INTERNATIONAL COOPERATION AND COORDINATION IN THE AREA OF FINANCIAL MARKET SUPERVISION AND SURVEILLANCE

Report by
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1. Mandate issued by the G-7 Finance Ministers and Central Bank Governors

In considering ways of strengthening the international financial system, the Finance Ministers and Central Bank Governors of the G-7 countries asked me at their meeting in Washington on October 3, 1998

> "*... to consult with other appropriate bodies and to consider with them the arrangements for cooperation and coordination between the various international financial regulatory and supervisory bodies and the international financial institutions interested in such matters, and to put to us expeditiously recommendations for any new structures and arrangements that may be required*."

This mandate was restated and extended in the declaration by the G-7 Finance Ministers and Central Bank Governors on October 30, 1998:

> "*We agree that better processes are needed for monitoring and promoting stability in the international financial system and for the International Financial Institutions, working closely with the international supervisory and regulatory bodies, to conduct surveillance of national financial sectors and their regulatory and supervisory regimes with all relevant information accessible to them.*

We agree therefore that we will:

(i) support the establishment of a process for strengthened financial sector surveillance using national and international regulatory and supervisory expertise, including through a process of peer review, and the IMF's regular surveillance of its member countries under Article IV;

(ii) to this end bring together the key international institutions and key national authorities involved in financial sector stability better to co-operate and to co-ordinate their activities in the management and development of policies to foster stability and reduce systemic risk in the international financial system and to exchange information more systematically on risks in the international financial system.

(...) we asked Dr Tietmeyer to consult the relevant international bodies on these reforms ..."*.*

In order to fulfil this mandate, I have held thorough consultations with representatives of all the G-7 countries, the international financial institutions, and various international bodies. These consultations were helpful in identifying key areas in the international financial system where improvements are essential in order to safeguard the proper functioning of the markets. A broad consensus emerged during this consultation process and is reflected in this report.

This report first describes the current international arrangements for promoting the stability of the financial system. It then sets out the areas in which improvements are needed and where action appears necessary to strengthen the sustainable functioning of the markets. The final section sets out a proposal for improved international cooperation and coordination in the area of financial market supervision and surveillance.

2. Current arrangements for the supervision and surveillance of the international financial system

There are various international organisations which share responsibility for the current arrangements concerning the supervision and surveillance of the international financial system.

The International Financial Institutions (IFIs) contribute in various ways to strengthening the global financial system:

- the International Monetary Fund (IMF) has responsibility under its Articles for surveillance of all member countries, and monitors developments in the global economy and financial markets;
- the IBRD (World Bank) under its mandate uses its expertise to assist 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 Organisation for Economic Co-operation 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 effected by various sector-specific international groupings of regulators and supervisors. In particular, these are

- the Basle Committee on Banking Supervision (BCBS), as an important rule-setting body in the field of banking supervision;
- the International Organization of Securities Commissions (IOSCO), which provides mutual assistance in order to promote the integrity of securities and futures markets worldwide; and
- the International Association of Insurance Supervisors (IAIS), which cooperates with supervisors in promoting high standards in the field of insurance supervision.

Moreover, there are groupings of central bank experts concerned with market infrastructure and functioning. In particular, these are

- the Committee on Payment & Settlement Systems (CPSS), which analyses payment systems and makes recommendations with the aim

of reducing the risks arising in this area, and

- the Committee on the Global Financial System (CGFS; formerly the Euro-Currency Standing Committee), which analyses global financial system conditions and makes recommendations for improving market functioning.

Current arrangements have made a significant contribution to raising standards of soundness and risk-awareness in financial systems. These are remarkable achievements even though they are sector-specific in their approach. However, the pace of change in markets and financial intermediaries brought about by the process of global financial integration has increasingly exposed 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. The rationale behind such an approach now has to be applied in a comprehensive manner.

There are three aspects to this: firstly, overcoming the separate treatment of micro-prudential and macro-prudential issues; secondly, bringing together the major international institutions and key national authorities involved in financial sector stability; and thirdly, integrating emerging markets more closely in this process.

