Vulnerabilities and surveillance of the international financial system

The International Banking and Finance Institute (IBFI) organised its fifth international monetary seminar from 12 to 16 May 2003 on the topic "Vulnerabilities and surveillance of the international financial system". This seminar brought together 43 participants from the central banks of industrialised and emerging countries as well as from international institutions (BIS, IMF, OECD, FSF, etc.), and around 30 speakers from various central banks, international bodies and the private sector.

The first two days were devoted to:

- *providing an overview of developments in the international environment, markets and the financial system including the insurance sector, which gave rise to a speech by a director at the French Insurance Association;*
- *analysing the vulnerabilities of the banking and financial system, in particular those stemming from changes in market techniques and market participants' behaviour;*
- *analysing accounting and prudential issues arising from the implementation of the future international solvency ratio and the introduction of the new international financial reporting standards;*
- *examining current ideas on resolving international financial crises, with particular focus on the approach proposed by the Banque de France with a view to fostering a "Code of conduct" for the voluntary renegotiation between sovereign issuers and creditors, as well as the IMF's point of view on the restructuring of sovereign debt, put forward by Anne Krueger, deputy managing director of the IMF, in a video-conference transmitted live from Washington [1].*

In the two days that followed, there ensued lively debate between the participants, who formed two workshops: one on the interactions between financial markets and monetary policy, and the other on the provisions of the New Basel Accord and the financial reporting standards and their impact on economic cycles [2].

[1] *A full version of Anne Krueger's speech follows on from this summary.*
[2] *A summary of the workshops can be found on the Banque de France's website: www.banque-france.fr/gb/banque/ibfi.*

The first workshop was mainly organised around three topics:

- *central bank communication, in the areas of monetary policy, foreign exchange and financial stability;*
- *methods of identifying vulnerabilities in financial systems;*
- *links between price stability and financial stability.*

The second workshop focused on three issues:

- *the new financial reporting standards put forward by the International Accounting Standard Board and their implications for credit institutions, in particular with respect to the principle of prudence and the need to avoid introducing artificial volatility into accounts;*
- *the future solvency ratio applicable to credit institutions as defined in the New Basel Capital Accord;*
- *the convergence or divergence between financial reporting and prudential standards.*

Although focusing on seemingly different issues, the rich and fruitful discussions that were held throughout the workshops revealed a broad community of views on financial stability issues underlying the two topics examined.

Moreover, a dinner-discussion was organised by Pr Avinash Persaud, holder of the Chair in Commerce at Gresham College, on the risks of financial instability arising from the standardisation of asset allocation approaches, herd behaviours and the blind use of portfolio risk management techniques.

Discussions ended with a round table debate, introduced by Governor Trichet and chaired by Mr Marc-Olivier Strauss-Kahn, Director General – Directorate General Economics and International Relations. Five speakers discussed the topic of "transparency and market discipline":

- *Mr Flemming Larsen, Director of the IMF's European Offices;*
- *Mr William Witherell, Director of Financial, Fiscal and Enterprise Affairs, OECD;*
- *Mr Michel Prada, former chairman of the COB and of the International Organisation of Securities Commissions (IOSCO)* [3]*;*
- *Mr Jan Brockmeijer, Deputy Executive Director for Supervision, Nederlandsche Bank;*
- *and Mr Svein Andresen, Secretary General of the FSF, who summed up the discussions.*

Mr Flemming Larsen discussed the issue of transparency in emerging economies in the light of the international financial crises that marked the past decade. In this respect, he stressed the benefits attached to the adoption and the effective implementation by these economies of the international

[3] *Michel Prada was appointed Chairman of the Capital Markets Authority* (Autorité des marchés financiers) *in November 2003.*

codes and standards promoted by the IMF and the World Bank. These codes and standards cover twelve key areas that would benefit from the application of the principles and standards developed by international bodies in the area of economic governance and financial regulation, and transparency and corporate governance. The IMF reports on the implementation of these codes and standards provide a good means to enhance transparency, market discipline and multilateral surveillance, while helping national authorities to identify priority actions for improving the resilience of their economy.

