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International Governance

The internationalization of banking has created additional concerns in a number of areas. Individual banks operate in multiple jurisdictions and even banks operating from a single jurisdiction may have extensive international risk exposure. Three key concerns arise. First, the complicated corporate structure of international banks and the fact that operations are often based in different jurisdictions make supervision difficult. Second, the portability of many banking transactions may provide opportunities for some institutions to engage in regulatory arbitrage by officially recording transactions in the jurisdiction with the least onerous regulatory regime. This can result in a bank taking on excessive risk, which may be poorly monitored because of the difficulty in supervising international banks. It may also lead to competitive deregulation among jurisdictions eager to see their financial sectors grow. Ill-considered deregulation could result in systemic weakness. Finally, the extent of international linkages between banks and banking systems makes it more and more likely that any significant banking crisis will have international or global dimensions.

As there is no recognized international supervisory authority, responses to these issues have taken the form of bilateral arrangements, multilateral agreements in a few areas, and efforts at coordination on the part of international organizations.

International Cooperation to Reinforce the Operating Environment

Even in an era of global finance, the framework for banking is still country specific and may be enforced by different authorities both within and between countries. For example, foreign branches may be supervised by home-country supervisors using criteria different from those used by host-country supervisors. Just as the domestic operating environment may provide opportunities for regulatory arbitrage between financial institu-

tions subject to different regulatory regimes, international differences in laws, accounting standards, supervisory rules, and exit procedures provide scope for such arbitrage. Regulatory arbitrage can result in competition among banks on an unequal basis and in decreased effectiveness of supervision as financial activities will tend to shift to jurisdictions where oversight is the most lax.

International harmonization of regulatory and supervisory standards can improve the operating environment for banks that are internationally active by simplifying banks' operations in an increasingly integrated international economy. Harmonization can make easier the conduct of consolidated supervision of domestic banks operating abroad, improve the oversight of foreign banks' local operations, and bring additional discipline to local regulatory structures. Harmonization also removes the incentives for competitive deregulation or regulatory arbitrage.

The Basle Committee has played a leading role in international efforts toward supervisory cooperation and regulatory harmonization.[108] The Basle Committee was established at the end of 1974 by the central bank governors of the industrial countries comprising the Group of Ten, in response to the growing awareness of the need to improve international supervisory collaboration, made more acute by the Herstatt and Franklin National Bank crises (Freeland, 1994, and Thompson, 1994). In particular, a lack of internationally coordinated supervision allowed the failure of Bankhaus Herstatt in 1974 to spill over to banks in the United States.

The first significant agreement by the Basle Committee, the 1975 Basle Concordat, was an attempt to clarify the operating environment for banks by establishing a set of principles governing the way in which the supervision of banks' foreign branches, subsidiaries, and joint ventures is carried out. As subsequently revised (see Box 1), the Basle Concordat attempts to ensure that no institution escapes adequate supervision. It should be noted, however, that not all countries participate in or fully implement the Basle Concordat, and that it did not avoid coordination problems when BCCI, Meridien, and Barings failed.

In the context of the EU,[109] a broader effort to harmonize the operating environment of banks across countries has been made. The European Economic Community treaty recognized that the liberalization of capital movements would be necessary to ensure the proper functioning of the common market. Since 1977, the EU has adopted a series of banking directives; these directives oblige EU member states to adapt their nation-

[108] Dale (1994) discusses the evolution of international efforts from cooperation to harmonization.

[109] The banking rules of the EU are applied also in the countries of the European Economic Area, comprising all EU member states, plus Iceland, Norway, and Liechtenstein. The rules are therefore applicable in a banking market of 370 million people.

Box 1. The Basle Concordat

The Basle Committee's first priority was to discuss modalities for international cooperation in closing gaps in the supervisory net for international banks and in improving supervisory understanding and the quality of banking supervision worldwide. Its approach was based on two basic principles: that no foreign banking establishment should escape supervision and that supervision should be adequate.

