Managing Risks to the International Banking System

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Changes in the financial markets over the past decade have threatened the stability of the international financial system, spurring the G-10 to strengthen bank supervision and regulation. The challenge now is to extend the benefits of multilateral arrangements to emerging market countries.

THE GROUP of Ten, or G-10—the policymaking body for the ten industrial countries with the largest economies—has responded to the momentous changes in financial markets in the 1980s and 1990s by strengthening supervision and regulation of the international banking system through several multilateral arrangements. These arrangements have generally been successful in reducing risks to the system and averting potential problems, although there have been some close calls (see box). To preserve the stability and efficiency of the global financial system, they now need to be broadened and extended to include emerging market countries that could have a systemic impact.

In recent years, a number of emerging market countries, particularly in Asia, have become important participants in the international financial markets. The exposure of investors and banks in industrial countries to emerging market countries has increased substantially, as portfolio investment flows and bank lending to the emerging markets have grown and the latter's financial sectors have expanded, relative to the financial sectors of industrial countries (see chart). Singapore and Hong Kong have become, respectively, the fourth and fifth largest foreign exchange trading centers in the world. Even developing countries that are not yet major players in the financial markets would benefit from being included in multilateral arrangements—a sound financial system can make an important contribution to economic performance. Although the Bank for International Settlements (BIS) is increasing its membership to include central banks from emerging market countries with large economies or major financial markets, there is little agreement on how to expand current cooperative arrangements of G-10 bank supervisors to include other countries.

G-10 cooperation

The major industrial countries have recognized the inadequacy of nationally focused strategies in today's financial environment. With the growing globalization of financial markets, financial institutions can move their business to countries with less stringent supervision and regulation to evade domestic prudential restrictions—and countries will compete with each other for this business. Cooperation in assigning responsibilities for prudential oversight of internationally active banks and in setting minimum standards for banks is therefore critical.

The G-10 countries have forged agreements in these areas through the Basle Committee on Banking Supervision, which was established in 1974, with a permanent secretariat at the BIS, after a crisis in the foreign exchange markets. In 1975, the Basle Concordat developed the principle that the home country is responsible for supervising, on the basis of a consolidated balance sheet, the global operations of international banks in its jurisdiction. The Concordat has been strengthened on several occasions (most importantly in the aftermath of the failure of the Bank of Credit and Commerce International (BCCI)). And, in 1992, the Basle Committee agreed on a set of minimum standards for the supervision of international banks and their cross-border establishments. The standards set out the right of home country supervisors to obtain the data needed for the consolidated supervision of international banks and strengthened the host countries' authority to impose restrictive measures if the minimum standards are not met. Such measures include imposing deadlines for meeting acceptable standards, obliging foreign branches to be restructured as

separately capitalized entities, and even closing banking establishments.

Another agreement forged by the Basle Committee on Banking Supervision concerns regulatory capital requirements for international banks. Internationally active banks will be allowed to use their own internal risk-management models to estimate and control the total net loss they could sustain during a specified number of trading days (the so-called value-at-risk methodology), with the regulatory minimum capital requirement for market risk then being determined as a multiple of the bank's value at risk. The new methodology creates powerful incentives for banks to improve risk management—successful efforts by banks to control their market risk are rewarded with a lower regulatory capital ratio.

Two other committees that address systemic issues are the Eurocurrency Standing Committee, which was created in 1962 in response to concerns about the growth of the Eurodollar markets, and the Committee on Payment and Settlement Systems, which was set up in 1989 to set standards for wholesale payments systems (see the article by Laura E. Kodres in this issue).

The success of the Basle Committee on Banking Supervision is due largely to three factors. First, the Committee has no international or cross-border means of enforcement and leaves enforcement to national supervisory authorities. Second, it has been careful to involve the international banking industry in achieving a consensus, as have the two other committees. Third, its membership has remained small and has not changed since its inception, enabling G-10 bank supervisors to build effective working relationships and reach agreements through mutual education and persuasion.