Mr William Witherell discussed the role of corporate governance rules and financial transparency as a means to guaranteeing the integrity and smooth functioning of financial markets. The challenge that now lies ahead for regulators and government authorities is to develop a legal and regulatory framework that fully integrates these requirements in order to rebuild investor confidence and to ensure the effective use of market discipline. As regards the scope of these requirements, he recalled the set of general principles defined in this context by the OECD. These principles are now embodied in the international standards, whose application is recommended by the FSF for industrialised and emerging economies alike. He also stressed the great importance of the rules of governance and internal control in financial institutions given their role in allocating resources, their responsibilities to investors, and their particular exposure to the risks of conflicts of interest owing to the nature of their activities.

Mr Michel Prada [4] first recalled the main areas in which regulators were currently working to restore market foundations and improve the functioning of the market: introducing international financial reporting standards, implementing corporate governance principles, organising and supervising auditors, and lastly defining professional standards for the players in charge of interpreting financial information and transmitting it to investors, analysts and rating agencies. He then discussed the challenges arising from the globalisation and increasingly broad scope of markets, underscoring the implications of the risk transfer techniques currently used by intermediaries and the factors underlying the recent excess volatility of asset prices. These developments call for, above and beyond the close co-ordination between the prudential regulation of intermediaries and market regulation, the stepping up of international cooperation between regulators and a better understanding of market mechanisms in order to counter factors of financial instability.

Lastly, Mr Jan Brockmeijer discussed Pillar III (market discipline) in the framework of the new capital adequacy regime for banks defined by the Basel Committee. Going hand in hand with the other two Pillars of the New Basel Capital Accord, Pillar III provides for a number of disclosure requirements that enable market participants and prudential authorities to obtain all the necessary parameters to assess risk profiles and the creditworthiness of credit institutions.

4 *A full version of Mr Prada's speech follows on from this summary.*

1| The IMF's view on the restructuring of sovereign debt
Anne O. Krueger's speech

The past year has witnessed a vigorous and constructive debate regarding the need to improve arrangements for the resolving of financial crises, and in particular the tools for restructuring sovereign debt. To be sure, this remains a controversial topic. But the debate has served to help define the issues, and to build understanding on possible ways to strengthen the international financial system. In particular, how to address the hopefully rare cases in which sovereign debtors and creditors must confront debt burdens that have become unsustainable. At times, however, the intensity of the discourse may have tended to mask the extent to which there has indeed been a convergence of views regarding the nature of the problem, and the desirability of taking actions to strengthen the system.

Today I would like to step back from the fray and look at the convergence of views on the diagnosis of the problem, and at some of the factors that will have to be part of the solution.

1|1 Importance of policies as crisis prevention tools

A first point on which there is general agreement concerns the importance of the sustained implementation of sound macroeconomic policies. And the critical importance of buttressing these with efforts to reduce vulnerabilities to crises. Strengthening tools for resolving crises and the debate about how to improve mechanisms for sovereign debt restructurings must never be allowed to detract from the critical need to persevere with reforms that could reduce the frequency, and mitigate the severity, of crises.

In this regard, substantial progress has been made in recent years. In many respects, the world economy is now more resilient to shocks. Moves toward more flexible exchange rate regimes, strengthening of domestic financial systems (particularly through enhanced banking supervision), and rebuilding official reserves have contributed to making economies more robust and less vulnerable to crises.

We should not forget that the crises in Asia, Russia, and Brazil of the late 1990s were typically associated with pegged exchange rates, a mix of monetary and fiscal policies that attracted short-term capital hoping to benefit from high domestic interest rates, and generally inadequate banking supervision. But we should not lose sight of the fact that there are a number of emerging market countries that have high debt burdens and continue to experience fiscal pressures.

Of course, through bilateral and multilateral surveillance, we are engaged in a continuous dialogue with our members, which focuses on the implementation of sound policies. But in recent years, the Fund has put enormous emphasis on prevention. Beyond working on strengthening macroeconomic policy frameworks, we have worked closely with our members to help them assess and manage vulnerabilities, strengthen surveillance over financial systems, and improve debt management. We have stressed the importance of remaining vigilant to developments in capital markets, re-orienting and re-designing policies where needed. For instance, it is important that financial supervision be kept in line with increased integration into global capital markets. Moreover, with the aim of improving the environment for private sector decision taking, we have promoted transparency, and have disseminated – and encouraged adherence to – standards and codes.