The original Concordat, entitled "Report on the Supervision of Banks' Foreign Establishments," was published in September 1975. It is a set of broad guidelines demarcating responsibilities among national supervisory authorities for banks' foreign branches, subsidiaries, and joint ventures: supervising liquidity should be the primary responsibility of host authorities, while supervising solvency should be the responsibility of home authorities for branches, and of host authorities for subsidiaries.

In May 1983, a revised Concordat on "Principles for the Supervision of Banks' Foreign Establishments" replaced the 1975 text. It incorporates the principle of consolidated supervision and fills some gaps in the supervision of international banks that appeared in some countries, especially offshore banking centers. In April 1990, a "Supplement to the Concordat" was issued to define more clearly how the Concordat was to be implemented in practice, seeking to ensure that adequate information flows between supervisory authorities. In July 1992, following the BCCI incident, the Basle Committee issued more stringent "minimum standards" to reinforce the Concordat.

Note: Prepared by Olivier Frécaut, Monetary and Exchange Affairs Department.

al legislation. The First Banking Directive of 1977 establishes the principle of mandatory licensing and sets common basic licensing requirements. The Second Banking Directive (1989) addresses a range of minimum standards, and provides that an institution authorized in one member state can operate in all member states. Along with this "single banking license" principle, other measures to establish harmonized standards of operation, minimum cover for deposit insurance, and the exercise of banking supervision on a consolidated basis have strengthened and unified the operating framework for banking across the EU.

The global framework for financial markets has also been considered in the context of payment system development. International initiatives in this area have been advanced by a number of public and private organizations and groups. Many of the major—and most broadly accepted—initiatives have been led by the Group of Experts on Payment Systems and subsequently by the Committee on Payment and Settlement Systems of

the Central Banks of the Group of Ten Countries. Their work has included proposals to minimize foreign exchange settlement risk, as well as risks arising in domestic payments and securities transfer systems. This has included proposing standards for domestic currency and foreign exchange netting systems.[110] In addition, the United Nations Commission on International Trade Law has done considerable work on model laws on credit transfers, while the EU Working Committee on EU Payments Systems has worked on the minimum common features for domestic payment systems within the EU, as well as on the design of both domestic and pan-EU, real-time, gross-settlement systems.[111]

International Cooperation to Reinforce Internal Governance

The most important initiative to reinforce internal governance internationally has been the widespread implementation of minimum capital adequacy standards. While many countries have individually established capital adequacy standards, the most prominent international standard and the primary vehicle for harmonization in this area is the Basle Capital Accord, discussed earlier. While most countries are not bound by the Accord, many have adopted the same standards, and it is doubtless that the attention focused on the issue of capital adequacy by the international agreement has facilitated widespread re-examination of existing standards in many countries other those of the Group of Ten.

Again, in the context of the EU, a broader range of initiatives to reinforce internal governance has been taken. For example, the First Banking Directive requires that "there shall be at least two persons who effectively direct the business of the credit institution." (European Union, 1977, Article 3). Subsequent directives have set concrete conduct of business standards for banks. The minimum level of initial capital has been set at ECU 5 million. A risk-weighted capital adequacy ratio of 8 percent is applied. Banks' holdings of equity in individual nonfinancial institutions are limited to 15 percent of the bank's capital, with the total of such holdings limited to 60 percent of capital. Large exposures to a single borrow-

110 The main initiatives regarding foreign exchange settlement risks were presented in "Report on Netting Schemes" (February 1989), "Report of the Committee on Interbank Netting Schemes" (November 1990), "Central Bank Payment and Settlement Services with Respect to Cross-Border and Multi-Currency Transactions" (September 1993), and "Report of the Steering Group on Settlement Risk in Foreign Exchange Transactions" (March 1996). The main initiatives regarding risks in domestic payments and securities transfer systems were presented in "Delivery Versus Payment in Securities Settlement Systems" (September 1992).

