

Global Supervision: a Term in Search of a Content

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1. Introduction

When Banca Nazionale del Lavoro invited me to speak at this Conference I was a central banker and my position as Chairman of the Basle Committee on banking supervision was probably the reason for the invitation. Since then I have crossed the line that separates central banking and banking supervision from securities and market supervision, and IOSCO has become the arena where I participate in the game of international cooperation among regulatory agencies.

My remarks today will not be based on theoretical research, but rather on practical experience with several aspects of supervision: national and international as well as banking and securities.

The distinction between the morning and afternoon sessions of this Conference lies in two expressions: 'monetary policy' in the former and 'supervision' in the latter. Globalization is the common denominator. And since the term 'stability' appears in the general title of the whole Conference, what really marks the difference between today's two sessions is the angle from which stability is being looked at: price stability and, more generally, macroeconomic stability when the subject is monetary policy; the stability of financial institutions and markets, i.e. microeconomic stability, when it is supervision.

We know that the macro and micro dimensions of stability interact significantly. From the early Eighties, when the Latin American debt crisis erupted, until less than one month ago, when markets tumbled in the Far East, events repeatedly showed how interdependent the macro and microsides of the coin were. This is also why the

□ Commissione Nazionale per le Società e la Borsa, Roma (Italy).

surveillance role of the International Monetary Fund has gradually widened from the macro-real to the micro-financial aspects of policies and country situations.

The title of my presentation – “Global Supervision: a Term in Search of a Content” – indicates that language is running ahead not only of reality, but even of thought; and Mario Sarcinelli’s desire was to have a paper that would help fill the gap. The underlying proposition can be formulated as follows: in a global financial system it seems natural that supervision should also be global. However, for a number of reasons, we do not know what this really means in practice.

I shall try to approach the subject in steps. Firstly, by briefly recalling the various ways in which finance is becoming global; secondly, by recalling the need for, and constraint of, a response; and, thirdly by indicating the scope for making supervision effective in a global financial world.

2. Multifaceted globalization

Obviously, the financial system is *global* because it stretches over the globe with an ever more closely knit network of cross-border transactions. But the geographical dimension is only one of several dimensions of global finance. The functional dimension is no less important. And the global nature of finance concerns both institutions and markets.

Geographical globalization is straightforward and needs no explanation. The exponential growth of cross-border operations has been described too many times to need any further illustration. It should not be forgotten that it involves the international mobility of two components of the balance of payments: capital and services. It is the combination of these two elements that has generated a geographically global financial system.

Technological advances in communications and data processing have made the internationalization of finance unstoppable by national authorities and governments. The fact that financial instruments and transactions have grown, domestically as well as internationally, so much faster than production and trade has resulted in a finance-driven internationalization of the economy.

By *functional* globalization I mean the gradual blurring, if not disappearance, of another borderline: that between financial instruments and services of different types.

Technological progress and financial innovation have created products which cannot be classified under any single one of the traditional contractual forms. Innovation has dramatically increased, product customization designed to meet selected needs has allowed the creation of complex instruments and it has enabled to unbundle risks into separate components.

Globalization has also altered the features of financial markets and institutions and changed their relative importance.

Markets have become global in the obvious sense that certain financial instruments (foreign exchange, government securities and a number of corporate bonds and stocks) are traded around the clock regardless of location.

Two other recent developments are equally important. Firstly, the proportion of total financial flows going through the market has considerably increased relative to the bilateral, tailor-made part. The shift from loans to bonds stimulated by the Latin American debt crisis, the process whereby a portfolio of loans is transformed into a stock of marketable assets, and the Nobel-rewarded technique for pricing options have all contributed to the dramatic increase in what could be called the marketability of finance.

Secondly, the very notion of what is a ‘market’ has altered, as a result of changes in technology, organization and even economic ideas. Over-the-counter markets have outgrown organized markets. The global market *par excellence*, the foreign exchange market, has no formal organization, legal status, membership, reporting or control. Meanwhile, organized markets have themselves been privatized, as they have increasingly come to be seen as service-producing enterprises that should be run as a business and even be listed on the stock exchange. Not only do players compete in the market, but markets themselves are players that compete against each other.