Of course, we must avoid complacency, and recognize that despite best efforts at prevention, crises will still occur. The 15 or so years since the resolution of the 1980s debt crisis have witnessed large-scale capital flows to emerging market borrowers. But we are now moving into a period in which an increasing number of emerging markets have become mature borrowers – by which I mean countries that regained access to capital markets have allowed their debts to increase to levels at which future net borrowing needs be kept strictly in line with their growth in their payments capacity. This has a number of implications:

- first, although we have recently seen some resurgence in capital market activity, in the period ahead we should not expect net debt creating flows to emerging markets to return to the scale of those witnessed in the 1990s. Indeed, the recent trends in net flows to emerging market sovereigns may be comforting to the extent that it may indicate that debt markets are not repeating the bubble behavior experienced in other asset markets;

– second, with only limited capacity to take on additional debt in the context of resolving crises, countries' room for maneuver to address building tensions may be more restricted than was the case in the past;

– third, close attention to developments in countries' vulnerabilities, and prompt corrective action, is more important than ever.

1|2 Resolution of financial crises

However, in a hopefully very limited number of cases, countries may experience rising debt or other capital account pressures – including unanticipated external shocks – which may develop into full-blown crises:

– in some cases, the source of the difficulties may lie in the balance sheet of the public sector. As a result of some combination of bad policies and bad luck, a sovereign may experience acute liquidity difficulties, and in extreme cases may find that its debt burden has become unsustainable;

– we are also likely to continue to witness cases where the source of the problem may lie in financial (or nonfinancial) corporate sectors. Recent crises have demonstrated the ways in which difficulties in one set of balance sheets in an economy can rapidly propagate across to other sectors, and spillover to the external accounts[1].

This suggests that the resolution of individual crises will need to be tailored to the diversity of situations that our members may confront.

In any event, there is typically at least a brief period between the recognition that a member has a building capital account or an acute debt problem and the outset of a full-blown crisis. But in such circumstances, time is the friend of neither country authorities nor private investors. Nevertheless, there is likely to be a window of opportunity for taking corrective actions that offer the prospect of resolving crises in a fashion that limits the scale of economic dislocation and preserves assets' economic value. The challenge confronting policy makers is to utilize the window, and thereby to avert an even worse outcome.

– In some cases, a combination of the forceful implementation of corrective policies, market based liability management operations, and official financing may allow for a rapid and orderly resolution of the crisis.

– In other cases, it may be necessary to complement the sustained implementation of corrective policies and the provision of official financing, with concerted measures to reprofile – or in some cases even reduce – debt service burdens. Here too the design of the measures to resolve a crisis will need to be carefully formulated to reflect the member's situation. In some cases, it may be necessary to restructure the debt of the sovereign. But if sovereign debt restructuring is the hammer in the international community's toolbox, we must recognize that not every crisis is a nail! Other cases may need to address some combination of the liabilities of nonsovereign debtors and capital flight.

1|3 The Fund's access policy

The Fund, through its role both as an advisor and as a lender, will continue to play a key role in the resolution of financial crises. And so access policy – the conditions under which the Fund is willing to extend support for a member's adjustment program, and the scale of such support – will remain an important parameter in the resolution of crises. The scale of potential financing needs has increased as a result of the increasing integration of countries into the global economy, and with it the risk of abrupt changes in market sentiment and reversal of capital flows.

In some cases, it may be appropriate for the Fund to provide large-scale access in support of a forceful adjustment program. This would be done with the expectation that, as policies take hold and confidence builds, this support will have a catalytic effect in facilitating a return to national and international capital markets. But it would only be appropriate for consideration to be given to large-scale access to the Fund's resources in cases where:

1 *See, for example, "A Balance Sheet Approach to Financial Crisis" (2002) by Mark Allen, Christoph Rosenberg, Christian Keller, Brad Setser and Nouriel Roubini, WP/02/210 (www.imf.org/external/pubs/ft/wp/2002/wp02210.pdf).*

– the member country is experiencing exceptional balance of payments pressures on the capital account, resulting in a need for Fund financing that cannot be met within the normal limits;

– a rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable;

– the member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge;

– the policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans, but also its institutional and political capacity to deliver that adjustment.