111 Their main proposals are presented in "Report to the Council of the European Monetary Institute on the TARGET System" (May 1995) and "Minimum Common Features for Domestic Payment Systems" (November 1993).

er or connected group of borrowers are limited to 25 percent of the bank's capital, with an aggregate maximum of 800 percent of capital.

Standards to limit market risk and money laundering have been set on an EU-wide basis. In addition, member states are obliged to exercise supervision over the internal control and accounting systems, although no concrete standards have been set in this area; the actual standards are set by the individual member states. In the context of the bank-licensing process, member states are also obliged to apply fitness and propriety tests to prospective bank managers and to assess the suitability of shareholders. These requirements must be complied with by the banks at all times, not only at the time of licensing.

International Cooperation to Reinforce Market Discipline

Reinforcement of market discipline at the international level has come chiefly in the area of data disclosure. For example, the IMF has recently put forward proposals for the dissemination by countries of economic and financial statistics (International Monetary Fund, forthcoming, mid-1997). These focus on improving the accuracy, consistency, and timeliness of monetary and other macroeconomic statistics. The Basle Committee has also issued recommendations regarding public disclosure of banks' activities. Such improved disclosure standards and additional information on the condition of individual banks would better permit market participants to assess banks' soundness, paving the way for improved market discipline.

Within the EU, standards have been set for bank disclosure, by means of the Directive on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions. This directive specifies the basic layout of the annual financial statements of banks, covering the balance sheet, the profit-and-loss account, and the explanatory notes to the annual statements.

It is notable that there is no international agreement regarding bank closure standards. Thus exit policy as an adjunct to market discipline functions only at the national level, with international cooperation essentially on an ad hoc basis.

International Cooperation to Reinforce Supervision

As in the areas of internal governance and market discipline, there have been efforts to improve international coordination and cooperation in bank supervision. These efforts have been spearheaded by groups of supervisors such as the Basle Committee, working on behalf of their own member supervisory agencies. The IMF has contributed to this effort

within the almost universal roster of its membership. The closest cooperation, however, has developed in regional groups, particularly the EU.

Basle Committee and Regional Supervisory Groups

As discussed above, the Basle Committee has promulgated recommendations and standards for consolidated supervision and capital adequacy and has formulated policies in other key areas, such as the regulatory treatment of market risks and operations in derivatives. It serves primarily as a forum for the Group of Ten supervisors. However, Basle Committee recommendations are increasingly seen as the global standard that many countries beyond the Group of Ten seek to adopt. Should the Basle Committee formulate further recommendations, they will in all probability receive serious consideration for adoption by supervisors worldwide.

In principle, international coordination on banking sector issues among a broader range of countries than those participating in the Basle Committee can be accomplished through the regional groups of supervisors that have been organized in east and southern Africa, west and central Africa, for the Arab countries, the Caribbean, central and eastern Europe, the EU, the Gulf Cooperation Council, Latin America and the Caribbean, SEANZA (Southeast Asia, New Zealand and Australia), and for countries with offshore centers. These regional groups seek to share experiences, harmonize practices and, on occasion, develop standards on a regional basis to complement those of the Basle Committee. The Basle Committee supports these groups and has promoted the creation of some of them.[112] Over time, the regional groups may develop into a mechanism for more intensive regional collaboration, which could include regulatory harmonization and supervisory cooperation; thus far they provide a useful forum for contacts between supervisors in neighboring countries.