As to financial *institutions*, they have become global as a result of the geographical and functional developments I have just described. They can operate worldwide and in all the different segments of finance: banking, securities, and insurance.

Although national legislations still confine the range of activities of individual entities to just one or a few segments of the full spec-

trum of financial products and services, international financial groups – composed of a variety of entities licensed in a variety of countries – have created a situation in which the constraints and limitations of national legislations are no longer binding. From this point of view there is in fact no significant difference, in this respect, between Merrill Lynch, Deutsche Bank, J.P.Morgan or Swiss Bank Corporation.

The financial players that are global in every respect, both geographically and functionally, are only a few. However, they set the scene for the operation of the international financial system and they handle a very large share of the total transactions.

It would be a mistake to consider this group of global players as a world apart, separated from the population of smaller or more local banks, securities firms, institutional investors, and industrial corporations. Between the large and diversified global players and the broader population of institutions that can be considered 'sectoral' (in a functional and/or geographical way) there are several channels through which contagion could easily pass in the event of a crisis. The specialized institutions are often the counterparties of the transactions of the global players. They hold the placing power on which the global institutions count. The global institutions actually manage much of the international payment system through correspondent banking. In sum, the fact that there are only a few global institutions does not mean global supervision is only a question of controlling just a few big players.

I have summarized the fourfold process of globalization in order to set the background against which the term "global supervision" has come to be used, even before it has acquired a precise meaning. To search for this meaning, however, we must first look at the nature and purpose of supervision.

3. The response: needs and constraints

Historically, the structure and organization of supervisory systems reflected the configuration of the underlying financial system. For each of the three components of the industry – banking, securities and insurance – there was a supervisory agency. The range of action of the

agency was entirely domestic: there was no need for regular contacts between the supervisors of different nations.

In today's world such an approach to supervision would inevitably fail to achieve the goals for which it exists. Within countries, the application of different regulations to different institutions essentially performing the same kind of function would (and often still does) create competitive distortions. Capital naturally flows towards financial centres where the burden of regulation is lighter; it tends to be invested in high-risk high return assets, with a resulting build-up of positions that are likely to be exposed to a sudden collapse of confidence. Well-organized financial institutions that diversify their activity geographically and functionally choose the most favourable charter and regulatory system, and even (as in the BCCI case) may shape their organisation with the precise objective of avoiding supervision completely.

A supervisory system that failed to respond to the many facets of the globalization of finance would not only be unable to pursue the public interest for which it exists, but would also aggravate the instability and unsoundness of financial activity and generate distortions in the allocation of capital.

Since the mid-Seventies, when banking and financial instability reappeared in the world after the relatively peaceful Bretton Woods era, a response to the new challenges of a global financial system has begun to develop. The pace of the response has been accelerated by each crisis that has occurred.

Looking at the events that have had *international* repercussions, we can mark some dates: Herstatt 1974, Ambrosiano 1982, Latin American debt 1982, BCCI 1991, Barings 1995, Mexico 1995. The chronology of the responses is summarized in the Appendix.

Domestic events have also been influential in reshaping the supervisory system. The growth of derivative markets in Chicago and worldwide; the revolution in the London market; the restructuring of supervisory Agencies in Sweden, Japan and Great Britain; the growth of the Far East markets; the banking crises in the US (Savings and Loan associations), France, the UK, Scandinavia and Japan; and far-reaching financial deregulation almost everywhere are just some of the steps that mark the evolution of financial systems and their supervision.

Before examining the key features that "global supervision", i.e. the adequate response to global finance, should have, it is necessary to underline the constraints that limit the pursuit of a first-best solution. They are political and institutional at the same time and work, in various degrees, both domestically and internationally.

At the international level, the obvious constraint is the fact that, while the *private* side of the financial world is free to adopt a fully international approach, it is Hobson's choice for the *policy* side to remain nationally rooted. The legislation, the judiciary process and the public money that may be needed in a crisis, as well as the mechanism of political accountability, are, and will probably remain in the foreseeable future, national, not international. This is why international policy cooperation is always, to a certain extent, a fragile conspiracy.

At the domestic level, the equivalent constraint is that the supervisory system, in both its rules and its institutions, is defined by law and is difficult to change without a lengthy and uncertain process of legislative reform.

