

Comment

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The basic thrust of John Heimann's interesting contribution is that, in order to safeguard the international financial system from systemic risk, the main priority should be that of promoting an *industry-led* effort to improve its internal risk management and related systems. I do not find much to disagree with in the arguments presented in Heimann's paper, nor with the recommendation for the major private players to work together to develop better and more consistent ways for containing major risks. And I agree that there is much to be gained from a joint effort in setting global standards between global private institutions and the 'supervisory community'. I would argue, however, that care should be taken for such a perspective not to appear nor result as being somewhat narrow and, perhaps, excessively optimistic. In particular, it should be emphasized that the prevention of systemic risk needs a number of efforts in different areas that require the active participation of the national supervisors and the international financial institutions as well as the major global market participants. Even if they are extremely relevant, I hesitate to subscribe to the idea that the major threats come from *errors* made by individual institutions and can be substantially reduced working on the internal systems of these institutions.

Other key requirements not necessarily considered by Heimann given the focus of his paper regard the critical role of stable macroeconomic policies, the enforcement of structural reforms designed to avoid serious distortions to financial incentives, divergences between private interests and the concerns of public authorities arising from standard public good/externality/moral hazard considerations involved in financial stability, and the role to be assigned to official national supervision, as well as to the international financial institutions.

□ OECD, Paris (France).

In this regard, I would like to raise a few issues. First, is it true that "the sudden failure of a major participant" along with "political shock such as invasion" (Heimann, p. 175) are (among) the major events that can disrupt the normal functioning of financial markets leading to systemic risk? While there is always the possibility that from an individual failure may start a chain of events leading to systemic problems, in practice this has not happened. This is so even in major cases such as Penn Central or Barings (and it might very well be, as hinted by Heimann himself, that it was the proper, *ad hoc*, reaction of both supervisory authorities and market participants that substantially reduced further risks stemming from the individual failures). I would recall, instead, that the major systemic threats in recent times have come from reversals of speculative booms in asset markets in which domestic banks have become heavily exposed, or from sovereign liquidity crises, such as that of Mexico and – but every crisis is different from the other – the recent turmoil in East Asia.

The second question concerns whether systemic threats do arise largely from defects in the internal management of individual market participants. In this respect, can improvements to internal risk management of private financial institutions by itself adequately reduce, if not ensure against, systemic risks (particularly so given "the increasing size, velocity, and complexity of international transactions" – cf. Heimann, p. 177)? In nearly all cases quoted by Heimann, the major factors behind the crises have been unsustainable macroeconomic policies combined with structural distortions to financial incentives and/or serious deficiencies in regulatory oversight (we are all struck by the recent events in emerging markets, but should not forget the bad examples given by some of the more advanced economies, with excessive risk taking in leveraged real estate investments). While the failure of an individual (at times major) institution is part of the game and cannot necessarily be avoided even in well regulated systems, the collapse of a financial system does not depend simply from the *bad management* by an individual institution. While this obviously plays a role, systemic problems typically involve widespread mistakes by many institutions which are responding to distorting signals in the outside financial environment. In nearly all cases, the financial problems involved did not come from the use of very sophisticated new instruments that have raised the complexity of financial transactions,

but they involved *old-fashioned* ways of losing money, such as real estate lending and bad bank loans.

While important, then, improvements to internal risk management of private institutions are not likely to reduce systemic risks. Partly because firms and their managers are under extremely great pressure to not fall behind the performance of their peers, internal management controls are likely to be inadequate when there are strong external incentives to take on excessive risks. Moreover, private incentives do not fully take into account the potential costs of systemic problems arising from such excessive risk taking. To be more precise, private incentives may be insufficient because of significant externalities that can arise in private financial behaviour when there are, or threaten to be, systemic problems. The textbook example of a bank run makes this simple point sufficiently clear: an individual who withdraws during a run effectively imposes a *cost* on other depositors by raising the likelihood that the bank will become insolvent before they are paid. Externalities also arise from limited liability and bankruptcy provisions, which can typically give rise to dead-weight losses that would add to those from insolvency (e.g. loss of the *goodwill* or other value from synergies of a going concern). Likewise, systemic problems give rise to major losses to the real economy that might be escaped by those who led to them.

