BANK OF ENGLAND

Speech

Banking Supervision and Financial Stability from an International Perspective

Speech given by

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Introduction

Twenty years ago, G7 agendas, or G5 agendas as they then were, tended to focus on macro-economic questions - exchange rate intervention, fiscal "locomotives" and the like. Today, the basic framework for macro-economic policy is common ground amongst the G7 and the emphasis is now much more on financial stability issues.

I want to say a word briefly about financial regulation in the context of this wider financial stability agenda. Specifically I want to talk about a current initiative in this area - promoted by the IMF, the World Bank, the Financial Stability Forum, and others - on so-called **Standards and Codes**. Its ultimate objective is to increase the overall robustness of national and international financial systems. Financial regulation has an important part to play in this - but it is only one instrument and cannot be effective on its own.

I will split up my remarks under the headings of "Why?" "What?" and "How?" Why is the initiative on Standards and Codes being pursued now? What Standards and Codes are we talking about? And how in practice can countries be encouraged to implement these Standards and Codes?

Why?

First, why? A number of factors have contributed.

One is **globalisation**. National economies are increasingly interlinked, so that problems in one can have rapid and significant knock-on effects in others. Put differently, as countries integrate themselves more closely into the global economy, their national economic and financial policies become more of a concern to other members of the international "club". These other members want reassurance that everyone is playing by broadly the same rules, or at least is not exposing the club as a whole to unreasonable risks.

Second, **greatly expanded international capital flows**. Over the past fifteen years, cross-border bank lending, as measured by the Bank for International Settlements, has risen by about 600%. There has probably been even faster growth in other kinds of cross-border financial claims. This compares with a 150% increase in nominal world GDP and 200% in nominal world trade. Large financial exposures mean that shocks are transmitted faster, and are likely to be more damaging, than when trade linkages were the main transmission mechanism.

Third, **increased emphasis on private markets**. Not only has the overall value of capital flows risen but the sources of funding for some developing countries and many emerging markets have shifted decisively from public to private. One result is that more attention is now being paid to the efficient functioning of private financial markets, and especially to the availability of accurate and timely information - "transparency" in the current jargon.

Fourth, recent experience. The concern about knock-on effects is not just theoretical - over the past twenty years country debt problems have on several occasions threatened to cause wider systemic damage. From Mexico in 1982 through the other Latin American debt crises of the 1980s, to Mexico again in 1994 and 1995, the East Asian debt problems of 1997 and 1998, to Russia in 1998 and Brazil in 1999 and now to Argentina and Turkey - all have led to intervention by, and the provision of substantial amounts of cash by, the international financial institutions.

No-one believes that Standards and Codes are a complete response to these problems. Many factors have contributed to debt crises. But in most of the countries concerned there were areas where policy fell short of recognised good practice, or where the financial infrastructure - for example the financial regulation regime - left the financial system excessively vulnerable, or where there was simply not enough reliable information for lenders and borrowers to make a proper assessment of risk. The position differed from country to country. But the different cases had sufficient in common to allow some general lessons to be drawn - and the current work on Standards and Codes is partly aimed at capturing those lessons. What it amounts to is **a broad effort to improve the quality and transparency of economic policy** in all countries - in the emerging markets but also the G7.

What?

Let me move on to "what?"

The label "Standards and Codes" does not convey a very specific agenda. It does not, in the present context, mean international, legally enforceable rules. In any event, there is very little legal machinery to enforce such rules. And even if there were, a legalistic approach might not be desirable for all sorts of reasons. An "informal" approach on the other hand leaves open the question of what happens when a country fails to meet a relevant standard - to which I will return in a moment.

Standards and Codes have been drawn up in many areas of financial policy. Depending on how you count them, upwards of 70 have been set out so far. To give you a flavour of the ground they cover, some of the main ones address:

- disclosure standards for fiscal and monetary policy
- data availability
- data availability · accounting and auditing standards
- payment system design and oversight
- insolvency procedures and
- the regulatory regimes for banking, securities and insurance.

