Surveillance, International Banking Standards and the Role of the International Monetary Fund *

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1. Introduction

For some time now, well before developments in Asia began to dominate the news, the management and staff of the IMF have been expressing the fear that the next major economic upheaval would have its origins in a banking crisis, or at least be compounded by one. At the time we began to do this, it did not seem particularly prescient. At the Fund we have been increasingly conscious that macroeconomic stability and sound banking go together. For this reason, we have viewed the widespread incidence of major banking failures throughout the world as of extreme importance for the Fund's surveillance of its members' macroeconomic policies. The incidence of banking problems has not been confined to particular regions, nor to countries in a particular state of economic development. One of the most remarkable aspects is that the phenomenon has been so pervasive; in one form or another, more than three quarters of the Fund's members have been affected during the last two decades. Most recently, events in Asia (Thailand and Indonesia especially, but also in other Asian countries) have vividly illustrated the consequences of the combination of a weak financial system and inadequate macroeconomic policies.

As a long-term matter, the globalization of trade and financial markets and the associated liberalization of international capital mar-

□ International Monetary Fund, Washington (USA).

kets may be the most important economic development of the late 20th century. The benefits will be measured ultimately in higher standards of living, as resources are allocated with increased efficiency and risk sharing is improved. However, the increased volume and volatility of capital flows have exposed vulnerabilities in recipient countries, often in the form of unsound financial and banking systems and deficiencies in financial incentive structures, institutions, and policies. While the long-term benefits of financial liberalization and globalization are not in doubt, the intensified market discipline over financial institutions and the frequency of financial sector problems in a range of countries have underscored the need for countries to move quickly to adopt international best practices in financial supervision and regulation. Moreover, recent events have reminded us that these are not just issues for individual countries. A country that receives a large volume of capital inflows and does not make the necessary policy reforms and institutional improvements may not only fail to reap the full benefits of inflows and risk damage to the living standards of its own people, by increasing its own vulnerability to crisis; it may also become the epicentre of contagion effects that can have massive adverse effects on other countries. Thus, these are not just matters of domestic policy interest but are of concern for the international community as a whole.

The critical role of the strength of the financial system was becoming clear to the entire international community before the Mexican crisis in 1994/95; it was crystal clear in that crisis and its aftermath; and it has been equally clear in the Asian events this year. By now, policy-makers have a good idea of what needs to be done to strengthen financial systems, by improving supervision and prudential standards, by ensuring that banks meet capital requirements, provision for bad loans, limit connected lending, publish informative financial information, and by ensuring that insolvent institutions are dealt with rapidly. Implementing those changes, particularly in a banking system already in trouble, is frequently difficult, especially where political pressures hamper the supervisory authorities. The task is nonetheless urgent: it cannot be emphasized strongly enough that a healthy banking and financial system is essential for the growth of the economy, and that a weak banking system is both a standing invitation to a macroeconomic crisis and a guarantee of the severity of any such crisis.

2. The role of International Monetary Fund

All this is agreed, and has led to action by the international community. In early 1997, a G-10 Working Party presented a report to the G-7 Finance Ministers outlining the key aspects of a sound financial sector and a market-based strategy for promoting financial stability. In the same period, the Basle Committee on Banking Supervision developed its *Core Principles of Effective Banking Supervision*. At the Denver Summit in June 1997, the G-7 Finance Ministers asked the IMF and the World Bank to encourage their members to adopt appropriate principles and guidelines in these areas. Moreover, the IMF has been encouraged to assist in detecting and preventing financial sector problems by strengthening its surveillance of the financial sector. In the recent past, in the context of the crisis in South-East Asia, efforts to rehabilitate the banking and financial sector have provided the centrepieces of the IMF programmes with Thailand and Indonesia.

What should be expected of the Fund? With our near universal membership, we have a potentially important role to play in international efforts to promote financial sector stability, not just in the emerging markets but across our entire membership. In individual-country surveillance with members, the Fund seeks to improve the macroeconomic environment and policies through its regular consultation discussions. In addition to assessing the macroeconomic effects of any problems in the financial system, the policy dialogue has increasingly focused on identifying financial sector vulnerabilities with potential macroeconomic implications and on suggesting corrective policy steps. IMF surveillance promotes financial sector policy frameworks consistent with internationally accepted standards, as developed by the supervisory community and other bodies; it also assesses progress in implementation.

In its multilateral surveillance – primarily through the *World Economic Outlook* and the *International Capital Markets* exercises – the Fund seeks to identify financial vulnerabilities and risks with a potential for generating regional and international spillovers. This work involves identifying deficiencies in areas such as: systemically important banking systems; international aspects of financial supervision and regulation; the design and operation of wholesale payments systems; and the functioning of the financial infrastructures underlying the major international financial markets.

Fund-supported adjustment programmes often include conditionality related to financial sector reforms, such as legal and regulatory improvements, systemic bank restructuring, privatization of banks, and the introduction of appropriate monetary instruments and market based systems of monetary management. The Fund also provides technical assistance, at the request of members, focussing on central banking (including central bank and banking legislation), and the design and development of monetary, foreign exchange, and public debt markets and instruments. Also covered are the areas of prudential regulation and supervision; lender-of-last-resort facilities, payment systems, and public sector guarantee arrangements; reporting and disclosure requirements, and linkages between banking systems and fiscal policies. In the arrangements with Indonesia and Thailand, Fund staff technical assistance has been integral to the preparation of the financial sector rehabilitation packages that are at the centre of adjustment programmes.