IMF Surveillance and Policy Advice

The IMF has been concerned with bank soundness for some time; its response to the international debt crisis of the 1980s demonstrated its awareness of the need for soundness of the international banking system and of principal international banks.[113] To the extent that the Fund provides, under adequate safeguards, a financial safety net for member countries, it can affect the performance of markets and the development of financial institutions across countries.[114] IMF surveillance of member

[112] See Basle Committee on Banking Supervision (1994).
[113] See Fischer (1995) and Harold James (1995), Chapter 12.
[114] On the role of safety nets in international financial markets, see Dale (1994).

countries' economic policies and the design of Fund-supported macroeconomic programs have in recent years increasingly acknowledged the importance of a sound financial sector. Some of the IMF's surveillance activities in this area are reported in the annual *International Capital Markets* survey and in the *World Economic Outlook* publications. In addition, financial sector reform measures have been included in many Fund-supported adjustment programs.[115]

The IMF's role is not as a banking supervisor, but as an advisor on policy. The IMF conducts regular broad-based consultations with all its members and is often deeply involved in the design and implementation of economic reform programs. In addition, the Fund has acquired knowledge of financial sector issues through its technical assistance and international market surveillance activities. It is particularly well placed in transition countries and some developing countries as a result of its surveillance over the condition of their macroeconomies and its intense involvement in the development of these countries' central banks. IMF consultations help to focus the authorities' attention on the interactions between financial sector policies for banking soundness and macroeconomic and other structural policies, the adequacy of official oversight systems in relation to market developments and the institutional environment, the sufficiency of the bank regulatory framework and its enforcement, and the desirability of adherence to international standards and norms of cooperation on supervisory issues.

The IMF is in a unique position among international institutions to offer such advice because it surveys the economies of virtually all countries and has access to expertise, both in-house and from member central banks, on a broad range of supervisory issues and policies. The Fund is thus well placed to advocate improved regulation, supervision, data disclosure, and resolution strategies, to complement the work of other agencies by setting structural issues in banking in a macroeconomic context, and to contribute to international harmonization of prudential policies.

Bilateral and Multilateral Technical Assistance

Banking supervision and regulation in many developing countries and virtually all economies in transition have benefited from external technical assistance. The World Bank and the various regional development banks have provided technical assistance in addressing banking sector problems in the context of structural adjustment lending and loans to support financial sector development and rehabilitation. Over the last thirty years, the IMF has provided advice and operational support in the

[115] See Schadler and others (1995).

strengthening of banking regulation and supervision to a broad range of countries in the context of its technical assistance programs aimed at developing and improving central banking practices in member countries. This work is supported by a network of cooperating central banks, which provide personnel and training support. Banking supervision in many countries has also benefited from assistance provided bilaterally or by regional organizations such as the EU.

Initiatives Within the EU

Globally, the most comprehensive program to improve supervisory cooperation and coordination is taking place within the EU. This cooperation goes beyond the harmonization of rules and regulations. The countries of the EU have also concluded among themselves a series of bilateral Memoranda of Understanding concerning practical cooperation in performing cross-border banking supervision, inspections of bank establishments in other EU countries by the home country supervisory authorities, sharing of information, and the implementation of corrective measures against banks. This is an experiment from which other countries can benefit. The economies in transition in Central and Eastern Europe are watching with particular interest, as most aspire to EU membership and may be expected to tailor their nascent supervisory arrangements to facilitate accession.

International Coordination Failures

In pursuing international coordination of bank supervision, the limits to what can be achieved by regulatory harmonization need to be recognized. Even so, despite the efforts of the past twenty years, much that is feasible remains to be accomplished.

Limits to the Benefits of Regulatory Harmonization

Regulatory harmonization among countries that share similar exposures to factors that threaten bank soundness is both possible and useful; there are practical limits, however, to the ability to achieve international harmonization. Full regulatory harmonization is not always appropriate. For example, the Basle Committee has successfully harmonized capital adequacy standards for the Group of Ten countries, by establishing a minimum standard of 8 percent of risk-weighted assets for banks in these relatively stable and diversified economies. The Committee stressed that higher levels must be adopted in uncertain or volatile conditions. Many countries beyond the Group of Ten have adopted the Basle capital stan-

dards even under conditions of high economic volatility and inadequate accounting and asset valuation, where a much stricter standard would be appropriate.[116]

Similarly, appropriate standards of liquidity will depend on local factors such as the characteristics and volatility of the demand for base money and the depth of the money markets. Regulations on loan provisioning should reflect prior experience with recovery of impaired loans, which will depend on local factors such as the legal procedures for loan recovery and for bankruptcy.

