International Transparency and Regulatory Challenges

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Much of the focus of activity since the Asian and other crises has been on measures to decrease vulnerability at the national level in recipient countries. (For an excellent analysis, see the *Working Group Report on Capital Flows*, Financial Stability Forum, 2000.)

However, it seems equally important to diminish vulnerability at the international level, as in recent crises imperfections in international capital markets played at least as large a role (if not a larger one) as mistakes and weaknesses in recipient economies. In this sense, it is disappointing that action at the international level, particularly in implementation of better transparency regulation, has till now been far less and slower than actions in recipient economies. A very positive step has, however, been taken with the creation of the Financial Stability Forum; it is, however, very problematic that developing countries have no participation in its meetings or decisions, even though they are invited to participate in its working groups. Representation of developing countries in the FSF would be highly desirable both for reasons of legitimacy and because it would provide the body with a wider range of expertise and perspectives.

At the international level, there are two challenges: (a) improving transparency of markets by providing relevant information on a timely basis, an effort that would be symmetrical to the large effort being undertaken on improving transparency in country economies; and (b) improving regulation of markets, where current regulations are imperfect or where gaps exist.

Better Transparency

As regards improved transparency on markets, a number of important actions have been taken. These include a meeting between compilers and users of data, held at the IMF in February 2000, to discuss data issues on capital flows.

Areas where improved information is urgent include highly leveraged institutions (HLIs) and over-the-counter derivatives (OTCS) as these are particularly opaque. But it is also essential to make progress on more complete and timely information on exposures by other institutional investors and banks to developing countries, as this is essential for better policy-making in general, and particularly so in times of crises.

As regards HLIs, the Report of the FSF Working Group on HLIs issued valuable recommendations on disclosure. These focus mainly on public exposure (also recommended by other reports, including a report by the International Organisation of Securities Commissions (IOSCO) Technical Committee). Two proposals are currently before the US Congress which seek to impose disclosure requirements only on large funds, which could have systemic importance, without disclosure of proprietary information. These efforts have been endorsed by the FSF working party, which also calls on all jurisdictions to consider the adequacy of their disclosure requirements and introduce, where necessary, appropriate changes to ensure that major hedge funds are subject to complementary disclosure requirements; this recommendation also applies to offshore centres, particularly those which currently host large unregulated hedge funds.

Because the build-up of leverage was not confined to hedge funds, the working group on HLIs has rightly stressed the need to enhance disclosure of risk exposures by all participants in financial markets, both regulated and unregulated; these include banks, insurance companies, securities firms, mutual funds and hedge funds. A voluntary study is being organised in this crucial field, with a final report to be prepared by the end of 2000, on appropriate steps to be taken to improve the state of disclosures by all intermediaries. The measures may require changes in regulatory practices or in the law. This seems an extremely valuable step, which hopefully will be implemented quickly.

Better Regulation

The case for additional regulation

There is growing support for the view that the process of international financial intermediation has a second-best element, in which welfare for both source and recipient countries can be increased by regulatory changes (through measures in source and/or recipient countries), which would reduce excessive lending or investing. It is noteworthy that the Chairman of the US Federal Reserve Board, Alan Greenspan, proposed, for the case of interbank lending, that it could be appropriate for either borrowing countries or lending ones to impose reserve requirements to 'deter aberrant borrowing: sovereigns could charge an explicit premium, or could impose reserve requirements, earning low or even zero interest rates, on interbank liabilities. Increasing the capital charge on lending banks, instead of on borrowing banks, might also be effective.'[1]

There is growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient countries. Indeed, an important part of the responsibility for discouraging excessive reversible inflows – as well as managing them – lies with the recipient countries. However, the experience of the 1990s, with a very large scale of international funds, compared to the small size of developing country markets, leads to the question whether measures to discourage excessive short-term flows by recipient countries are sufficient to deal with capital surges and the risk of their reversal.

