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Governing the Global Regulatory System
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Financial Markets Reform

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GOVERNING THE GLOBAL REGULATORY SYSTEM[1]

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This chapter is set against a background in which the regulatory world is grappling with the realization that its regulatory regimes have been less than adequate to cope with the fast changing pace of financial innovation, sophisticated securitization and unfettered financial liberalization.

The Existing Regulatory System

A quick review of the existing system and its overlapping structures is useful to first set the current situation in perspective. There is no single international regulatory body in the financial world. The earliest institution which comes closest to being described as a global oversight body was the Bank for International Settlements (BIS). This was the first international (but not global) financial institution and was established in 1930. It originated after the First World War as a means of handling reparation payments imposed on Germany, but emerged into an international institution which focused on cooperation among central banks, though for many years it also comprised many non-banks as its members. For many years its representation excluded developing countries and emerging markets, and was principally European-focused. Currently, representation on its Board is from major European countries, US and Canada with currently three other members, Mexico, China and Japan. Its 55 member central banks are mainly from Europe, whether significant or not, and from significant non-European emerging markets. In more recent years, membership of its subcommittees has been extended to include several emerging market countries. It retains however, mostly a developed country focus, principally

European. While attendance at its annual meetings includes all central banks, some developing countries have observer status.

The most influential group linked to, but separate from, the BIS is possibly the Basel Committee on Bank Supervision (BCBS), a Committee that provides a forum for cooperation on banking supervisory matters. This Committee develops guidelines and supervisory standards. The Committee describes itself as being best known for its international standards on capital adequacy; the Core Principles for Effective Bank Supervision and the Concordat on cross-border banking supervision. The Committee's members are from Belgium, Canada, France Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States, and are represented either by their Central Bank or regulator where the regulatory function is not performed by the Central Bank.

The guidelines set by this group have become international guidelines and are copied by many supervisors across the world. Financial markets, as well as the IMF and World Bank (through their conditionality) have tended to influence/push developing countries to adopt this standard even though they do not participate in their design. The Basel II recommendations that are presently being implemented by many countries were devised principally by this group.

Formal channels for coordinating with supervisors of non-bank financial institutions include the Joint Forum established in 1996. The BIS describes this forum as a senior group of supervisory standard-setters. It includes the chairman and secretaries general of the International Association of Securities Regulators (IOSCO) and the International Association of Insurance supervisors (IAIS).

Other supervisory groups have developed to cater to geographical needs. For example, the Advisory group for Bank Supervisors and Securities Regulators comprises securities regulators and bank supervisors of the APEC group (Asia) and ADB (Asian Development Bank) countries. Similarly, the Caribbean Group of Bank Supervisors performs this function for the Caribbean, while in Latin America the ASBA group, or the Association of Supervisors of Banks of the Americas, performs this function for the Americas.

The International Monetary Fund (IMF), was set up after the BIS, through the Bretton Woods agreement, was founded in July 1944. Originally comprising 45 countries, it played a key role in the international monetary system. The Fund itself notes that in an era of fixed exchange rates and the gold standard and in a context where many developing countries were establishing their own currencies and their own central banks, there was an important role for the IMF in providing lender of last resort facilities to many developing and developed countries. In addition to lender of last resort functions, it also provided and continues to provide an important economic and financial monitoring function through its Article IV consultations and in more recent years, Financial Sector Assessment Programmes (FSAPs), the latter of which reviews the wider financial sector beyond commercial banks and central banking. A third function, a technical assistance function has become a very important role of the IMF. The Fund has also been very critical in assisting the Heavily Indebted Poor Countries (HIPC) in obtaining debt forgiveness from their major creditors, and serves as a forum for intellectual discussions on the international financial system.

Several other international financial oversight entities have emerged, most with specific responsibilities or areas of interest. The International Organization of Securities Commissions (IOSCO) is an organization of regulators of the securities industry whose objective is to cooperate in order to promote high standards of regulation, to exchange information, provide mutual assistance, and generally protect the integrity of the securities markets.

Other International organizations have developed in order to promote common international standards in finance or related areas. Among these is the International Financial Reporting Standards (IFRS) body which issues standards adopted by the International Accounting Standards Board (IASB). Many of the standards forming part of the IFRS were issued by IASB between 1973 and 2001. In providing comprehensive guidelines for accounting professionals auditors, financial managers and users of financial statements, this organization influences the balance sheet statement and reported income of financial entities and is therefore important in influencing what regulators see as the value of the assets and liabilities of financial entities.