Since the pace at which the financial landscape is changing is much faster than the pace at which the international and domestic order can possibly move, the institutional *status quo* has to be taken as a double constraint in the search for an effective response.

4. Three principles

The response to the globalization of finance inevitably comes in a piecemeal fashion, without a preset plan, and often under the pressure of financial events and political sensitivities, an attempt can be made to find a hidden strategy, implicit in the measures adopted over time, a strategy that could both provide a rationale for past actions and a guide for the future. I would say this strategy could be formulated in the following proposition: to adequately respond to the challenge of global finance, supervision should increasingly be: *i*) market friendly; *ii*) objective oriented; *iii*) internationally structured.

Saying that supervision must be market friendly means that it has to work, to the largest possible extent, *with* rather than *against* the market. It has to be designed in such a way as to inject positive rather than perverse incentives with regard to the behaviour of market par-

ticipants. It has to stimulate the production of antibodies giving more weight to managerial control than to regulator's repression.

All that is fairly well accepted today, but it was very far from being the case twenty or even ten years ago. The supervisory systems designed in the mid-Thirties after the banking and financial crisis of the Great Depression were quite unfriendly to the market, as they based the pursuit of financial stability on limits to competition, price regulation, compulsory specialization, prohibitions and command.

A reversal of this approach has been gradually imposed by three forces: first, the wave of financial innovation and technological change that made repressive regulation easy to circumvent; second, a change in the intellectual climate; and, last but not least, the process of internationalization, which led to competition between regulatory systems.

There is a limit to market friendliness. Supervision cannot become so market friendly as to disappear. I do not believe that the classic economic arguments calling for a degree of regulation and supervision of the banking and financial industry have lost their validity. Financial and monetary stability and investor protection are all public goods that markets do not produce spontaneously. This means that even the friendliest regulatory system always entails a degree of coercion. Neither, I believe, can this minimum degree of coercion be privately produced. The reforming of the British regulatory system can be interpreted as a rebalance in favour of external regulation with respect to self-regulation.

But what, then, does market friendliness actually mean?

I would answer as follows. Firstly, the supervisor should require those he regulates to observe certain principles and meet certain standards, but should leave them as free as possible to choose the means and the instruments. Secondly, regulation should be designed to deliver the public good quickly and visibly, so that the benefits are cashed effectively and coercion is not perceived as lasting for long.

In the international supervisory fora, such as the Basle Committee and IOSCO, a market-friendly approach is imperative in all rule-making. The reason is that internationally agreed rules have to cut across the diversity of national regulations and allow different implementation techniques.

The second principle is that supervision should be organized 'by objective' rather than by institution or by function. The traditional

approach, which still prevails in several countries relied on supervisory agencies specialized by type of institution: one supervisor for banks, another for securities and another for insurance. The functional and institutional dimensions of financial globalization have made this approach hard to apply and potentially harmful. There is in fact a growing risk of creating distortions by applying different rules to the same type of activity simply because it is carried on by a bank, a broker-dealer or an insurer.

Organizing supervision by function would mean having a different set of rules for each type of activity, irrespective of the type of institution that engaged in it. This is an appropriate method in many respects but it is inadequate to deal with the primary concern of stability. Insolvency hits institutions, not functions, and the regulatory provisions that address stability should continue to refer to financial institutions or groups.

A supervisory system organized 'by objective' is one in which two different sets of rules (and possibly two different supervisory agencies) are put in place to deal with the two types of objectives pursued by financial supervision everywhere: stability and fairness.

Stability and fairness are both necessary over the whole spectrum of financial activities, institutions and services, although their relative importance varies. Each corresponds to one aspect of the safety and efficiency of finance; each deals with a potential failure of the market mechanism; and each has its own instruments: typically, an obligation to hold capital on the one hand and to disclose information and to follow fair business practice on the other.

In today's financial world the supervisory system would gain in consistency and effectiveness if *all* stability-oriented rules were issued by a *single* supervisory agency for *all* types of financial institution, and all the rules aimed at transparency (conduit of business rules, disclosure requirements, etc.) were also issued by one agency.