Aizenman and Turnovsky (1999) have formalised such analysis by developing a rigorous model that analyses the impact via externalities of reserve requirements on international loans (both in lending and recipient countries) on the welfare of both categories of countries. They thus evaluate the macro-economic impact of reserve requirements in a second-best world, where there is moral hazard due to likely bail-outs on the lender's side and sovereign risk on the borrower's side; both generate large negative externalities on welfare. The general conclusion of their model is that the introduction of a reserve requirement in either the source or recipient country reduces the risk of default and raises welfare in both countries.

Regulatory changes can help smooth capital flows to emerging markets, without discouraging them excessively. This is in contrast to views based on a belief that crises in emerging markets are due only to moral hazard, and that the appropriate way to combat such moral hazard is by scaling down the role of the IMF in providing financial packages before and during crises. However, such a reduction of the role of the IMF could either make crises even more costly and/or lead to a sharp reduction in private flows to developing countries. These are both highly undesirable effects which could significantly diminish welfare, particularly, but not only, in the developing economies, as well as undermine support for open economies and market-based economic policies in developing economies. Therefore, an approach based on better regulation is clearly better and more welfare enhancing than one which cuts back the role of the IMF.

[1]Remarks by Alan Greenspan before the 34th Annual Conference of the Federal Reserve Bank of Chicago, 7 May 1998.

Filling gaps

The broad welfare case for applying reserve requirements in both source and recipient countries can also be applied to institutional investors and, in particular, to mutual funds, which became increasingly important in relation to banks in the 1990s. This growing importance occurred both within the developed countries, and particularly within the USA, where mutual funds receive more than 50 per cent of total deposits in the financial system, and in capital flows from developed to developing countries (see d'Arista and Griffith-Jones, 2000).

The narrowing of differences between banks and institutional investors like mutual funds, and the fact that securities markets and thus mutual funds also have access to the lender of last resort – nationally in the USA but more importantly in our context also internationally, due to the frequent rescue packages put together by the IMF in recent serious currency crises – suggest the importance of improving prudential standards for institutional investors such as mutual funds.

As regards portfolio flows to emerging markets, there is an important regulatory gap, as at present there is no international regulatory framework which takes account of market or credit risks on flows originating in institutional investors, such as mutual funds (and more broadly for flows originating in non-bank institutions). This important gap needs to be filled, both to protect retail investors in developed countries and to protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows.

Institutional investors like mutual funds, given the very liquid nature of their investments, can play an important role in contributing to developing country currency crises. (For recent evidence, see Kaminsky, Schmukler and Lyon, 2000.) It seems important, therefore, to introduce some regulation to discourage excessive surges of portfolio flows. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors, such as mutual funds. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps for other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities and/or agreed internationally. The guidelines for macro-economic risk, which would determine the cash requirement, would take into account vulnerability variables as defined by the IMF and the BIS.

The fact that the level of required cash reserves would vary with the level of countries' perceived 'macro-economic risk' would make it relatively more profitable to invest more in countries with good fundamentals and relatively less profitable to invest in countries with more problematic macro or financial sector fundamentals. If these fundamentals in a country deteriorated, investment would decline gradually, which hopefully would force an early correction of policy and a resumption of flows. Though the requirement for cash reserves on mutual funds' assets invested in emerging markets could increase the cost of raising foreign capital for them, this would be compensated for by their having a more stable supply of funds, at a more stable cost. Furthermore, this counter-cyclical smoothing of flows would hopefully discourage massive and sudden reversals.

The September 1998 Emerging Markets IOSCO Report on Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets has in fact described in some detail and evaluated rather positively the above proposal. This report emphasised that 'there appears to be scope – and an urgent need for further work. This is very likely to require a multilateral effort – i.e. by regulators from both source and recipient countries in collaboration with the industry.'

As regards HLIs, the FSF working group on HLIs rightly focused on two problems: systemic risk linked to high leverage and reduction of the market, and the economic impact of the collapse of unregulated HLIs. Particular emphasis was placed on HLI activities in small and medium-sized open economies where the potential damage that can be caused by large and concentrated positions can seriously amplify market pressures.