The Financial Stability Forum (FSF) is of much more recent vintage. It was convened in 1999 and describes its objectives as principally to promote international financial stability through information exchange and cooperation in financial supervision and surveillance by bringing together on a regular basis, national authorities responsible for financial stability in significant international financial centers. Its first major initiatives related to offshore centers. It has not included developing countries among its members, though all G20 would become members following G-20 decisions in the April

2009 London meeting. The Financial stability Forum becomes the Financial Stability Board with more power.

It makes recommendations and calls for their implementation in financial centers of both emerging markets and in developing countries. The FSF has comprised in recent years 12 countries (G7 plus Hong Kong, Switzerland and Netherlands, Australia and Singapore) including related institutions in those countries and nine international standard setting organizations. The FSF Secretariat is housed in the BIS.

The Financial Action Task Force (FATF) is an intergovernmental body which describes its purpose as that of developing and promoting national and international policies to combat money laundering and terrorist financing. The FATF is a policy–making body created in 1989 that works to bring about legislative and regulatory reforms in these areas. The FATF has published 40+9 recommendations in order to meet these objectives. The FATF members were originally 16 and now number 28. They comprise principally European and North American countries with subsequent additions of Japan, Mexico, Singapore and South Africa. Several International Organizations have observer status.

There are other relevant international regulatory organizations, among them the Committee on the Global Financial System (CGFS) chaired by the Vice Chairman of the Federal Reserve Bank of New York. This Committee monitors developments in global financial markets for the Central Bank Governors of the G10 countries. The Committee sees itself as having a mandate to identify and assess potential sources of stress in global financial markets, to further the understanding of the underpinnings of the financial markets, and to promote improvements to the functioning and stability of these markets.

The CGFS, formerly known as the Euro currency Standing Committee, was set up in 1971, initially to monitor the currency markets, mainly the Eurodollar market, and principally the rapid growth of offshore deposit and lending markets. The Committee was renamed and its mandate revised in February 1999.

The Financial Stability Institute (FSI) is another arm of the BIS. Its primary role is to improve the coordination between national bank regulators through holding seminars and acting as a clearinghouse for information on regulatory practice.

The Institute for International Finance (IIF), a global association of private financial institutions provides comment on international events and hosts seminars and conferences on financial topics on a regular basis, from a private sector perspective.

From time to time other Ad Hoc Committees are set up to deal with specific issues, for example, the Senior Supervisors Group comprising financial supervisors from five countries was set up to review disclosure practices of financial services firms concerning their exposures to certain financial instruments that the market place considered to be high risk.

These groups sometimes coordinate with each other both through formal and informal channels, but the group with the most representative membership is the IMF which currently comprises 185 members. However up until recently, the IMF had not concentrated its resources on regulation of banks or on monitoring or evaluating the innovations in the financial system and exploring its implications. It is unclear whether it should increase its role in this area, as the BIS and FSF may be better suited for this role, if the latter’s membership is expanded. Naturally, the IMF should play some role, especially in macro-prudential issues.

While the Financial Stability Forum is active, it tends to function in an issue-oriented fashion. It seems to have overtaken the role of the Committee on the Global Financial System, a Committee set up to monitor developments in global markets for Central Bank Governors of G10 countries, following concerns about the growth of offshore deposits and lending markets. The FSF, if it widened its mandate to continual monitoring rather than an issue-based approach could come closest to the kind of entity which has the track record needed to coordinate regulatory and oversight functions of bank regulation, securities, insurance, accounting rules and payment system issues and monetary and financial stability issues.

There is an admission that there has been a dramatic increase in cross border flows, sovereign wealth funds, outward investment from developed countries and inward investment into North America from China and other developing countries and more recently in equity support from non traditional sources for financial institutions. Given this accepted interdependence, there is a basis for more meaningful international dialogue, with a greater role for developing and emerging countries.

The Impact of Innovation and the Challenge for Regulators

It is against the background of this regulatory framework and in the context of a philosophy of financial liberalization and integration of financial markets that innovative financial technologies took off. Financial technologies however rapidly went beyond the regulatory framework and it is now fairly well acknowledged that regulatory frameworks have not kept pace with financial innovation.