In other cases, however, these conditions may not be satisfied, and so it would not be appropriate for the Fund to provide exceptional access to its resources. Accordingly, in such cases the resolution of crises must entail some form of concerted refinancing or restructuring of the claims on sovereign and/or nonsovereign debtors.

1|4 Strengthening the arrangements for resolving sovereign debt difficulties

Now let me turn to efforts to strengthen arrangements for resolving sovereign debt difficulties. The debate surrounding the Sovereign Debt Restructuring Mechanism (SDRM) served as a useful platform to consider avenues for improving the debt restructuring process. While we do not now have the high level of support that would be required to make the adoption of the proposed mechanism feasible, the analytic work and broad discussion has been extremely helpful in helping to develop our thinking on where the main shortcomings lie.

The focus of our current efforts is on promoting the inclusion of collective action clauses (CACs) in debt contracts, and, more generally, on finding ways to improve arrangements for sovereign debt restructuring within the existing legal framework.

1|5 Process of debt restructuring

Let me first address ways in which the process of debt restructuring could be improved. A number of commentators have highlighted, in particular, the absence of procedural clarity regarding the conduct of debtors and creditors.

These concerns have contributed to calls for a voluntary Code of good conduct. The various proposals that have emerged – including, importantly, from the Banque de France – are constructive, and could, in our view, help provide greater predictability to the restructuring process under any legal framework:

– a Code could be made applicable to a broad set of circumstances, ranging from periods of relative tranquility to periods of acute stress, and could constitute an established set of best practices. In contrast, proposals for strengthening arrangements for debt restructuring have a more limited scope and purpose – to facilitate the resolution of financial crises;

– by its very nature, a voluntary Code, while potentially helpful, could not resolve collective action problems. This is a subject to which I shall return in a moment;

– finally, a Code could only be effective to the extent to which it is able to attract broad support among debtors and their creditors. Accordingly, the most promising approach to developing a code that could form the basis of a consensus would be for it to be developed jointly by debtors, their creditors, and other interested parties (including the Fund). Conversely, it appears unlikely that a Code designed by the Fund would attract broad support, though we stand ready to collaborate with others in the elaboration of a code.

Recent adaptations in Fund policies could be complementary to a Code. Last year the Fund's Executive Board adopted a modification of the lending into arrears policy – the policies that govern the circumstances under which the Fund can provide financial support for a member's adjustment program during the period in which it has arrears to private creditors, and is attempting to reach agreement on a restructuring. This policy establishes expectations regarding the behavior of debtors that are receiving financial support from the Fund in such circumstances:

The debtor should engage in an early dialogue, which should continue until the restructuring is completed:

– the debtor should share relevant, non-confidential information with all creditors on a timely basis. This would include an explanation of the adjustment program and the financial circumstances that justify a restructuring, as well as a comprehensive picture of all domestic and external claims on the sovereign;

– the debtor should provide creditors with an early opportunity to give input on the design of the restructuring strategy. This could help address the specific needs of different types of investors, thereby increasing the likelihood of a high participation rate.

In addition, in cases in which creditors have organized a reasonably representative committee on a timely basis, there is an expectation that the member would negotiate with such a committee. Our policy suggests a number of principles that should guide the debtor's conduct during negotiations. In formulating these principles, we have drawn on the expertise of workout specialists reflected, for example, in the report by the Council on Foreign Relations (CFR), and efforts by International Federation of Insolvency Professionals (INSOL) to distill best practice for nonsovereign workouts.

1|6 Collective action difficulties

Let me add a few words concerning the motivation behind initiatives to promote the inclusion of CACs. An important shortcoming of the existing arrangements for the restructuring of sovereign debt relates to the failure of collective action. It complicates the process of reaching agreement on a restructuring. There is a danger that individual creditors will decline to participate in a voluntary restructuring in the hope of recovering payment on the original contractual terms, even though creditors – as a group – would be best served by agreeing to a restructuring:

– the problem of collective action is most acute prior to a default, where individual creditors may have some reasonable hope of continuing to receive payments under the terms of their original contracts;

– following a default, the options facing creditors – particularly those who have no interest in litigation – are more limited and so the problems of collective action may be less acute. But a more formal mechanism would still make sense in such cases. It would provide greater clarity as to the predictability and transparency of the process by which agreement could be reached, while of course eliminating the possibility of at least some creditors hoping to secure better terms through litigation.

