on Inter-Bank Netting Schemes of the Central Banks of the Group of Ten Countries (“The Lamfalussy Report”)
- Delivery versus payment in Securities Settlement Systems
- OTC Derivatives: settlement procedures and counterparty risk management
- Clearing arrangements for exchange-traded derivatives

Financial regulation and supervision

Banking

- Core Principles for effective banking supervision
- International convergence of capital measurement and capital standards
- Overview of the Amendment to the Capital Accord to Incorporated market risks
- Amendment to the Capital Accord to incorporated market risks
- Supervisory framework for the use of “back-testing” in Conjunction with the internal models approach to market risk capital requirements
- Principles for the supervision of banks’ foreign Establishments (The “Basel Concordat”)
- Minimum standards for the supervision of international banking groups and their cross-border establishments
- The supervision of cross-border banking
- Enhancing bank transparency
- Sound practices for loan accounting and disclosure
- Framework for internal control systems in banking organisations

Securities

- Objectives and principles of securities regulation
- IOSCO Resolution: Principles for record keeping, collection of information, enforcement powers and mutual cooperation to improve the enforcement of securities and futures laws
- Methodologies for determining minimum capital standards for internationally active securities firms which permit the use of models under prescribed conditions
- Guidance on information sharing
- Report on cooperation between market authorities and default procedures
- Principles of Memorandum of Understanding
- Operational and financial risk management control mechanisms for over-the-counter derivatives activities of regulated securities firms
- Risk management and control guidance for securities firms and their supervisors
- Client asset protection
- Securities activity on the internet
- Coordination between cash and derivative markets: contract design of derivative products on stock indices and measures to minimise market disruption
- The application of the Tokyo Communique to exchange-traded financial derivatives contracts
- Principles for the supervision of operators of Collective Investment Schemes
- Report on investment management principles for the Regulation of Collective Investment Schemes and Explanatory memorandum

Insurance

- Insurance supervisory principles (“Core Principles”)
- Principles applicable to the supervision of international insurers and insurance groups and their cross-border business operations (“Insurance Concordat”)
- Supervisory Standard on Derivatives

TABLE 2: KEY STANDARDS[1]

	Issued By
Macroeconomic Fundamentals	
Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Code of Good Practices in Fiscal Transparency	IMF
Special Data Dissemination Standard/General Data Dissemination system[2]	IMF
Institutional and Market Infrastructure	
Insolvency[3]	World Bank
Principles of Corporate Governance	OECD
International Accounting Standards (IAS)[4]	IASC[5]
International Standards on Auditing (ISA)[4]	IFAC[5]
Core Principles for Systemically Important Payment Payment Systems	CPSS
The Forty Recommendations of the Financial Action Task Force	FATF
Financial Regulation and Supervision	
Core Principles for Effective Banking Supervision	BCBS
Objectives and Principles of Securities Regulation	IOSCO
Insurance Supervisory Principles	IAIS

[1] While the key standards are categorised here by policy area, some of them are relevant to more than one area.

[2] Economies with access to international capital markets could be encouraged to subscribe to the more stringent SDDS and all other economies could be encouraged to adopt the GDDS.

[3] The World Bank is coordinating a broad-based effort, involving relevant institutions and legal experts, to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCIT RAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.

[4] The IAS and ISA are used in some jurisdictions but are not endorsed by all jurisdictions. The IAS are currently being reviewed by the BCBS, IAIS and IOSCO.

[5] The International Accounting Standards Committee (IASC) and International Federation of Accountants (IFAC) are distinct from other standard-setting Bodies in that they are private sector bodies.