In recent years, advancing technology has allowed for far-reaching structural changes in global financial markets. Financial innovation has manifested itself in various ways, the most prominent being the growing importance of new and complex financial instruments, new business models which focus on multiple financial activities facilitated by financial liberalization, and significant developments in the area of securitization and disintermediation. This is compounded by the rising importance of relatively new, largely unregulated players, such as hedge funds, private equity firms, conduits and structured investment vehicles (SIVs). Financial innovation seemed limitless and regulators were left behind in the process.

This rapid innovation led to major structural changes in financial intermediation which impacted the global financial system, and financial market activity had expanded at a tremendous pace. Simultaneously, the push for capital market integration and deregulation rapidly gained strength. According to McKinsey and Company, global cross-border flows as a percentage of global GDP jumped from 4.8% in 1990 to 15.4% in 2005. As a result, the likelihood of contagion effects became even greater.

However, dependence on capital markets and on sustained market liquidity also increased (as discussed in the chapter by Turner in this book), as banks and other intermediaries placed greater reliance on their ability to 'originate and distribute' loans and other financial products. They also depended on the market to manage their risk positions dynamically as economic and financial conditions changed, many through the use of credit derivatives.

This placed additional pressure on the robustness of financial market infrastructure to handle large changes in trading volumes and to cope with periods of strain. The coincidence of greater levels of deregulation and integration of capital markets implied that if a major problem arose it was more likely to spread quickly across borders.

Combined with strong returns in the capital market, the profitability of major financial institutions ballooned. This environment encouraged an increase in risk-taking as many players “hunted for yield”. Estimates of the hedge fund industry note that the industry grew by leaps and bounds having jumped from US $497 billion in assets under management in 2000 to US $1,868 billion in 2007. Interestingly, the composition of the investors also changed.

Measuring Risk Where Credit can be Sliced and Diced

The widespread use of structured credits effectively lowered the compensation for bearing credit risk and market risk to historically low levels. It is during this time that a market for bearing risk through complex structures of credit derivatives flourished. There were a few warning signals, particularly about hedge funds, but not many warnings about securitization generally. Regulators were caught napping and the rating agencies did not spot the weaknesses.

There are two aspects to this problem. One is the absence of oversight bodies which were monitoring and had authority to forestall this problem. The other was the absence of rules or processes that would help to prevent its occurrence. There was also clearly a need for internal corporate ground rules at the operational level. However, cessation of securitization as an investment tool is not an option. Securitization is here to stay. It is a critical factor in achieving financial flexibility in a world of global flows. However, it is important that credit originators bear greater responsibility for the credit worthiness of the credits they originate. Because of the difficulty of tracking risks in securitized loans which have been leveraged several times, loan originators should be required to take more responsibility, by keeping part of the loans and to suffer some penalty for failure of the loans they originate.

Concentration and Risk Management

Developing guidelines for risk management and requiring compliance to them are a core remedy for the concentration of risk. Developing internal risk management measures and processes at the level of the firm are very important. Portfolio concentration seems also to be an important area, which requires attention. Both sectoral and instrument concentration are both risk areas for which guidelines need to be developed.

Regulatory Slips

In addition to the national oversight level, there were serious failures with global regulatory and oversight systems. The IMF did not see itself as having specific responsibility for these developments. The BIS, while it did see itself as an entity with some responsibility for the stability of the financial system, does not directly have regulatory tools, was a European-dominated organization, and most of its clients were not, at the time, experiencing problems to the same degree as in the US (that is less clear now). They did draw attention to the risks, largely in the area of hedge funds, but did not appear to display serious alarm and were perhaps too hesitant in requesting remedial measures from US regulators, in whose jurisdiction the problem was escalating most. Furthermore, the BIS does not have authority over national regulators.

The initiatives which had been taken in the late nineties when offshore centers were flourishing, and which gave rise to the FSF and the FATF did not replicate themselves with the same aggression nor lead to concerted action as in the case of the offshore centers issue, nor did regulators evaluate the nature of the problem sufficiently quickly. Even in the case of offshore centers, it became increasingly important that both market participants and policy makers improve their understanding and assessment of threats to financial stability, and take steps, where appropriate, to contain and reduce them.

The FSF and the IMF with their emphasis on macro-prudential indicators and early warning systems have recently been active in the development of models to identify and assess potential sources of major vulnerability to the financial system. This involves great degrees of dialogue by regulators with practitioners, to understand better current approaches to measuring risks, and to encourage improvements and the sharing of best practices in stress testing techniques. The FSF lacks the network for so doing. The latter (the IMF) has that network, but presently lacks the track record of analyzing financial markets, instruments, structures and flows with a view to improving quickly on risk management techniques.