But we should not fall into the trap of believing that default is a good solution to collective action difficulties. Of course, there is no doubt that following default, agreement on a restructuring would eventually be reached. But default – and the associated uncertainties regarding creditor-debtor relations – tends to be associated with widespread economic dislocation. Proposals for strengthening arrangements for debt restructuring are intended to increase the likelihood that early agreement can be reached on restructuring that can restore viability. They are also intended to see that neither debtors nor their creditors must bear costs that are unduly large.

But I am pleased to be able to say that progress is being made! I would like to take this opportunity to applaud Mexico, Brazil, and most recently, South Africa for the inclusion of CACs in their recent bond issues governed by New York law. These are very important steps. If this leads to the establishment of a new market standard, it could go a long way toward a more orderly and efficient process for debt restructurings. The Fund's role in this area is to promote the voluntary use of CACs through its surveillance, as recently mandated by the International Monetary and Financial Committee (IMFC).

1|7 Dealing with banking system crises

In addition to the work on improving the sovereign debt restructuring process, there is also a need to develop further our thinking on a number of other issues arising in the context of a crisis. One is how best to assist members in addressing systemic banking crises, particularly in cases in which the system is highly-dollarized, and/or cases in which systems that are highly exposed to sovereign debt.

With highly-dollarized banking systems, issues arise regarding the extent to which liquidity assistance can be sustained in the event of a crisis, where that assistance has to be provided in a currency that the government does not have the ability to create. The inability of a central bank to serve as a credible lender of last resort in these circumstances may end up fueling a run and leading to greater economic disruption. In this context, questions may arise as to the extent to which it would be appropriate for the official sector to step in with additional financing to boost the central bank's lender of last resort capacity, which in turn raises several issues regarding debt sustainability and the adequacy of macro policies.

As the recent cases of Argentina and Uruguay illustrate, the combination of a highly-dollarized banking system and a rigid exchange rate regime can result in vulnerabilities are difficult to manage. In this context, severe liquidity losses stemming from a bank run will quickly feed into a currency crisis and eventually necessitate a sharp exchange rate adjustment. The adjustment in relative prices may in turn induce an unsustainable debt profile and severe balance sheet problems in the corporate sector. These problems will be further compounded when the banking system is largely exposed to the sovereign's unsustainable debt, and as restructuring will unavoidably amount to a further deterioration in banks' balance sheets. Thus, measures to stem the effects of debt restructuring on the banking system also need to be considered in greater depth.

1|8 Conclusion

In conclusion, let me summarize the five key areas where there appears to be broad agreement.

First, there is no doubt about the critical role of prevention and the importance of sustained implementation of appropriate macroeconomic and structural policies. The best way to ensure that countries gain the benefits of globalization while avoiding the pitfalls is through constant vigilance in economic management, including the prudential supervision of financial systems.

Second, there is a need to improve the existing arrangements for restructuring sovereign debt. The intention is not to make sovereign debt restructuring an easy option. But rather to allow debtors with unsustainable debt burdens to reach agreement on a restructuring without unnecessary dislocation and loss of asset values. Of course, nobody believes that this is the complete answer to the difficulties of resolving financial crises. The restructuring of sovereign debt is likely, as a practical matter, to need to be complemented by other measures. Including those to stabilize and restructure the domestic financial system, and perhaps resolve balance sheet difficulties in the corporate sector. It may also need to be conducted against the background of temporary resort to some combination of exchange controls and a deposit freeze. But that is a subject for another day.

Third, a key market failure relates to collective action. This is the main pillar of both the contractual and statutory approaches to improving the arrangements for sovereign debt restructuring. Welcome progress is being made with the incorporation of collective action clauses into sovereign debt contracts. This is encouraging. Now that the first mover problem has been resolved, we must redouble our efforts to promote the widespread adoption of such clauses.