Some of the agreements reached by these committees are also implemented by countries that are not members of the G-10. The 1988 accord on risk-weighted capital standards for international banks is one example. Others, however, such as those relating to the sharing of supervisory responsibility and information, are difficult for nonmembers to implement, in part because of the confidential nature of supervisory information. Some of the intangible benefits flowing from the work of the committees are also not easily transferred to nonmembers—for example, the educational benefits of the consensus-building approach, which has led to a great improvement in the quality of prudential supervision in G-10 countries. Also, the successes and international prestige of the committees have made it easier for supervisors in the committees' member countries to overcome domestic opposition to agreed regulatory measures.

Emerging markets

There is widespread agreement among supervisors and market participants in the major industrial countries that a way will have to be found to extend the improvements in the supervisory and regulatory infrastructure in international financial markets to the systemically important emerging market countries. Two reasons are generally cited.

First, a financial crisis in an emerging market country may cripple economic performance, with potentially adverse consequences for the country's trade and financial partners, as was demonstrated in the Mexican crisis in 1995. Because capital markets in most developing countries are still relatively underdeveloped, the banking system typically plays a central role, intermediating the overwhelming share of domestic savings and cross-border capital flows. Bank assets are therefore particularly vulnerable during economic downturns, and may bear the brunt of any increase in short-term interest rates required to defend an exchange rate in the event of a sudden capital outflow. Second, integration of the emerging market countries into the international financial system will require, among other things, that both the quality of prudential supervision and the ability of financial institutions in these countries to manage risk be raised to international standards. Only then will financial institutions in industrial countries be prepared to offer their counterparties in emerging market countries the same kinds of terms they offer each other.

Certain characteristics of the emerging market countries' financial and legal systems may make surveillance difficult, however. For example, bank supervisors may have less technical ability and fewer resources than their counterparts in the G-10 countries (Hong Kong and Singapore are exceptions), and supervision and financial accounting methods may not be sophisticated enough to keep up with internationally active financial institutions. Moreover, supervisors may be unable to get a comprehensive picture of all of the activities of domestic banks, as domestic and foreign banks move some wholesale activities in emerging markets offshore and alter their risk positions through the use of derivatives and offshore transactions. Legally, it may be difficult for supervisors to implement prudential directives. Economies dominated by a small number of large corporate groups may be unable to avoid concentrations of risk and ownership. And, in many countries, extensive financial safety nets have undermined market discipline with respect to credit allocation.

Necessary measures

Most banking supervisors in the G-10 countries think that existing institutional

Improving communication and coordination

The recent incidents involving Barings and Daiwa Bank suggest that there is room for improving communication and coordination between banking supervisors in the G-10 countries and futures markets supervisors. If communication between the Bank of England, the Singapore International Monetary Exchange, and the Osaka Securities Exchange had been better, authorities might have been alerted earlier to the large positions being built up by Barings on the two futures exchanges. The fact that the problem occurred in the overseas securities subsidiary of a bank made supervision much more complicated. The incident led futures markets regulators to adopt a new set of principles guiding the exchange of information—the so-called Windsor Declaration.

In the case of Daiwa Bank, communication between the Japanese Ministry of Finance and US regulators after Daiwa's problems had come to the attention of the Finance Ministry was also poor. The Ministry affirmed publicly that the exchange of information would have been better had the Basle Concordat been followed.

arrangements cannot easily be enlarged to include emerging market countries and should not be disrupted. New arrangements are needed that complement, rather than replace, existing arrangements. International banks and institutional investors have indicated that they would support efforts to broaden surveillance to include some emerging market countries, provided that these efforts are consistent with the existing international framework and do not introduce new restrictions.

Although there is little agreement in the official sector on the details of how to expand existing arrangements, there is a consensus on three main points.

First, international cooperation in the area of financial surveillance should be based on home country control, rather than on supranational legal arrangements. Legally binding international treaties would not only be difficult to negotiate in the supervisory and regulatory area but would also be insufficiently flexible in implementation and slow to respond to changes in the international financial environment.