In addition, varying institutional frameworks will produce different operating conditions even with harmonized prudential regulations. The official safety net of supervision, lending of last resort, and deposit insurance will differ from country to country; market responses will be conditioned not only by regulations but also by the nature of the financial support that can be expected in the event of a problem.[117] The competitive structure of the banking system as well as of the broader financial industry will also determine the degree to which a level playing field across countries can actually be constructed through bank regulations.

Thus the focus on international standards compatible with those of the Group of Ten should not be allowed to detract from the development of a framework for sound banking appropriate to the country concerned. While the value of identifying best practices is clear, the real work must take place in applying those practices to create a sound banking environment in each different economic, political, and institutional context.

Insufficiency of Supervisory Coordination

International coordination is not yet sufficiently developed to offset the differences in operating environment, regulation, and supervisory procedures across jurisdictions. For example, confidentiality provisions make it difficult for supervisors to share information on the condition of banks and their major customers across jurisdictions, even where bilateral arrangements are in place. The only recognized international standards at present are those developed by the Basle Committee. They cover areas of limited relevance to developing and transition countries that do not have the financial infrastructure necessary to facilitate the standards and practices used by the Group of Ten. In addition, while the Basle Committee provides policy recommendations on some specific supervisory issues, it has not involved itself in legislation, accounting, valuation, taxation, or resolution issues.

[116] See Dziobek, Frécaut, and Nieto (1995) and Kane (1995).
[117] See Dale (1994).

Gaps remain in the international oversight framework. Fragmented international supervision allowed the failure of BCCI in 1991 (addressed by subsequent Basle Committee guidelines on consolidated supervision by home country authorities) and of Meridien Bank in 1995 (which occurred despite those guidelines having been issued). International supervisory coordination was also an issue in the Barings and Daiwa cases. Improved information exchanges might have helped supervisors in Singapore, Osaka, and Tokyo perceive that Barings was speculating rather than hedging. Better collaboration between supervisors could have prevented much of the rancor associated with discovery of the Daiwa fraud and the subsequent removal of that bank's license to operate in the United States.

Very little has been done to prevent international spillovers and systemic risk arising from a bank failure. Policies for bank liquidation and restructuring typically are purely domestic. There is little harmonization of exit procedures or standards for early intervention. Crisis resolution is done on an ad hoc basis, despite the clear need for international coordination demonstrated by several significant failures. The spillover effect due to the way in which the 1974 failure of Herstatt Bank was handled is a classic example. In the cases of BCCI and Barings, closure was coordinated across jurisdictions. The failure of Meridien, on the other hand, was marked by a distinct lack of international communication and coordination among supervisors.

The difficulties in improving international cooperation in this area should not be underestimated. Consider the case of a financial services group operating banking, insurance, and securities subsidiaries. Each of these business lines may be regulated by a separate authority, and the banking units may be overseen by the central bank as well as banking supervision and deposit insurance agencies. Operations in different securities markets may be monitored by different regulators as well. Thus in each country multiple agencies may be concerned when the group becomes unsound. Multiply that by the number of countries within which the group may be operating, for example, under the EU's single passport, and one begins to get a sense of the challenge that lies ahead in coming to terms with the international dimensions of unsoundness.

Recently the Basle Committee has been seeking to expand its role by providing training programs through the regional supervisors' groups, and there have been calls for the IMF to assume a more assertive role in monitoring banking systems (Fidler, 1996a and 1996b). It must be recognized, however, that while IMF surveillance can add international and macroeconomic dimensions to banking system oversight, neither the Basle Committee nor the IMF can replace proper banking supervision and improved collaboration between supervisors. The international community is only just beginning to grapple with these issues in a concerted manner.

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