Fourth, there is considerable merit in efforts to improve the transparency and predictability of the debt restructuring process. Here I see strong complementarities between a possible Code of good conduct, some of the proposals for CACs, the recent revisions to the Fund's lending into arrears policy – which establishes expectations regarding debtor's behavior *vis-à-vis* their creditors – and a number of key features of the SDRM proposal. But we have further to go.

Finally, there is a need for further thinking on how to deal with the implications of a crisis for the banking system and how to reduce the effects of debt restructuring on the financial sector when it is highly exposed to sovereign debt. The experience of Argentina has served to illustrate how these elements may combine to generate massive economic and social disruptions.

2| Transparency and market discipline
Michel Prada's speech

First of all, I would like to thank you for inviting me to this seminar on issues that I have continued to take a close interest in since my departure from the French Stock Exchange Commission. I will certainly repeat some of the things that have already been said, but that rather goes with the territory.

I believe that the increasing awareness of the need for much greater co-ordination of market regulation on the one hand and prudential regulation on the other is one that should be analysed in the light of recent events.

The Asian crisis in 1997 and the Russian crisis in 1998 prompted the awareness of the need to forge closer links between the different systems of financial regulation by bringing together:

- first, prudential regulation of the financial intermediaries that bear risk in their balance sheets: banks, investment firms and insurance companies;

- second, regulation of the markets themselves, which has traditionally been aimed at correcting any asymmetries of information among market players, guaranteeing the smooth running of the markets and protecting savers;

- lastly, the work of these two systems of regulation should be co-ordinated with the actions of international organisations, IFIs and the leaders of the major economies.

This is a fairly recent approach which arises, of course, from globalisation and, perhaps even more so, from disintermediation. It takes into account the recognition that there is a close link between the macroeconomic approaches that have conventionally been used for the analysis and management of financial stability, and microeconomic approaches, which have perhaps been given less attention in the past. As a result, it is now deemed necessary to integrate these two approaches in an infinitely more co-ordinated manner.

The setting-up of the Financial Stability Forum in 1999 was a reflection of this development. The Forum's work has made possible significant progress in studying problems and finding solutions to them, whereby, for conceptual and operational reasons, market foundations are distinguished from the more technical aspects of prudential regulation.

Furthermore, until very recently, the focus was *de facto* on issues relating to emerging markets, since market disturbances there appeared to be at the root of global instability and financial vulnerability. This was the perspective at the end of the 1990s. We can also say that Japan was a source for concern in this context.

The new situation, with the bursting of the net economy bubble, the various scandals that have occurred principally in the United States, and the slowdown of the world economy – which was certainly exacerbated by the crisis in international relations, but which is essentially due to a loss of confidence in the system and the need to rid it of excessive debt – has changed the way in which financial regulation and the relationships between its various instruments are approached. Thus, questions are now being raised not only about emerging markets but also about the markets that are considered the most highly developed.

The deliberations and activities of the major players in the field of regulation, as reflected in the discussions of the G7 and G8, can – somewhat artificially – be divided into the two central themes that I alluded to just now:

- first, how can we restore market foundations and improve the functioning of the market?

- second – and this is more open to debate – should the conventional instruments of prudential and macro-financial regulation be complemented by a more appropriate approach that takes into account the specific developments in the financial markets themselves?

There is a fairly broad consensus on the first theme. To keep it brief, it relates to the issue of information, which is at the heart of market efficiency and integrity.

The serious malfunctionings observed in recent years have shown that the information supplied to the market was too often inaccurate or incomplete, or even plainly misleading. This had an impact both on market players' individual and collective behaviour and on the manner in which market regulators intervened.

There are three major issues that underlie the question of market foundations:

- first, the need to use appropriate language to format and communicate information;

- second, the need to identify, contain and, if possible, anticipate – if they cannot be eradicated – the conflicts of interest that distort the behaviour of major market players, whose role is to disseminate, verify and interpret information;

- lastly, there is the more general issue of ethics, of the basic morality of market players, particularly those that by definition benefit from the asymmetry of information inherent in a market system.

The role of market regulators ought to be a central one on all these issues. This is not the case in all countries either because regulation has not yet reached the necessary level of maturity, or because regulation is still in the hands of professional interests that have not always managed to deal with their own conflicts of interest and problems of self-discipline.

However, substantial progress is being made in terms of international convergence, notably under the aegis of the International Organization of Securities Commissions (IOSCO) and the other regulatory bodies supported by the Forum.