Therefore, there is a public interest in maintaining financial stability and preventing systemic crisis via lender of last resort, deposit insurance, and/or other explicit or implicit public insurance. However, it is well known that this insurance may create moral hazard problems, that is it may create incentives to take excessive risks that regulation needs to further restrain. It follows that authorities need to require disclosure, impose transparency and enforce rules against *self-dealing* and other conflict-of-interest type behaviour. There is reason, then, to support what Heimann proposes. As I understand it, it amounts to market participants accepting to bind their hands and agreeing on global standards that would ensure *them* (and, given their size and importance as well as their "immense complexity", the international financial system at large) against systemic risks, that is major, fatal losses. But, put this way, there remains a substantial problem of enforcement. Official supervision and regulation is thus again justified because of the incentive that private entities obviously have to conceal information in order to extract rents from those with less informa-

tion, an incentive that may lead to efforts that end up with socially inefficient outcomes. The fact that private institutions obviously have much information not directly available to authorities may also create problems of the following kind: allowing the largest firms to set standards for measuring and managing risks could afford them an opportunity to unduly promote adoption of provisions that benefit their competitive position (and may reduce the contestability of a market). In any case, given that a *safety net* needs to be maintained (the complete elimination of systemic risk obviously can only be aimed at), private agents by themselves may not have adequate incentives to set standards to avoid risk-taking that is excessive for the society as a whole; accordingly, authorities need to be directly involved in the setting of these standards and in overseeing compliance to ensure that excessive risk-taking is adequately discouraged.

This leads to my final point. What is the appropriate role of national supervisors in containing systemic risks and what role may or needs to be played by international financial institutions? The emphasis of traditional supervision has necessarily shifted away from numerical limits and strict rules on what can or cannot be done toward ensuring adequate incentives for prudent behaviour, and that adequate internal systems are in place to ensure that risks are properly managed, with adequate disclosure to allow sufficient market discipline. But, as Heimann correctly observes, much remains to be done. It is clear that the international global dimension requires that a major role be played by the global private financial institutions themselves. What is most important, then, is not only co-operation between these institutions but also between them and the various national supervisors. The objective is to put in place reforms that would lead to increase transparency in credit and financial markets, improve accounting standards, foster the disclosure of relevant information. This applies not only to the emerging markets but also to the working of the financial and banking structures of some of the major world economies, as can be immediately appreciated from the chapter on the financial services industry of the OECD *Report* on regulatory reform published in the course of 1997. In this *Report* the experience, the prospects and the problems present in Japan as in Korea, in Canada as in Germany, are highlighted, and a set of specific recommendations are advanced. But also with regard to the emerging markets, I can only recall that efforts to rapidly improve their financial structures

are essential given the investment flows that the ageing advance economies will likely direct toward those markets.

In all this, international financial institutions such as the IMF and the World Bank will continue to play a number of roles (perhaps with limited success, that has to be compared, however, to the difficulties of the tasks): providing advice and carrying out surveillance in the interest of crisis prevention; facilitating crisis management through the provision of emergency funds subject to strict conditionality (and here, obviously, different approaches should be applied to different circumstances: there is not a simple recipe good for all seasons); providing technical assistance on financial system reforms; and encouraging the adoption of internationally accepted norms. In fact, between the alternatives of creating a new global 'super-supervisor' and limiting ourselves to the very important but somewhat narrow limited task of having the private sector setting "global standards in concert with the supervisory community" (Heimann, p. 183), there is a third way, the one that is laboriously and somewhat painfully carried out nowadays, with all the difficulties and the obstacles that it necessarily faces: that is, global co-ordination and, where necessary, harmonization of global supervisory institutions; setting of core principles and endorsement of best practices by such institutions, in close consultation between the private sector and the national authorities; assistance by international financial institutions in crisis prevention and management, of the kind currently carried on (and from some quarters also, at times constructively, criticized).

There are no magic recipes as there are no possible shortcuts. And we cannot do without continuing to monitor and review – even if at times, perhaps, with mixed success – financial systems and special issues, such as the adherence to codes of capital liberalization but also the more basic multilateral surveillance (and peer review) of structural reforms and macroeconomic policies in the OECD member countries, as well as in the transition and more dynamic non-member economies.