Second, international agreements and arrangements should include all countries with financial institutions that are significant players in the international financial markets because of the likelihood, in the absence of comprehensive coverage, of regulatory arbitrage by financial institutions and competition among countries to attract these institutions. Furthermore, since the number of countries with institutions that participate in the international financial markets is likely to increase, it is important to have a well-established, flexible mechanism for adding countries to multilateral agreements.

Third, international agreements should be narrowly focused on (1) minimum standards for the regulation and surveillance of internationally active financial institutions; (2) assignment of responsibility between home and host countries for the surveillance of the operations of international banking institutions; and (3) the exchange of information among national supervisory authorities.

Supervisors in the major industrial countries broadly agree that a list of minimum prudential standards should include, among other things, five key items:

• a requirement that national supervisors have the ability to supervise financial firms on a "globally consolidated" basis (this term is open to a wide range of interpretations) so that no important domestic or foreign banking activity remains without oversight;

• regulatory capital standards, including standards for the management of market risk;

• internationally accepted loan-classification and provisioning rules;

• limits on large exposures (including intragroup exposures); and

• sufficient legal authority for supervisors to obtain all relevant financial information through on- and off-site inspection and to close financial institutions or limit their activities when regulatory requirements are violated.

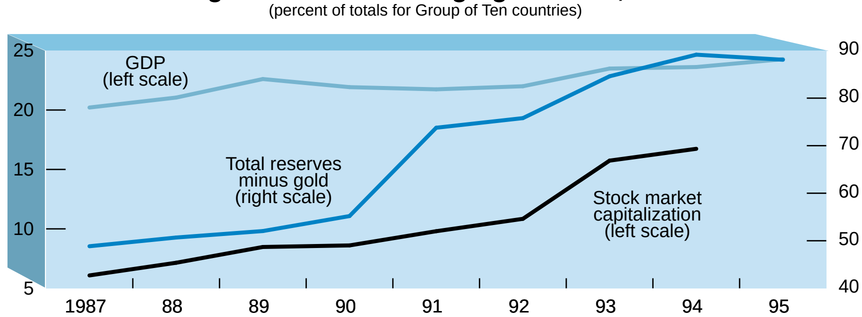
The promulgation of minimum standards is generally viewed favorably by supervisors and market participants alike; the success of such standards depends on how rigorously they are implemented. Moreover, even though they may need to be guided by internationally agreed standards, countries should adopt standards that reflect individual differences in financial structure and vulnerability, and domestic supervisors should have full authority over the regulation of domestic financial activity.

Regional arrangements

A failure to broaden existing multilateral frameworks for the surveillance of international financial markets could create pressure for countries to enter into regional arrangements. The proposal by Governor Bernie Fraser of the Reserve Bank of Australia to set up an "Asian BIS" may be a first step toward such an arrangement. Although the proposal does not envisage definition of minimum supervisory standards—at least at this time—the exchange of information and cooperation in times of turbulence is a stated objective. Some central banks in Asia have also made joint efforts to prepare for sudden pressure on exchange rates. And a number of cooperative regional arrangements have been set up in Asia, Europe, the Middle East, and Latin America and the Caribbean, mainly as consultative bodies that provide regional technical assistance and training and facilitate cooperation.

Regional arrangements may be helpful in certain respects but will prove inadequate in the long term. Financial institutions increasingly operate globally in wholesale markets, not regionally. This is why the European Union has modeled many of its legally binding prudential requirements for European Union banks on the requirements of the Basle Committee on Banking Supervision. Nevertheless, regional initiatives could complement a global approach by providing a channel for promulgating best practices and implementation and for sharing views and information. F&D

Growing influence of emerging markets, 1987–95
(percent of totals for Group of Ten countries)



Sources: International Finance Corporation, *Emerging Stock Markets Factbook*, various issues; and International Monetary Fund, *International Financial Statistics*, various issues, and World Economic Outlook databases.
Note: The group of emerging markets, as defined by the International Finance Corporation, consists of 26 countries and includes Australia and New Zealand, which have weights of 8.5 percent, 3.5 percent, and 12.0 percent in the calculations for GDP, total reserves minus gold, and stock market capitalization, respectively.

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