The FSF working group considered formal direct regulation of currently unregulated institutions. This would include a licensing system, minimum capital and liquidity standards, large exposure limits, minimum standards for risk management and even an enforcement regime with fines for transgressions.

Such regulation was seen to have several very desirable effects (such as regular oversight over HLIs and a reduction in the likelihood of disruptive market events) but, due to what were seen as both philosophical and practical problems, the working group did not recommend applying a system of direct regulation to currently unregulated HLIS at this stage, although it did not reject the possibility of establishing such a regime in the future. It emphasised that the failure to carry through its recommendations would prompt such reconsideration.

The philosophical objection relates to the fact that direct regulation would not be aimed at investor protection (as investors are sufficiently wealthy or sophisticated to do their own due diligence), but on the mitigation of systemic risk. However, it could be argued that mitigation of systemic risk is also an increasingly valid regulatory aim. There are also practical objections, including how to avoid leakage through offshore centres. However, current efforts to improve and complete regulation in offshore centres should help overcome those problems. (See discussion in the FSF Working Group Report on Offshore Centres.) Other practical issues are more technical and more valid, including the need to adapt capital adequacy and large exposure rules to the specific risk profile of HLIs. This should be done in such a way that any regulatory capital requirement does not adversely affect the efficiency and liquidity of markets in which HLIs are significant participants. This seems particularly important in a context in which several large hedge funds have been wound down, which may diminish some of the negative impacts they had in recent crises, but it could, according to some observers, deprive markets of contrarian actors, who have useful roles to play in stopping the deepening crises.

The need to regulate HLIs directly must be revisited, partly in relation to the implementation (or not) of other measures recommended by the working group and their perceived impact. These measure include:

- stronger counter-party risk management;
- stronger hedge fund risk management;
- enhanced regulatory oversight of HLI credit providers;
- greater risk sensitivity in bank capital adequacy;
- building a firmer market infrastructure;
- better public disclosure of HLIs (discussed above);
- enhanced national surveillance of financial market activity at the national level to identify rising leverage and concerns relating to market dynamic;
- taking appropriate preventive measures, where necessary, and putting in place good practice guidelines for foreign exchange trading, which could be adapted in individual emerging markets.

Removing regulatory distortions and dampening exuberance of bank lending

As regards bank lending, there has firstly been concern that the 1988 Basle Capital Accord contributed to the build-up of short-term bank lending and its reversal in East Asia and elsewhere, due to significantly lower capital adequacy requirements for short-term lending than for long-term lending. The new proposal, published in June 1999, attempts to address this distortion by reducing somewhat (though perhaps not sufficiently) the differential between capital adequacy for short-term and other lending. However, the new Basle recommendations, though including many positive elements (see, for example, Caillous and Griffith-Jones, 1999), also contain suggestions that have been widely seen as problematic. These include increasing the role of rating agencies to determine country weightings for capital adequacy, which could aggravate the pro-cyclical nature of bank lending and thus encourage larger surges and larger reversals. This is clearly an undesirable outcome.

There is important evidence that rating agencies act in a volatile and, especially, pro-cyclical fashion. If that were the case, reliance on ratings in the new system would exacerbate boom-bust cycles and could undermine the stability of the financial system.

The most recent evidence of this pro-cyclical pattern is the Asian crisis. Indeed, as pointed by various authors (see, for example, Turner, 2000; Cornford, 2000; Reisen, 1999), rating agencies failed to downgrade the East Asian countries before the crisis but then worsened it because they brought down the ratings as the crisis unfolded. Reisen and von Maltzan (1999) assess the impact on the market of the publications of ratings by the main rating agencies and find that sovereign ratings lag behind, rather than lead, the market.

