Fordham Journal of Corporate & Financial Law

Volume 4 | Issue 1 Article 5

1999

Banking Supervision and Government Policy: The Role of Regulators in International Financial Reform

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BANKING SUPERVISION AND GOVERNMENT POLICY: THE ROLE OF REGULATORS IN INTERNATIONAL FINANCIAL REFORM*

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I would like to provide a few informal remarks on the U.S. Treasury's perspective on international issues and discuss some of the issues we have been addressing in the Group of Seven ("G-7") and "G-22 processes." I want to touch on three separate, but related, issues in chronological order: first, the run-up to the Asia crisis; second, the Asia crisis itself and what we refer to as the "Halifax II process" or "G-22 process"; and third, the follow-up to that, which we are referring to as the international financial architecture process.

For the last several years, the U.S. Treasury and other finance ministries in the G-7 countries have been interested in financial crisis issues and how to deal with them. Beginning in 1995 with the Mexico crisis, we discussed this topic at the annual economic summit in Halifax, Nova Scotia in Canada.[1] Subsequently, at the economic summit in Lyons, France, we started focusing on financial regulatory issues with a two-track approach: the first on industrial countries, the second on emerging markets.

In the industrial countries area, which we refer to as "the financial stability" topic, we looked at the role of international

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* This speech was originally presented at the Derivatives and Risk Management Symposium on Stability in World Financial Markets, held at Fordham University School of Law on January 28, 1999.

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1. *See, e.g.,* Bob Davis, Peter Gumbel and Rick Wartzman, *Disputes Between G-7 Nations Crowd Out Big Issues at Summit,* WALL ST. J., June 19, 1995 at A2 (noting that one of the results of the 1995 meeting of the G-7 in Halifax was its call for the IMF to set up an "Emergency Financing Mechanism" to permit quick approval of loans to countries facing large scale financial crises).

financial conglomerates. We particularly examined the issues of very large international financial institutions that operate across functional lines, in banking, securities, and insurance, as well as across geographic lines in the United States, Europe, Japan, and elsewhere, and how best to supervise those industries and modernize our system of regulation in line with the underlying markets. Since a single global financial regulator is not a feasible idea from our point of view due to sovereignty concerns, we had to look at the problem in terms of promoting regulatory cooperation and information exchange among regulators to address the implications of the operations of these larger firms. The second track was on emerging markets and the recognition that strengthening supervision was critically important to avoid banking crises and financial instability in emerging markets. Estimates of the cost of banking crises in various countries have ranged from several percent of GDP to fifteen or twenty percent of GDP.

The G-7 established a working group following the Lyons Summit in 1996 which consisted of finance ministries and central bankers from several key industrial countries and emerging markets along with representatives of other international organizations, such as the IMF, the World Bank, the Basle Committee on Banking Supervision, and the International Organization of Securities Commissions ("IOSCO"). This working group issued a report in April 1997, in time for the 1997 Denver Summit.[2] The report looked at some of the problems in the financial sectors in emerging markets, considered the key elements of a robust financial system, and recommended a concerted strategy for improving the financial sectors and financial supervision in these economies, including a more in-depth role by the IMF and the World Bank in the financial sector. Out of that process came some very significant developments, including the Basle Committee's Core Principles

2. THE WORKING PARTY ON FINANCIAL STABILITY IN EMERGING MARKET ECONOMIES, FINANCIAL STABILITY IN EMERGING MARKET ECONOMIES (1997). This report is available from participating institutions and on the website of the Bank of International Settlements at <http://www.bis.org>.

for Effective Banking Supervision,[3] which were released later that fall and served as a guideline for most of the emerging markets in terms of improving their system. A year later, IOSCO issued a similar set of principles.[4]

Unfortunately, we did not have time to implement the strategy before the Asia crisis erupted in the summer of 1997 in Thailand and quickly spread to Indonesia and Korea by that fall. But by the spring of 1998 we realized, along with the G-7 countries and others, that we should look at the lessons learned from the Asia crisis and how we might better deal with crises that erupt in the future. Although we can never totally eliminate crises, we can reduce their risk and increase the resilience of the international financial system.

In the spring of 1998, Secretary Robert Rubin of the U.S. Treasury and Chairman Alan Greenspan of the Board of Governors of the Federal Reserve Bank convened and chaired a special meeting of twenty-two countries' finance ministers and central bank governors. This became known as the "Halifax II" process, based on the original "Halifax I" process after the Mexico crisis. Because twenty-two countries participated, it also received the nickname of "G-22." Since then more than twenty-two countries have been involved, so we do not use that term anymore.

The ministers agreed to establish three working groups to address some of the key problems and solutions to the Asia crisis. The first group focused on transparency and accountability

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3. BASLE COMM. ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (1997) [hereinafter BASLE CORE PRINCIPLES].

4. INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO), INTERNATIONAL DISCLOSURE STANDARDS FOR CROSS-BORDER OFFERINGS AND INITIAL LISTINGS BY FOREIGN ISSUERS (1998) [hereinafter IOSCO CORE STANDARDS.] *See A Resolution of the President's Committee on IOSCO Endorsement of Disclosure Standards to Facilitate Cross-Border Offerings and Listings by Multinational Issuers*, IOSCO (Sept. 1998) <http://www.iosco.org/resolutions/resolutions-document17.html> (resolving to endorse the IOSCO CORE STANDARDS and recommending that its members take all steps necessary and appropriate to adopt them). The SEC has proposed revisions to its Form 20-F used by foreign private issuers which incorporate the IOSCO Core Standards. International Disclosure Standards, Securities Act Release No. 33,7637, 69 S.E.C. Docket 6 (Feb. 2, 1999).

issues, for private financial institutions as well as governments and international institutions such as the IMF and the World Bank. The second group considered strengthening financial systems, similar to the earlier work on emerging markets but including industrial countries. The third group examined international crises, which involved work on debtor-creditor relations, improving bankruptcy regimes, and actually working through the crises.

