Evolving Cooperation and Coordination in Financial Market Surveillance

How should existing arrangements for the surveillance and supervision of the international financial system be adapted to the challenges posed by increasingly integrated markets? New initiatives, including setting up the Financial Stability Forum, have recently been taken in this area.

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IN CONSIDERING ways to strengthen the international financial system, in October 1998 the finance ministers and central bank governors of the Group of Seven industrial countries asked me to consult with other bodies on the arrangements for cooperation and coordination among the various international financial regulatory and supervisory organizations and the international financial institutions and make recommendations on any new structures and arrangements that might be needed.

The Group of Seven subsequently agreed that better processes were needed for monitoring and promoting stability in the international financial system and that the international financial institutions, working closely with the international supervisory and regulatory bodies, should conduct surveillance of national financial sectors and of their regulatory and supervisory regimes.

This process of strengthening financial sector surveillance would include both peer review and the IMF's regular surveillance of its member countries under Article IV of its Articles of Agreement. To this end, the ministers and governors agreed to bring together the key international institutions and national authorities involved in financial sector stability to coordinate their activities in managing and developing policies to foster stability and reduce systemic risk in the international financial system and to exchange information more systematically on risks to the international financial system.

With this mandate, I consulted representatives of the Group of Seven, the international financial institutions, and various other international bodies. In the course of these consultations, broad consensus emerged on the key areas in the international financial system where improvements were deemed essential to safeguard the proper functioning of the markets.

Current arrangements

Various international organizations currently share responsibility for the supervision and surveillance of the international financial system.

The international financial institutions contribute in various ways to strengthening the global financial system:

- the IMF—which, under its Articles of Agreement, is responsible for surveillance of all member countries—monitors developments in the global economy and financial markets; and
- the World Bank, as required by its mandate, uses its expertise to assist developing countries in the design and implementation of reforms to strengthen financial systems, including banking, capital markets, and market infrastructure.

In addition,

- the Bank for International Settlements (BIS) provides analytical, statistical, and secretariat support for various official groupings working to strengthen the global financial system; and

• the Organization for Economic Cooperation and Development (OECD) participates in the process of macroeconomic and financial surveillance and formulates guidelines for evaluating and improving the framework for corporate governance.

The cooperation and coordination of supervisory practices are carried out by various sector-specific international groupings of regulators and supervisors:

• the Basle Committee on Banking Supervision, which serves as an important rule-setting body in banking supervision;

• the International Organization of Securities Commissions, whose members help each other to promote the integrity of securities and futures markets worldwide; and

• the International Association of Insurance Supervisors, which cooperates with supervisors in promoting high standards in the field of insurance supervision.

There are also groupings of central bank experts concerned with market infrastructure and functioning:

• the Committee on Payment and Settlement Systems, which analyzes payment systems and makes recommendations to reduce any risks that might arise in their operation; and

• the Committee on the Global Financial System (formerly the Euro-Currency Standing Committee), which analyzes conditions in the global financial system and recommends ways to improve market functioning.

These current arrangements have contributed strongly to raising the standards of soundness and risk awareness in financial systems. These are remarkable achievements, especially considering that their efforts were designed to affect only specific sectors. However, the pace of change in markets and financial intermediaries as a result of global financial integration has increasingly demonstrated the limitations of such an approach. The establishment of the Joint Forum on Financial Conglomerates represented an initial response to the dichotomy of fragmented supervisory structures and increasingly integrated markets. Such an approach must now be applied more comprehensively.

There are three aspects to this approach: first, to coordinate the treatment of micro-prudential and macro-prudential issues; second, to bring together the major international institutions and key national authorities involved in financial sector stability; and third, to integrate emerging markets more closely into this process.

Ultimately, strengthening cooperation should make a substantial contribution to a better functioning of the financial markets. This process will make full use of the considerable benefits of free capital movements for all participants in the global financial system.