These problems should not, however, put in question the need to reform the 1988 Accord. The current system has fixed weightings which do not adjust with the cycle. In the event of a recession the increased amounts of bad loans (which are usually not fully covered by provisions) will impact upon the lending bank's capital and can lead to decreased lending if the bank is already facing a relatively low capital asset ratio and, as is likely in a recession, is unable to raise new capital.

Thus the answer may lie in the implementation of an explicit counter-cyclical mechanism which would, in boom periods, and in contrast to ratings, dampen excess bank lending. Counter-cyclical elements can also be introduced in regulating other actors (see above for mutual funds). On the contrary, in periods of slowdown and of scarcity of finance, the new mechanism should not further accentuate the decline in lending, as exemplified by the 1997–98 Asian crisis, but rather encourage it.

There would be two linked objectives in introducing elements of counter-cyclical regulation. One would be to help smooth capital flows; the other would be to smooth the domestic impact of volatile capital flows on the domestic financial system and, therefore, on the real economy. Introducing counter-cyclical elements into regulation would help build a link between the more micro-economic risks on which regulators have tended to focus till recently and the macro-economic risks which are becoming increasingly important, both nationally and internationally.[1] Counter-cyclical elements in regulation related to bank lending could be applied, either internationally, nationally or at both levels.

Several mechanisms could be used to introduce a counter-cyclical element into the regulation of bank lending. One mechanism would be to get the required capital ratio higher in times of boom and to allow banks to use the additional cushion provided by the higher capital ratio, so that they could sustain lending in times of recession at a lower capital asset ratio (when increased bad loans are likely to be reducing their capital). Some practical difficulties may arise in implementing such a mechanism, of which the most serious may be getting international agreement on a general formula for cyclically adjusted capital asset ratios.

A second mechanism for introducing counter-cyclical elements in bank lending regulation is for regulators to encourage higher general provision for possible loan losses (that is, provision which is subtracted from equity capital in the books of the bank) to cover normal cyclical risks (Turner, 2000). This would allow for provision built up in good times to be used in bad times, without affecting reported capital. The way to ensure this would be to maintain higher general provisioning in relation to all loans. The main problem with this, according to Turner, may be that tax laws often limit the tax deductibility of precautionary provisioning. However, it is possible to change such tax laws, as was indeed done in the late 1980s in the UK. A third mechanism, especially relevant for domestic bank lending, is for regulators to place caps on the value of assets (such as real estate or stocks and shares) acceptable as collateral, when the value of such assets has risen sharply in a boom and is at risk of declining sharply in a recession. Rules could be used such as averaging values for the last five years, or accepting only 50 per cent of current prices in the peak period of a boom. The latter mechanism seems to have the least problems of implementation (indeed, reportedly, it is already applied in some jurisdictions, for example Hong Kong).

A fourth possible counter-cyclical mechanism is that, as suggested by McKinnon and Pill, monetary authorities could monitor and try to limit or discourage lending for property, construction and personal consump-

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[1]We thank Andrew Crockett for his suggestive remarks on this point.

tion, as these items tend to increase substantially in booms, where they often become a major factor. A possible implementation problem would be that it may be difficult to verify final use of credit, so that such measures could be partially evaded.

Furthermore, regulators should be flexible in the downturn, particularly to allow banks to easily use cushions (for example of capital or of provisioning) in times of recession; it may even be advisable, if a recession is very serious, to allow ratios to fall below normally required levels, in order to help sustain lending, on the understanding that they will be rebuilt as soon as the economy starts recovering. A tension may arise here between the regulatory concerns about individual bank liquidity and solvency, and the macro-economic externalities of their actions, particularly in recessions. Specific issues seem to require further study. How best can the distinction between a temporary boom and a permanent increase in growth be made? After what period of 'boom' should regulatory changes be introduced? How large should such changes be? What are the best mechanisms through which counter-cyclical measures can be introduced – flexible capital adequacy ratios, higher provisioning against losses or more 'realistic' pricing of collateral? Should such measures be introduced for both international and domestic lending, or preferably for one of them? This paper provides only initial thoughts on these important issues.