Today, all we can do is to list the main areas into which the huge task at hand can be broken down. The first is the definition of internationally recognised accounting standards that are suited to the market economy. This is the role of the International Accounting Standards Board (IASB), which is charged with designing principles and standards that correspond to the needs of this type of economy.

The IOSCO has played a key role in this area by monitoring the proposals of the former IASC, then by recognising the core standards of the IASC in 2000, and today this process is well under way with the support of the European Union, which has adopted its own standards. As a consequence, the debate is now focusing, as I see it, more on a sectoral problem – that of banking and insurance – than on general critique of the IASB standards.

The second area of work, which was just mentioned at length, and I won't dwell on it, concerns the actual implementation of principles of corporate governance to ensure that the management of companies is subject to appropriate checks, and delivers to shareholders and markets, in accordance with the principle of transparency, relevant, consistent and timely information, which is, of course, accurate and sincere regarding the company's strategy, and its objectives, prospects and results.

The IOSCO and the OECD are in the front line in this area.

The third area is an effective audit system that guarantees the quality of financial information and in particular its compliance with the relevant standards. This has to do with the way the audit profession is organised and its oversight and the IOSCO has finally started to address the question.

The Enron crisis and the other scandals really have triggered a radical shift in thinking in many countries, above all in the United States, where hitherto there was a reluctance to involve regulators in laying down standards for behaviour in this area.

In October 2002, the ad hoc committee of chairmen of Securities Commissions that belong to the IOSCO's Technical Committee, which was set up after September 11, adopted a set of standards designed to prevent conflicts of interest between auditors and consultants, to promote the audit committees that were referred to just now and to establish in each country a supervisory system for auditors that is external to the audit profession.

The fourth area is that of professional and ethical standards that need to be laid down for professions that interpret information, disseminate assessments and advise the public.

Here again, the IOSCO was for a long time reluctant to intervene in this area until circumstances led it to address the question via two working groups, one of which deals with analysts and the other with rating agencies.

That work is under way; so far, not much can be said about. Regarding rating agencies, I personally think that the time has come for us to ask these structures to organise themselves as a profession.

It is probably the only financial profession that is not organised either at a domestic or an international level.

I also think that it is time to ask the rating agencies to define among themselves, make public and, of course, apply technical standards and standards of governance that are published, as it is the case for most other professions, so that people have a better understanding of how they function and to prevent potential conflicts of interest.

In particular, I am concerned with the question of whether, in some instances, we might not see the emergence of a similar phenomenon to that observed in auditing.

Once these agencies have established profitable business lines in their main area of activity, it is obviously very tempting for them to capitalise on this core business by developing side lines, which, if they take on a significant dimension, can have a substantial impact on the company's main business line and create conflicts of interest. This is what has led to the ruin of certain auditing firms.

This completes the overview of these market foundations. My impression is that there is a great deal of international consensus on these subjects. Of course there are different views, different cultural perspectives, but there is no real disagreement regarding the need to implement appropriate standards in a much more proactive way than in the past.

Of course, the question remains regarding the effective implementation of the relevant standards. This will require efforts in terms of self-regulation, the involvement of government bodies in each of the countries concerned and lastly – perhaps above all – the technical support and determination of the major international organisations, which can provide assistance via the programmes that have just been referred to.

Our second topic is rather different in terms of its philosophical perspective and is probably more controversial.

It concerns the relationship between the macro-financial functioning of markets and the issue of financial stability.

As I see it, the problem stems from the fact that the bulk of prudential regulation is focused on the soundness of intermediaries, with no direct intervention in the overall functioning of markets, in which non-intermediaries such as ordinary, generally unregulated, issuers and investors do business with one another. Meanwhile, market regulators, *i.e.* securities regulators, focus for their part on the functioning of the market, rules of conduct and information, and restrict themselves to noting developments and trends, but refrain from commenting on or attempting to steer these developments.

In a world undergoing a rapid process of disintermediation and internationalisation, combined with incredible technological progress and financial innovation, clearly new questions arise. Against the background of conventional monetary policy, is the containment of intermediaries' vulnerability through ever more effective risk management sufficient to guarantee and manage financial stability?