Areas for improvement

The recent crises in international financial markets have highlighted three areas in which improvement is needed.

First, there must be enhanced efforts to identify incipient vulnerabilities in national and international financial systems. Moreover, there should be concerted procedures to understand better the sources of systemic risk and to formulate effective financial, regulatory, and supervisory policies to mitigate them.

Second, there should be more effective procedures to ensure that international rules and standards of best practice are developed and implemented, and that gaps in such standards are effectively identified and filled.

Third, there must be improved arrangements to ensure that consistent international rules and arrangements apply across all significant financial institutions, and that there are procedures to ensure the continuous flow of information among the authorities responsible for financial stability.

Identifying vulnerabilities. The recent crises have underscored the importance of assessing domestic vulnerabilities in the light of evolving global conditions, as well as of relaying such assessments to interested parties to forestall delays in correcting inadequate structures and destabilizing trends.

While the national authorities, international financial institutions, international regulatory bodies, and central banks all gather and assess data on parts or the whole of the international financial system and regularly monitor aspects of systemic stability, none of them has the breadth of information or the capacity to formulate a complete assessment of evolving risks. In view of the many sources from which systemic risk can arise, better procedures are needed to systematically pool and efficiently use the information available to these bodies in their assessment of domestic financial vulnerabilities and global conditions.

Recent events have also illustrated the potential risks posed to the world economy by financial market problems and the threat of chain reactions, or "contagion," in the financial sector. These developments have demonstrated the importance of mitigating systemic risk by better understanding and more effectively alleviating the factors that bear on it. Disabling shocks to the global financial system may arise from a variety of factors and circumstances, including macroeconomic weaknesses, the collapse of major institutions, and weaknesses in the infrastructure that underpins and connects financial systems. The answer lies in transparency, close monitoring, and—if necessary—coherent and appropriate action to forestall accelerating adverse developments.

The various regulatory bodies deal predominantly with micro-prudential issues concerning the stability of the individual institutions within their purviews. However, the greater role of financial markets in channeling funds from surplus to deficit sectors and in managing a wide variety of different risks has made it increasingly important to focus on the sustainable functioning of markets, including the health and operation of individual institutions. This implies a greater need to consider micro-prudential policies in a wider setting, including ways in which such policies could be blunted or sharpened by market practices and discipline.

Greater efforts are also needed to foster improvements in the functioning of markets. These include systematically overseeing the processes by which markets and market participants are adequately informed.

Systemic threats may also arise from unsupervised financial service providers, notably, major, highly leveraged institutions (as has been underlined in a recent report, "Sound Practices for Banks' Interactions with Highly Leveraged Institutions," by the Basle Committee on Banking Supervision). In addition, difficulties at nonbank financial institutions and large insurance companies could have spillover effects. Developing an appropriate response will require the various regulatory groupings and the national authorities of the markets in which these entities are domiciled and operate to become involved.

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Standards and codes of conduct. A systematic approach to strengthening financial systems is needed to ensure that gaps in international standards or codes of conduct are identified and effectively filled. This calls for intensified cooperation and coordination between national authorities, international regulatory bodies, and the international financial institutions charged with monitoring and fostering implementation. In particular, national authorities and regulatory groupings must ensure that the process of developing standards benefits from the wide-ranging information obtained by international financial institutions in their surveillance and assistance activities in individual member countries. The emerging market economies to which those standards would apply should be involved more closely in these processes, in order to enhance their commitment to implementing them.

A major challenge for the international community in the years ahead will be to foster and monitor the worldwide implementation of accepted best practices and, in particular, of compliance with the Core Principles issued by both the Basle Committee on Banking Supervision and the International Organization of Securities Commissions, as well as with those being developed by other international bodies. The international financial institutions, using their established procedures for consultations, will need to assist countries in strengthening their financial systems. The information and expertise available to national authorities and international supervisory bodies can enhance the effectiveness of the international financial institutions.