Each working group released a report in early October.[5] I will speak briefly on the Working Group Report on Strengthening Financial Systems. Some of the conclusions and weaknesses identified are perhaps self-evident.

In Asia, after a considerable amount of work and discussions among a large number of people, and visits and discussions with the countries affected, we identified a series of weaknesses in the financial sector. There is obviously inadequate supervision of the banks in those countries, inadequate prudential standards and regulation, practices of directed and connected lending, poor credit culture, and poor risk management. Other problems include substandard internal controls in the banks, poor regulatory reporting, poor public disclosure, bad practices by banks in the corporate sector, implicit government guarantees and bailouts of the banking system liabilities, and heavy reliance on short-term bank debt. These were significant factors in the five Asian countries most significantly affected by the crisis.

In the Working Group Report on Strengthening Financial Systems, we took a three-pronged approach to try to address some of these weaknesses: The first prong was to recognize the need for international standards in many more areas. We have the Basle Core Principles,[6] and now the IOSCO Core Standards,[7] but we also recognized the need to complete the formulation of

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5. WORKING GROUPS OF THE G-22, REPORT OF THE WORKING GROUP ON TRANSPARENCY AND ACCOUNTABILITY (1998); WORKING GROUPS OF THE G-22, REPORT OF THE WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS (1998) [hereinafter REPORT ON STRENGTHENING FINANCIAL SYSTEMS]; WORKING GROUPS OF THE G-22, REPORT OF THE WORKING GROUP ON INTERNATIONAL FINANCIAL CRISES (1998).

6. BASLE CORE PRINCIPLES, *supra* note 3.

7. IOSCO CORE STANDARDS, *supra* note 4.

International Accounting Standards[8] and for OECD to finish its work on corporate governance standards.[9] Presently, the Basle Committee is examining standards in risk management, asset valuation, and payment systems.

The second prong, in addition to adopting standards or developing standards, is to convince countries to actually implement them. This is a more difficult subject due to countries' sovereignty. There was quite a bit of discussion on promoting these standards and developing incentives, and the work in this area is still ongoing.

Finally, how do we do a better job of monitoring and ensuring that countries in fact are complying with these standards? Again, this is still ongoing work, but there are some areas of agreement, such as having the IMF monitor countries' compliance with these standards as part of their annual surveillance. Following the report of these three working groups, the G-7 leaders and finance ministers issued a sort of "next-steps statement" on October 30, 1998. This statement covers our work agenda between now and the Cologne Summit. More importantly, it is a mandate for finance ministries to work with their central bank colleagues to explore the scope for strengthening prudential supervision in the industrial countries, including looking at the implications of highly leveraged institutions and offshore centers, and then strengthening financial systems in emerging markets.

This has generated quite a bit of work, particularly in reference to the hedge fund issues addressed by this Symposium. In addition to the President's Working Group on Financial

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8. The International Accounting Standards are developed and published by the International Accounting Standards Committee [hereinafter IASC]. *See* IASC, Current Standards (last visited Aug. 3, 1999) <http://www.iasc.org.uk/frame/cen2.htm>. The objective of the IASC is to "achieve uniformity in the accounting principles that are used by business and other organizations for financial reporting around the world." IASC, Home Page (last visited Aug. 3, 1999) <http://www.iasc.org.uk/frame/cen0.htm>.

9. OECD PRINCIPLES OF CORPORATE GOVERNANCE, OECD Doc. SG/CG(99)5 (Apr. 19, 1999).

Markets, which is looking at hedge funds,[10] a number of international groups are doing that as well, as you heard this morning. The Basle Committee Working Group is releasing a report today.[11] IOSCO has now started a report on hedge funds.[12] The G-10 Committee on the Global Financial System (formerly the Euro-Currency Standing Committee) is working on this issue as well.

That brings us up to date. I am going to stop here and let my colleagues talk more about this subject.

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10. The President's Working Group on Financial Markets released its report on April 29, 1999, entitled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management. See* Statement on the Report of the Working Group on Financial Markets, 35 WEEKLY COMP. PRES. DOC. 763 (May 3, 1999) (statement of President William J. Clinton) (welcoming the report and describing its recommendations as "an important step in our efforts to promote more secure financial markets.").

11. BASLE COMM. ON BANKING SUPERVISION, BANKS' INTERACTIONS WITH HIGHLY LEVERAGED INSTITUTIONS (1999). This report was issued simultaneously with BASLE COMM. ON BANKING SUPERVISION, SOUND PRACTICES FOR BANKS' INTERACTIONS WITH HIGHLY LEVERAGED INSTITUTIONS (1999). *See Press Release, Banks' Interactions with Highly Leveraged Institutions,* Basle Comm. On Banking Supervision (Jan. 28, 1999) <http://www.bis.org/press/index.htm> (reporting that the two reports were issued in response to recent financial market developments, including the near collapse of LTCM).

12. *See Press Communiqué,* IOSCO (Feb. 4, 1999) <http://www.iosco.org/press/presscomm990204.html> (reporting that the Technical Committee of IOSCO has established a "Task Force on hedge funds and highly leveraged institutions.").