The Fund's efforts are intended to raise the general awareness of authorities in member countries of the potential macroeconomic consequences of unsound financial systems, to promote principles of financial sector soundness, and to offer appropriate solutions to problems in selective cases where financial weaknesses may become a major concern. Of course, the Fund is neither a rating agency nor a banking supervisor and cannot be in the business either of certifying that a country's financial sector is safe and sound or alternatively of making adverse judgements on these issues. Further, Fund surveillance cannot address all of the areas in the financial system that may need improvement, nor can it be expected to provide specific assistance to the regulatory and supervisory authorities in meeting their day-to-day challenges

3. "Toward a framework for financial stability"

Fund staff have developed a general framework for identifying the strengths and weaknesses of financial systems and have produced a distillation of widely-accepted views of what might constitute a framework for financial stability, focussing on banking soundness and pinpointing the deficiencies that have frequently led to macroeconomic repercussions. Our work was condensed into a paper, "Toward a framework for financial stability", which was produced in collaboration with the World Bank, other key institutions and supervisors from different regions.[1] This paper will provide guidance for the IMF's financial sector surveillance and will also aid Fund staff in the design of appropriate and consistent lending programs and in providing technical assistance.

It is important to stress that the Fund has drawn to the maximum extent possible on the work of the Basle Committee. The Framework similarly draws heavily on the work of the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC). On the other hand, while the Framework was developed in consultation with the World Bank, the Fund does not cover issues, such as the restructuring of individual financial institutions or private capital market development, which are more appropriately dealt with by the World Bank or one of the regional development banks.

The Framework starts with the premise that a weakened banking system – stemming from weakened in the management of banks themselves, and in the structural environment in which they operate – is a source of vulnerability in all economies, but especially in developing and transition economies. More generally, an inadequate or weak legal and institutional infrastructure and a poor incentive structure can lead, *inter alia*, to excessive risk-taking and undermine corporate governance and market discipline, which are fundamental aspects of sound banking.

The Framework covers the key aspects of a sound financial system: transparency, public sector guarantees, prudential regulation, supervisory oversight, and supervision of cross-border banking. It attaches high priority to the increased transparency of banking information, a fundamental component of which is the realistic valuation of bank assets. To deal with incentive problems, the Framework provides ground rules for the provision of the financial safety net-dealing the best practices for lender of last resort facilities and deposit insurance. As well, it elucidates the issues involved in a credible exit poli-

[1] David Folkerts-Landau and Carl-Johan Lindgren, "Toward a framework for financial stability", IMF, September 1997, with the Core Principles of the Basle Committee included as an annex to the paper.

cy and stresses the desirability of a system of prompt corrective action for troubled institutions. In the area of banking supervision, the Framework draws heavily on the Core Principles, supplementing them when warranted by the Fund's experience. While the details of prudential regulation and supervision are important, they are of little help if supervisors lack the capacity for implementation or the autonomy or authority for enforcement. The Framework takes a step back from the day-to-day responsibilities of supervisors and provides general advice on the prerequisites for an effective supervisory agency. Lastly, the Framework covers the international aspects of maintaining banking soundness. Most of this discussion is based on work of the Basle Committee, reiterating their past and more recent work on the supervision of international banking groups and their cross-border establishments.

Our Framework paper reflects an important aspect of the role of the Fund, namely that we are in a unique position to contribute to the dissemination of best practices - and thereby, over time, to contribute to a harmonization of financial policies and practices internationally. For that reason, we have appended to the published version of the Framework paper the Basle Committee's *Core Principles for Effective Banking Supervision*, and IOSCO's *Principles and Recommendations for the Regulation and Supervision of Securities Markets*.

We intend also to report back to our membership and other international organizations on the experiences of member countries with various principles, best practices and guidelines, as gleaned through our surveillance and technical assistance activities. Coordination with other international organizations is of course a high priority in the period ahead and the Executive Boards of the Fund and the World Bank have recently discussed a joint Bank-Fund paper concerning Bank-Fund collaboration in strengthening financial sectors.

4. Concluding thoughts

Continued, concerted international efforts to promote financial stability are critical for countries to achieve the potential benefits of a more liberal and global financial system. As recent events in Asia have underscored, they are also vital to reduce the risk of financial crises.

Such crises can not only damage the individual country at the epicentre but, through the contagion effects we have witnessed in recent months, can also have important spillover impacts on others. Thus these are issues for all countries and for the international community as a whole. The Fund will continue to find the means, within its mandate and resource constraints, to promote financial stability and banking soundness in the financial systems of its member countries and in the international financial system. These kinds of unglamourous but immensely important preventive measures reduce the risk of financial crises. And of course, when crises do occur - as they inevitably will, because not all risk of crisis can be eliminated - the Fund stands ready to do its duty, which is to help stabilize economies that may need financial assistance, provided they are willing to undertake appropriately ambitious economic reform and adjustment programmes. In this work too, the Fund will do its best to ensure that the necessary bank and financial sector reforms are undertaken and implemented.