Ultimately, the process of strengthening cooperation should make a significant contribution to a better functioning of the financial markets. This will make possible a full utilisation of the considerable benefits which free capital movements provide to all participants in the global financial system.

3. Areas in which improvement is needed

Recent events in international financial markets have highlighted three areas in which improvement is needed.

Firstly, strengthened efforts are necessary to help identify incipient vulnerabilities in national and international financial systems and concerted procedures are needed for a better understanding of the sources of systemic risk and to formulate effective financial, regulatory and supervisory policies to mitigate them.

Secondly, more effective procedures are required 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.

Thirdly, improved arrangements are necessary to ensure that consistent international rules and arrangements apply across all types of significant financial institutions, and that procedures exist for the continuous flow of information among authorities having responsibility for financial stability.

Some elaboration of each of these areas follows.

3.1 Identification of incipient vulnerabilities and concerted efforts to mitigate systemic risk

Recent events have underscored the importance of assessing domestic vulnerabilities in the light of evolving global conditions and vice versa, and of relaying such assessments to relevant parties to forestall delays in the correction of inadequate structures and of destabilising trends.

While the national authorities, the IFIs, the international regulatory bodies and the central bank groupings each gather and assess data on segments or the whole of the international financial system, and regularly monitor aspects of financial system stability, none 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 for systematically pooling and efficiently using the information available to these bodies in their assessment of domestic financial vulnerabilities and global conditions.

Recent events have also illustrated the potential risks to the world economy arising from financial market problems, and the threat of chain reactions in the financial sector. This has demonstrated the paramount importance of mitigating systemic risk by better understanding and alleviating the factors that bear on it. Disabling shocks to the global financial system can arise from a variety of factors and circumstances, including macroeconomic weaknesses, the collapse of major individual institutions, and weaknesses in the infrastructure that underpins and connects financial systems. That requires transparency, close monitoring and, if necessary, coherent and appropriate action to forestall accelerating developments.

The various regulatory groupings deal predominantly with micro-prudential issues pertaining to the stability of the individual institutions within their purview. However, the greater importance of financial markets for channelling funds from surplus to deficit sectors and for managing a wide variety of different risks has made it increasingly important to focus on the sustainable functioning of markets, which includes the health and operation of individual institutions. This implies a greater need to consider micro-prudential policies in a wider setting, including the ways in which such policies could be blunted or sharpened by market practices and disciplines, or have unintended aggregation effects. Greater efforts are also needed to foster improvements in the functioning of markets, including systematically overseeing the processes by which markets and market participants are adequately informed.

Systemic threats can also arise from unsupervised financial service providers, notably major highly leveraged institutions (as has been underlined in a recent report by the BCBS entitled “Sound Practices for Banks’ Interactions with Highly Leveraged Institutions“). Additionally,
spill-over effects could arise from difficulties at non-bank financial institutions and large insurance companies. Developing an appropriate response will require the involvement of the various regulatory groupings and the national authorities of the markets in which these entities are domiciled and operate.

3.2 Developing and implementing standards and codes of conduct

Strengthening financial systems will demand a systematic approach to ensuring that gaps in international standards or codes of conduct are identified and effectively filled. This calls for intensified cooperation and coordination between the national authorities, international regulatory bodies and the IFIs charged with monitoring and fostering implementation. In particular, national authorities and the regulatory groupings need to ensure that the process of developing standards benefits from the wide-ranging information obtained by the IFIs in their surveillance and assistance activities in individual countries. Greater involvement in these processes of the emerging market economies to which those standards would apply is needed to augment their commitment to implementing them.

A significant 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 BCBS and IOSCO, and those being developed by other international groupings. The IFIs, 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 groupings can enhance the effectiveness of the IFIs in these tasks and vice versa.