Size, Market Share and Mega-financial Institutions

The extent to which mega-financial institutions were at risk has become evident during the recent financial crisis. This has made it clear that there is a need to focus more on size, governability, adequacy of internal controls and internal information flow as increasingly important aspects of financial governance are conducted by oversight bodies of mega-banks. Some large banks have increased their capital by going to the market, some tapping into sources outside of their jurisdictions. There may be some issues here of too light a regulatory hand and over confidence in the role of the market. Responsibility rests with the CEOs as was evident in the firing of CEOs of large financial institutions in the US. It emphasizes that Information flow, internal oversight systems, distributed decision-making and incentive systems which support good governance need to be an integral part of review by regulators, particularly so in mega-financial institutions where distance from the operation can be a problem.

Innovation, Financial Market Development and Monetary Policy

The role for central banks in influencing macroeconomic outcomes has also changed as a result of the inter-connectedness of capital markets and the internationalization of financial flows. The development of deeper, more complete and more competitive financial markets has strengthened the pass-through effect of central bank interest rates to market interest rates, and has led to a closer relationship between market and bank interest rates. Consequently, the deepening of financial markets has served to amplify the effects of monetary policy on bank interest rates, and *ceteris paribus* other variables such as inflation.

However, a countervailing truth has also been evident. The major monetary policy transmission channel through bank lending has become less important, but new regulations are still focusing on the quality of bank credit. The widespread use of credit derivatives has meant that banks could respond more flexibly to changes in financial market conditions, and may therefore not pass through each and every change in the central bank's official short-term interest rate. Moreover, financial developments have not only broadened banks' options in terms of responding to interest rate changes; they have also broadened borrowers' financing opportunities, reducing their dependency on bank loans.

These developments have meant that there is a more urgent need for adequate amounts of data and regulatory mandate to provide policymakers with sufficient ammunition to maintain financial stability. Indeed, in some jurisdictions, investment banks, the key institutions in this securitization boom fell outside the prudential purview of key financial regulators.

Measuring Stability

Initiatives to build robust financial stability indices have thus far not been good enough or easily understandable by the market. Moreover interpreting them with sufficient precision in order to focus in on remedial areas in need has been a fuzzy exercise.

The concept of financial stability involves various financial intermediaries, financial market segments and infrastructure, for which a whole host of different quantitative and qualitative indicators can be used. As a consequence, determining the degree of financial stability remains a highly integrated and complex task. It therefore means that the governance system which has responsibility for ensuring financial stability must be able to monitor information and analyze developments in several financial sectors and not just in commercial banks.

Recognition of the multi-faceted nature of ensuring financial stability contributed to the concept of a single regulator as evidenced in the establishment of financial services authorities in some jurisdictions and was intended to help to deal with the problem of the widening scope of financial transactions and interconnectedness. It is beginning to appear that it is becoming increasingly difficult for a single regulatory authority to fully grasp all the intricacies of securities regulation, insurance, banking and derivatives use and all other financial institutional arrangements simultaneously. It seems, therefore, that what is required is not only greater depth of understanding by regulators in each specific financial area but also more specialization together with greater collaboration among regulators with a view to ensuring greater stability in the systems as a whole. As Stiglitz proposes in his chapter in this book, the latter function could be performed in the US by a Financial Stability Commission.

The role of calculating the feedback effects between financial system behavior and the real economy has long been conducted by central banks on a national scale and by the IMF on a global scale. The latter still retains a very important role. The IMF may be well positioned to evaluate these effects, but it is not clear that it is best positioned to set regulatory criteria.

Therefore, there seems to be a role for an oversight monitoring body with multiple oversight responsibilities, but with the ability to access a wide range of inputs from various regulatory bodies with regulatory responsibilities. The bodies which come closest to this are the BIS and FSF, despite the drawback that they are not truly global institutions (but it is encouraging that that the G-20 committed in November 2008 to expand its membership), It is useful to note here that the BIS is in some ways the engine room of the FSF.

Given that feedback effects play a crucial role in assessing a financial system's vulnerability to contagion, and system-wide stress, vulnerability is an area that some international oversight body needs to concentrate on more intensively. Since this requires continuous monitoring and interactive dialogue and risk management skills, a joint FSF/IMF/BIS collaboration may be the best route.