Whether these two agencies should coincide – as in Sweden, Denmark, Belgium and now the United Kingdom – or be separated – as in Italy, Germany and France – is a matter for debate. I have a preference for the two-agencies approach and for entrusting the central bank with the task of stability-oriented supervision. The reason for this preference is that stability and transparency may sometimes be in conflict. Historically, the guardian of stability used to regard disclosure as potentially harmful to the pursuit of its task. Providing

depositors with better information about the real situation of a bank was not always seen, by the supervisor, as conducive to stability. The traditional approach to banking supervision was to *protect* the depositor directly, not to *inform* him or her to the extent necessary to activate self-protection. A problem bank would be quietly rescued before full disclosure could trigger panics or runs. It would make little sense, however, to be dogmatic on the issue of one versus two-agencies and to make it a constitutional rule is an eccentric idea.

The third principle is that global supervision should be structured internationally. There is little need to explain why in a world of complete mobility of capital and financial services, where institutions and markets operate without frontiers, supervision should operate at the same level. The problem is how to achieve this end.

This can be seen by looking at the two examples of international cooperation in banking and securities supervision. Undoubtedly, to date the former has succeeded in establishing a much longer record of international rule-making than the latter. This is not due to a stronger legal or statutory basis. On the contrary, IOSCO – the organization for securities – has very formal by-laws while bank supervisors have none.

The difference depends on other factors. The first is leadership. In banking, international cooperation is led by the Basle Committee, a Committee "that does not legally exist", composed of only a few countries (the G-10), with no more than 25 persons around the table and where the key countries are committed to active cooperation. Dissemination beyond the G-10 has, for many years, occurred spontaneously, driven by a recognition of the intrinsic quality of the work done in Basle and by a desire to acquire credibility. IOSCO is a much wider, more democratic but less effective organization of over 80 countries, too large to develop a 'club spirit', where leadership is hard to establish.

The second factor is the role of 'the centre': the secretariat and the chairman. In banking the totality of the technical work is done by the secretariat in Basle and the chair of the Committee is held by the same person for relatively long periods (11 years in the case of Peter Cooke!), who devotes most of his time to the task and develops a real strategy. IOSCO has continuously rotating chairpersons and most of the technical work of committees and working parties is done in the

home institution of the person who happens to hold the chair at the time.

The third underlying factor is resources. Bank supervisors have the generous support of rich central banks and the BIS, while securities supervisors are struggling to raise pennies and dimes.

These differences in organization are critical and are connected to functional reasons that make cooperation in the securities field more difficult to achieve than in banking. The latter is much more precisely identified in many respects. It has only one objective, systemic stability; it is addressed to well-defined institutions, banks; it leaves little room for self-regulation. The world of securities regulation is much less homogeneous and its borders less clear. The industry is composed of many different types of institution (banks, brokers, dealers, investment banks, funds of various types, etc.). The borderline between regulation and self-regulation varies from country to country. The objective(s) entrusted to the supervisory agency also vary across countries.

Thus, what I have called "structured cooperation" is being achieved more slowly in my new job than in the previous one, although it is equally, and perhaps more, necessary.

5. Conclusion

A supervisory system designed along the lines indicated by the three principles just described would effectively deal, in my view, with the many aspects of globalization. The difficulty is to move towards the new configuration starting from a quite different one and being subject to legal and institutional constraints that are very hard to remove.

What we need, in such circumstances, is to be even more careful and determined not to miss a single opportunity to move forward, trying to compensate the narrowness of the room of manoeuvre with clear analysis and vision. A conference like this is a welcome opportunity to do exactly that.

APPENDIX

INTERNATIONAL COOPERATION IN FINANCIAL SUPERVISION

Chronology

- 1974 – Creation of the Basle Committee on Banking Supervision.
- 1975 – Basle Concordat on Supervision of International Banks.
- 1983 – Creation of IOSCO.
- 1988 – Basle Capital Accord on Capital Requirements.
- 1993 – Creation of IAIS.
- 1995 – Windsor Declaration on Supervision of International Futures Markets.
 - Creation of Joint Forum on Supervision of Financial Conglomerates.
 - Halifax Communiqué.
- 1996 – Boca Raton Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations.
 - Basle Accord on Market Risk, Amendment to Basle Capital Accord.
 - Joint Basle-IOSCO Statement.
- 1997 – Basle Core Principles.
 - Tokyo Communiqué on Derivatives Commodities Markets.