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

3.3 Improvements in cross-sector financial supervision

The international regulatory groupings have made considerable progress in harmonising and strengthening national financial regulation and supervision. Minimum standards have raised levels of soundness and helped to create a more level playing field, and the continuing issuance of risk-management guidance improves defences at individual institutions. These efforts, including the work of the Joint Forum, 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 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 the fact that countries have different financial and supervisory systems.

The functional bodies also need to take account of the work being done by private-sector groupings and to assess, in cooperation with national authorities, the question of the appropriate prudential and regulatory response to significant players operating outside existing regulatory arrangements, including the adjustment of prudential policies governing those within their purview.

3.4 Specific issues to be addressed

From the current standpoint, action is required in the following areas:

– improving arrangements for the surveillance of global vulnerabilities, including the pooling of information available to the IFIs and the international regulatory groupings, the development and assessment of macro-early-warning indicators, and the creation of procedures to ensure that information reaches the relevant parties;
– creating procedures for coordinating the work of national and international regulatory groupings, and for the exchange and pooling of information among them;
– assessing the need for the regulation of non-regulated entities;
– strengthening and, where appropriate, encouraging the development and implementation of international best practices and standards, including fostering improved in–house risk management at financial institutions in the wake of recent market events, and promoting appropriate transparency and disclosure rules for all market participants.

4. Proposal for improved cooperation in the area of international financial market surveillance and supervision: convening a Financial Stability Forum

The previous sections set out a number of specific areas in which existing arrangements for the supervision and surveillance of the international financial system could be strengthened. Sweeping institutional changes are not needed to realise these improvements. Instead, a process in line with the mandate should be set in motion to ensure that national and international authorities and groupings 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.

The following approach would appear to be suitable:

The G-7 should take the initiative in convening a Financial Stability Forum. Such a Forum should 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 would report to the G-7 Ministers and Central Bank Governors. It would replace the series of ad hoc groups that have been convened by the G-7 over the past few years with a view to strengthening the international financial system.

The Forum should be limited to a size that permits an effective exchange of views and the achievement of action-oriented results within a reasonable time frame. In developing objectives, priorities and programmes for action, the Forum would work through its members, taking into account their comparative advantages.

The members of the Forum would be representatives of national and international authorities responsible for questions of international financial stability. It would comprise the ministries of finance, central banks and senior supervisory authorities - initially of the G-7 countries. In addition, the IFIs and key international regulatory groupings would participate. Representation should be at a high level (i.e. Deputy Ministers and Deputy Governors, Deputy Heads of the IFIs, Chairs and appointed members of international groupings).

Given the need for the Forum to have a manageable size, national representation would be limited to three members; the IFIs (IMF and IBRD) would be represented by two participants each, the other international organisations (BIS and OECD) by one member each; the international regulatory groupings (BCBS, IOSCO, IAIS) would be represented by two members each, and the CGFS and CPSS by one each. Participation could over time be extended to include representatives from a small number of additional (i.e. non G-7) national authorities that could contribute substantially to the process, or to invite them to attend meetings as guests.

The chairperson should be appointed in a personal capacity for a period of time which is adequate to ensure continuity in the work of the Forum. Experience would seem to indicate a term of not less than three years.
I would like to suggest the appointment of Mr Andrew Crockett, General Manager of the BIS, for a term of three years.

The Forum would meet as often as needed to achieve its objectives. Initially two meetings a year could be envisaged. The first meeting of the Forum could be held in spring 1999.

The Forum could ask members to form working groups in order to facilitate its work or address specific ad hoc issues. A permanent “Chairman’s Group“ composed of the representatives of the IFIs and the international regulatory groupings and, if necessary, of national supervisors directly involved in specific issues could meet around or between the Forum’s meetings to coordinate follow-up activities to the Forum’s outcome.

Support for the Forum would be provided by a small secretariat located at the BIS in Basle. Members of the secretariat could be drawn from the BIS and from the participating international financial institutions. Staff from the IFIs would not be expected to move to Basle; if appropriate, they could remain based in Washington, working closely with their colleagues in Basle.