Data Availability and Relevant Data Identification

With the exception of market prices and regulatory information, only a limited set of data is available in a timely manner and in a manner that facilitates international comparison. For instance, financial intermediaries' financial reporting contains little or vague information on risk transfer mechanisms, and the use of off-balance sheet financial derivatives.

New regulatory issues can also arise either from the changing nature of the domestic financial system or the challenges arising from globalization and financial integration across borders. Therefore, the data needs for studying the latter problems need to be more aggressively analyzed and translated into data identification and reporting.

In addition, methods need to be devised for handling the shifting demand for data in an environment in which financial markets are constantly undergoing change. This is the regulators challenge. At present, stability forecasting is often scattered with respect to risk categories, financial market segments and structural or regulatory issues. While every national regulator should be involved in this process, global recognition may be needed at the global level. This must not be confused with any doubts about the skills and knowledge of such special geographic groupings.

Central Bank as Regulator or Financial Services Authority?

Having set guidelines, the issue of compliance is important. Over the years there has been a simultaneous shift from a direct and administered system to market-determined and marked-based systems of determining interest rates, exchange rates and other key financial variables. However, the regulator or policymaker must still remain vigilant at all times to ensure that private owners and management of financial intermediaries operate within defined risk parameters, observe the standards, guidelines and codes diligently, comply with prudential regulations and norms, and follow the best corporate governance practices. The regulator who has responsibility for compliance may not necessarily be the regulator who sets the guidelines, since guidelines can span regulatory authorities. The need for coordination is therefore essential.

Even the role of governments in the process of underwriting balance sheets has been an issue. In the UK it was the Government which gave assurances to depositors about the safety of their funds following the Northern Rock problem. In the US, the questions also arose around the issue of appropriateness of central banks bailing out financial institutions (which were not banks) and the use of funds which would otherwise be available to the Treasury. This issue of bailing out financial institutions which central banks do not regulate also has implications for reporting obligations and raises the specter of the wisdom and practicality of a single regulatory authority and the moral hazard of an institution which regulates, but does not provide financial support, and the information and regulatory needs of the authority which does. It is noted that Northern Rock was regulated by the FSA but was bailed out by the Bank of England.

Importance of Real Time Information

The use of technology to produce an updated management information system on real-time basis, and the re-engineering of business processes and systems, are the tools, which can help regulators to remain on the top of the potential problems. In many instances, the ability to regulate effectively is also dependent on the robustness of governing legislation, rules and regulations, as well as the ability of legislators to act quickly in changing such laws and regulations.

Very often financial regulators and legislators take years to enact laws and regulations while financial activity is changing rapidly. In this situation, the regulatory system can be made irrelevant in the face of fast-paced financial developments.

In this context, the content, characteristics, embedded risks and the accounting of the ever growing array of financial instruments, particularly derivatives, hedge products and other similar products, as well as the risks they generate, have to be fully understood so that guidelines governing them may be revised and made relevant, and this is done quickly. However, while some of these rules may be set by securities regulators, it is banks, which use securities. The absence of appropriate rules by securities regulators is affecting the stability of banks and near-banks who answer to different regulators, and who may need in extremity to be bailed out by the central bank.

Common Standards and Disclosure Requirements

Regulators have to insist that there are common standards for valuation of assets and liabilities, with common yardsticks for measurement. However, it is not clear that these standards should necessarily be accounting standards. Transparency and disclosure standards have to be kept under constant watch and suitably upgraded so that the innovators are obligated to provide the full range of information required to evaluate risks. While the regulators should not stifle all financial innovation, they should have the capacity to understand the risks involved and disseminate them to the market participants. If innovations create danger of systemic risk, they need to be regulated however.

The traditional approach toward regulation, which is mainly compliance-oriented with an emphasis on the review of portfolios rather than the evaluation of processes, has diminished effectiveness in the present dynamic landscape. The imperatives of market innovation demand a departure from the current predominant approach towards a more proactive approach that forces banks to recognize issues when they occur or, preferably, even ensure that the probability of their occurrence is known and the risks contained. This approach puts more emphasis on examining the bank's risk measurement and management processes instead of simply reviewing its assets portfolio. It demands that a bank's risk management processes should be scaled to reflect risk appetite and complexity of operations. Specifically, the bank which engages in more complex business lines should be expected to have in place credible internal risk measurement models and should assess and maintain economic capital adequate to cover the underlying business risks.