We have been observing the transfer of risk from the market by intermediaries that used to carry virtually all of this risk in their balance sheet at a time when markets did not occupy the same role and were under the control of the relevant regulator.

Risk transfer is direct when issuers deal directly with investors *via* the market, and since the early 1990s we have seen a tremendous growth in corporate bonds.

Another example of direct risk transfer is when banks' trading departments move away from their traditional framework and no longer work with banks' capital but with that of their clients. This issue is becoming increasingly important in the light of the development of techniques of alternative fund management, *i.e.* products that are marketed for use by professionals and those with experience in the field, but which in my country, as in many others, have begun to be sold directly or indirectly to the general public.

Lastly, indirect risk transfer occurs when intermediaries hedge against risks they have taken with regard to their clients and on the markets by using derivatives or securitisation, or through contractual risk transfer. In this scenario, some of the ultimate risk holders are not subject to macro-prudential regulation, *i.e.* pension funds, mutual funds, reinsurers and individual investors.

We can see, therefore, the kind of chain reaction that can take place and cause destabilisation and vulnerability when, at first sight, it appears that the robustness of the financial system is assured. If markets become exuberant, asset prices skyrocket, debt that has been collateralised using these assets can also skyrocket and nobody is in a position to contain the trend.

Initially, the risk does not appear directly in the balance sheets of intermediaries that have proven solidity. It is only when the markets come down from their dizzying heights that people become aware of what has taken place. This sparks a crisis, a crisis of confidence, then a crisis of growth, and then possibly – let's hope it won't happen – a financial crisis.

Another topic in a similar vein also appears important to me, which is perhaps even more controversial than the first: that of the extreme volatility of asset prices.

Many people regard volatility as part and parcel of the way the market functions and consider that we should not by excessive regulation take the risk of producing perverse effects and increasing market inefficiency.

It needs to be recognised, however, that excessive volatility itself – the recent period demonstrates this – gives rise to perverse effects and can actually reduce the credibility of the market model as such.

At this stage, it is not a question of proposing action to deal with volatility, but rather of having a better understanding of the processes involved, and identifying the potential mechanisms that exacerbate destabilisation.

As with the externalisation of risk that I talked about earlier, the first observation to make is that there is inadequate information and a lack of understanding regarding the nature of these phenomena. It is interesting to note in this respect that the Securities and Exchange Commission (SEC), which for a long time was reticent regarding regulators' involvement in these issues, has just decided to study the potentially destabilising effects of short selling combined with securities lending and the strategies of alternative fund managers.

The British Financial Services Authority (FSA) and the French Financial Markets Council and Stock Exchange Commission have also begun to study these issues, and the Committee of European Securities Regulators (CESR) is also looking into this area.

The Financial Stability Forum has addressed these matters at its recent meetings, and the Bank for International Settlements also recently published some interesting studies, notably on credit risk transfer which, it notes, largely escapes statistical analysis.

Preparing the French G7 presidency provided an opportunity to look at these questions regarding the relationship between market functioning and financial stability.

It was in no way, of course, a question of recommending solutions based on an interventionist ideology rejected – quite rightly – by advocates of the market economy. It was rather a case of taking note of recent developments, recognising that we do not have an adequate information base regarding these matters, and encouraging the relevant organisations – IFIs, regulatory organisations, central banks – to address these issues.

I believe that it is crucial to give these areas special attention in order to gain a better understanding of the sources of these destabilising factors that are liable to damage the credibility of assumed market efficiency. An in-depth study of the relationships between the microeconomic regulation of markets and the prudential regulation of intermediaries is also needed.

By way of conclusion, I would like to react to some of the arguments we are seeing in the press at the moment, especially in France, I'm afraid to say.

I do not believe that recent events, as serious as they are, should prompt any sort of back tracking or calling into question of the major progress that has been made since the 1980s in terms of building a global market economy.

In this regard, the sometimes fundamental and often fearful critique of globalisation and expansion of markets is not productive. We should, on the contrary, deepen our understanding of these developments, reinforce international co-operation among regulators – in the broadest sense – and representatives of the financial industry, design and implement better and more comprehensive standards, and patiently build a world-wide system of regulation that is in keeping with globalised financial markets.