Many of the components - for example, accounting standards and the Basel Core Principles on banking supervision - pre-date the Standards and Codes exercise and have status in their own right. But they have been brought together within the overall Standards and Codes framework.

The length of the list illustrates the wide range of policies which the international community believes are relevant to financial stability. As well as financial regulation, it includes many other aspects of the financial infrastructure. And the list also points to the critical importance for financial stability of a stable macro-economic environment.

How?

So finally "how?" How can countries be encouraged to comply with international Standards and Codes?

An "across-the-board" approach for 70 or so standards and 180-odd countries is simply not feasible. But there are several ways of making the exercise more manageable. The first has been to focus on twelve key standards - basically the ones I mentioned a moment ago. A second has been to acknowledge that different standards have different priorities for different countries, and that these priorities are likely to change over time. In some cases there is 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 capital requirements without a proper accounting framework. The "key" standards are key in the sense that aiming to meet them would make sense for many, even if not all, countries.

The second point under the heading of "How?" is that, without someone to orchestrate and monitor implementation, the whole Standards and Codes programme would very likely fizzle out. Even if everyone accepted that all the Standards and Codes were sensible - and that is still a big "if", notably for some emerging markets - there are many potential difficulties in turning principle into practice. Who should this orchestrator be? No single institution has a remit running across all the territory. But the IMF probably comes closest and has been assigned the task. But just to be clear, "the task" is to monitor and coordinate the overall process, not to be responsible for each of the individual parts.

A third question concerns incentives. Why should a country commit to observe international Standards and Codes? The general incentive should clearly be that compliance will improve domestic economic performance. But there is a question whether, beyond that, foreign private investors or official international lenders could or should provide more direct incentives.

This is a contentious issue and as yet it is not resolved. The kind of "carrots and sticks" which have been considered include: restrictions on market access for financial firms whose home state regulation does not meet international standards; a requirement for sovereign borrowers to disclose in prospectuses for international debt issues their national compliance with key standards; and adjustment of the terms of access to funding from international financial institutions to reflect a borrower's compliance with international standards. But in the long term, probably the more important issue is how far the private sector, in their lending and investing decisions, pay attention to compliance with Standards and Codes.

To be honest, the evidence on this so far is not altogether encouraging. Financial firms seem to have, for the most part, a patchy knowledge of what the Standards and Codes programme is about. And even when they are aware of the programme, they are often unsure how to plug the results into their internal risk management procedures. And even less certainly do they reflect the results in the pricing of their loans or investments. But some firms do; and others are beginning to recognise the potential value of paying attention to compliance with Standards and Codes. It is hard to demonstrate, certainly for the moment, any hard connection between compliance and creditworthiness. What can be said, however, is that many countries which have experienced financial instability have been seriously non-compliant with one or more of the key standards.

Concluding comments

I have tried in these comments to set banking supervision - not just the new Basel Accord but the whole supervisory approach set out by the Basel Committee - in the more general context of making national and international financial systems safer.

Let me conclude with three points.

First, the effective implementation of the Standards and Codes 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 contacts.

Second, it is important to have a realistic timetable. The Standards and Codes programme is not something which can be delivered overnight, within a few months or even within a year or two. It is bound to require a sustained effort. The important thing is to make a start.

And third, better performance by and information about borrowers is only half the story. The counterpart is better use by lenders and investors of the information that is available. I believe there is an important challenge to find incentives which can be applied on the "buy" side, so to speak, to encourage improved risk management practices.

One last observation: I may have given the impression that Standards and Codes is essentially an issue for emerging markets. It certainly is an issue for many of these countries; but it is also relevant to the developed economies, including the UK. Next year the UK will be subject to a review by the IMF of its own compliance with the major standards, and of its arrangements more generally for maintaining financial stability. This exercise will mainly involve the Bank, the Treasury and the FSA but it will aim to present an overall picture of the robustness - we hope! - of the UK financial sector.

References

Author 'Title' *Source*