Capital Adequacy

The emphasis on adequate capital has helped a great deal in the past, but cannot in itself ensure solvency and stability of the financial system in all situations. The prevailing Basel Capital Accord was an initial step towards achieving capital adequacy. However, there are some inherent rigidities which fail to cover many of the risks that banks assume in their business operations. This explains the shift towards less rigid capital adequacy concepts, which have however been undermined through regulatory capital arbitrage. The subprime crisis in the US is testimony to the effects of regulatory arbitrage and the impact of regulatory loopholes, which can occur in even the most developed financial system.

While the BIS has been the most pro-active in trying to stay on top of these aspects of risk measurement in the industry, it too has fallen behind. This could principally be because the BIS has been concentrating primarily on commercial banks, whereas many of the weaknesses in the financial systems had moved to the securities markets.

Measuring Fair Value

Accounting and bank regulation guidelines do not always coincide. Recent accounting mark-to-market rules of the IFRS are a case in point. Indeed, the role that mark-to-market accounting may have played in the evaluation of assets of financial institutions in recent months, and in hampering the ability of creditor financial institutions to organize workouts of debt with their customers, has been a matter of some discussion. Accounting rules tend to make the decision to reschedule or reorganize debt workouts a matter for greater provisioning by the financial institution, thus discouraging workouts and the long-term prospect of recovery.

In the recent U.S. case, government intervened and mandated that some customers must be given time to reorganize their debts. However, accounting rules do not predispose to making arrangements with one's creditors. The verdict is out on how the Spanish solution of dynamic provisioning has solved the problem. The counter-argument is that these systems prolong the period over which debt is collectible and in the meanwhile might be misrepresenting the value of the asset. Discussion and dialogue with the accounting associations seem to be critical to resolving this problem which has the potential for preventing recovery of debt over the longer term. Regulators need therefore to work closely with international accounting standard-setting bodies to ensure that accounting guidelines do not aggravate financial crises.

Review of Basel II Accord

The Basel II Accord was expected to eliminate some of prior-mentioned market anomalies, but also has serious problems. For example, the Accord includes definitions for the measurement of operational risk and legal risk, but there is no definition or little interpretation for a major risk such as reputational risk. Still, Basel II covers a more comprehensive range of risks, better aligns regulatory capital to underlying risks, integrates capital requirement to a larger framework and provides for the role of supervisors in evaluating risk and market discipline. However, it may further encourage pro-cyclical bank lending, by putting rating agencies and banks' own models at the heart of determining capital adequacy.

Since it provides options to banks, it appears to encourage improvements in the risk-management processes. Policymakers have already realized the importance of this new accord, and presently it is in different stages of implementation across the globe. However, the implementation in itself demands even more concentrated efforts and capacity-building both by regulators and stakeholders. However, following the mortgage market subprime crisis in the US there are growing concerns about the advanced approach which gives banks flexibility to develop their own risk assessment systems, in light of what occurred in the investment banking community when these institutions had total autonomy to do so and failed.

The role of the market needs to be enhanced to discipline businesses indulging in excessive risk-taking. But this is not going to be an easy task nor will it be sufficient, especially in the economies that have built-in safety nets which translate to negative incentives, and which hamper market discipline on the one hand and in turn encourage excessive risk taking by financial institutions on the other.

Moral Hazard and Market Discipline

The usefulness of market discipline in augmenting the supervisory roles cannot be overlooked, but has to be reworked. While some safety nets are indispensable, we should seek ways to reduce associated moral hazard, and perfect the market discipline framework to complement supervisory practices. The extent to which markets discipline themselves is however being questioned and it is becoming clearer that there must be penalties for inappropriate and risky behavior which threaten system stability.

Market discipline basically centers on responses to provision of adequate information and incentives for market participants to act in the interests of market stability. We need to identify the information that could enhance market discipline. This must include a requirement that banks entering the global arena need to meet international standards with respect to transparency and disclosure and face penalties for failing to do so.

Improved disclosure about the risk profile, risk-management practices and performances, and related matters facilitates market discipline by enabling the market participants and supervisors to assess the soundness of a bank given the level of risks it assumes. The market assessment of the bank's soundness as reflected in the pricing of its products by the market could be used as an indicator for devising effective policy responses.

A great deal of effort has been put into the introduction of Basel II by the Basel Committee and in most organizations there is a tendency to protect one's creation. However, it is important that given the questions that have been raised about certain aspects of Basel II in the context of the subprime crisis and the moral hazard of self assessment, that the architects of Basel II revisit some of the major tenets of the new proposed regulatory framework, especially the advanced approach.