National and international regulatory authorities must also develop procedures to ensure that market participants pay heed to the standards that have been developed for managing and pricing the risks they incur with respect to their counterparties. Enhanced procedures will be needed to coordinate and promote efficiency in this effort and to avoid overlaps between the international financial institutions, as well as with the rule-making capacities of the international supervisory bodies.

Improving financial supervision. The international regulatory bodies have made considerable progress in harmonizing and strengthening national financial regulation and supervision. Minimum standards have made financial systems sounder and have helped to create a more level playing field. Continuing risk-management guidance is improving defenses at individual institutions. These efforts, including the work of the Joint Forum on Financial Conglomerates, should be sustained. At the same time, further efforts are required to address issues raised by the blurring of distinctions between different types of financial operations and institutions. Advances on issues such as developing consistent rules for the treatment of risk, arrangements for the pooling of information, and closer cooperation between different supervisory authorities continue to be hampered by countries' different financial and supervisory systems.

The regulatory bodies also need to take account of the work being done by the private sector. They must cooperate with national authorities in assessing the appropriate prudential and regulatory response to organizations operating outside existing regulatory arrangements.

Specific issues

Action is required in the following areas:

• improving arrangements for the surveillance of global vulnerabilities, including the pooling of information available to the international financial institutions and the international regulatory bodies, and the creation of procedures to ensure that information reaches the relevant parties;

• creating procedures for coordinating the work of national and international regulatory bodies, and for the exchange and pooling of information among them;

• assessing the need for the regulation of nonregulated entities; and

• strengthening and, where appropriate, encouraging the development and implementation of international best practices and standards, including improved in-house risk management at financial institutions in the wake of recent market events and appropriate transparency and disclosure rules for all market participants.

Financial Stability Forum

I have outlined a number of specific areas in which the existing arrangements for the supervision and surveillance of the international financial system could be strengthened. Sweeping institutional changes are not needed to realize these improvements. Rather, a process has now been set up to ensure that national and international authorities and groups can coordinate efforts to promote the stability of the international financial system and to improve the functioning of the markets in order to reduce systemic risk.

In February 1999, the Group of Seven unanimously endorsed my proposal to convene a Financial Stability Forum. This Forum will meet regularly to assess issues and vulnerabilities affecting the global financial system and to identify and oversee the actions needed to address them. The Forum reports to the Group of Seven.

The Forum is limited in size to allow for an effective exchange of views and to achieve results within a reasonable period. In developing objectives, priorities, and programs for action, the Forum will work through its members, taking account of their comparative advantages.

The members of the Forum are representatives of the national and international authorities responsible for questions of international financial stability. While the Forum was the initiative of the Group of Seven countries, participation was envisaged to be extended over time to include representatives from additional national authorities able to contribute substantially to the process. As of September 1999, representatives of Australia, Hong Kong SAR, the Netherlands, and Singapore will participate in meetings of the Forum. Representation is at a high level (deputy ministers and deputy central bank governors, deputy heads of the major international financial organizations, and chairs and appointed members of international groupings). The chairperson serves in a personal capacity for a three-year period, which ensures continuity in the work of the Forum. The first chair is Andrew Crockett, General Manager of the BIS.

The Forum will meet as often as is needed to achieve its objectives. Initially, two meetings will be held a year. The first meeting was held in Washington in April 1999; the second is scheduled for September 1999. At its first meeting, the Forum decided to set up three working groups to focus on issues concerning highly leveraged institutions (hedge funds), offshore financial centers, and the problems that short-term capital flows might create for countries. A permanent Chairman's Group comprising representatives of the international financial institutions, the international regulatory groupings, and, if necessary, national supervisors directly involved in specific issues could meet around or between the Forum's meetings to coordinate follow-up activities. Support for the Forum is provided by a small secretariat located at the BIS in Basle, with staff drawn from the BIS and the participating international financial institutions. F&D

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