The Role of Ratings

In a Basel II - regulated world, and in a world where market discipline matters greatly, ratings will become even more important. Ratings should reflect risk and prompt more responsible behaviour by financial institutions who value their ratings and the investors who rely on them. This too has its challenges since in many instances pricing is based on a risk rating, itself the product of analysis of information that has been provided to the ratings agency by the specific issuer. Following the subprime fallout, the validity of ratings, rating agency modelling, methodology and compensation have been called into question. Therefore, any enhanced program aimed at improving the governance of the global financial system may require some changes to the ratings infrastructure and the extent to which ratings reflect risk and are not overly influenced by massive corporate profits of high-risk institutions (see chapter by Goodhart in this volume). Indeed a special rating for risk may be appropriate – one that refers both to the risk in the firm and transferred risk—i.e. risk transferred by the firm to the system. There needs to be a series of major changes to plug the loopholes in the system and regulators need to ensure that they are as proactive as possible.

Global Liquidity Management

Over the past several years the liberalization of the financial system has created the need for liquidity to be provided, not to governments through the IMF as was the case in the past through stabilization program, but directly to financial institutions. The internationalization of finance and the existence of mega–banks emphasizes the need for liquidity support across large financial institutions (see again discussions by Turner in this book). This may very well be beyond the capability of monetary authorities. There is a need to identify how this problem can be solved and how that liquidity can be provided before the problems occur. What is more serious is that where these problems are systemic and are not restricted to any individual bank, access to liquidity could be very problematic. This eventuality needs to be considered before it occurs.

Towards a Revised Global Governance Structure

The question of developing a multi-pronged over-arching monitoring body is an important factor in a revised governance system. The nucleus of this exists in the BIS and the FSF and the IMF. Around the BIS there already are, in addition to the Basel Committee on Banking Supervision, several useful sub-committees, for example, the Policy Development Group which has a number of sub committees - on Risk Management and Modelling, Liquidity, Definition of Capital, on Trading Book matters, and on Cross-border Bank resolution. The downside of this arrangement is the degree of possible tunnel vision since most of the sub-committees arose out of the Basel II Accord, which it now appears needs some modification in light of recent events. It also has problems of representation of emerging and developing countries.

The recently established International Liaison Group is the group with the widest representation, as it includes a number of emerging markets supervisory authorities. In addition, the existence of the Joint Forum which includes securities and insurance could form the nucleus of a multi-pronged monitoring entity. The issue here is global acceptability. Most of these groups, even the International Liaison Group –which has the widest representation – falls short of the international representation of an organisation like the IMF which has 185 members. The question is, how much is lost in terms of global stability by the exclusion of these countries? Is their inclusion in the IMF – albeit even there in a notional way - enough, or are they destined to continue to be excluded on the grounds that they are not systemically important? There seem to be losses, both in terms of efficiency and legitimacy, from such exclusion.

The Financial Stability Forum (now Board) attempts to function as a critical issues forum with representation beyond banking. This Forum, which in the spring in

2009 was finally broadened to all G20 countries, includes a number of international financial regulatory organisations including the International Association of Insurance Supervisors (IAIS), the International organisation of Securities commissions (IOSCO), the International Accounting Standards Board (IASB), the Committee on Payments and Settlement Systems (CPSS), the IMF, World Bank and BIS. It is not considered to be an arm of BIS, but is housed in BIS. This comes closest to being a multipurpose oversight body, but lacks global representation and clear authority, (though both aspects have shown some improvement in recent decisions) something which needs to be remedied further if it wants to be considered an effective global body with the ability to speak to other countries with authority. The group therefore, by reporting to the IMF would possibly be able to give itself some legitimacy. The report of the FSF of April 2008 on enhancing market and institutional resilience is an example of its work; a good analysis with general recommendations and with specific recommendations promised later. However, which entity will determine whether and how the recommendations are implemented is the key question? The IMF? The BIS?

Summary

This chapter attempted to analyse the international financial governance system, its strengths and weaknesses and in the course of the chapter a number of issues were ventilated and a number of recommendations made. The chapter does not call for a total revamp of the financial governance structure, but rather for a number of improvements; among them dealing with the issue of legitimacy and also importantly, since some of these issues had been identified prior to the current difficulties, ensuring that systems and regulated entities accelerate their responses to the recommendations.

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