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Issues in International Banking Regulation: Global Policies for Global Markets

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Until the early 1970s banking regulation was considered to be the exclusive preserve of national policy makers. However, the growth of international lending and the emergence of multinational banks servicing this business from offices spread across the globe made regulators aware of the need to coordinate their activities. First, the inter-penetration of national banking markets by foreign banking establishments called for a clear understanding as to which authority was responsible for regulating which banks. Second, the close linkages between national banking systems through the interbank market meant that financial stability in one jurisdiction could be adversely affected by problems originating in another jurisdiction. And, finally, the fact that banks from different countries were competing for business within a global market raised the possibility of competitive distortions arising from uneven national regulatory arrangements. It was against this background that regulators from the leading industrial countries felt it necessary to establish a forum to coordinate their policies.

Today, the trend towards globalization of financial markets is proceeding apace, given further impetus by the dismantling of exchange controls, a dramatic rise in cross-border investment flows and increased access to domestic banking markets by foreign institutions. A number of other developments are also posing a challenge to regulators. First, banking is no longer a distinct financial service, but has become intermingled with other financial activities, including securities business. The process of securitization, by which banks repackage and sell loans to non-bank investors, has further blurred the boundaries between bank lending and securities market financing . Second, banks' heavy involvement in the explosive growth of over-the-counter derivatives markets has provoked a major controversy over the systemic risks associated with derivatives trading and the appropriate regulatory response.

Finally, and perhaps most importantly, the banking industry worldwide is facing intensified competition on a number of fronts. Within domestic markets price cartels, administered interest rates and other restrictive practices are being dismantled; cross-border competition is increasing due to enhanced reciprocal rights of access (notably within the single European market); and there is now a growing competitive threat from non-bank financial institutions (securities firms and insurance companies) which are eroding banks' share both of aggregate lending and of short-term savings.

The ever-changing financial environment in which banks operate ensures that the regulatory problem can never be finally resolved: new issues emerge and old issues reappear in a different form. This Chapter assesses the current international regulatory agenda in the light of the trends noted above. Section 1 reviews the evolution of the Basle regulatory regime, Section 2 considers a number of issues in preventive regulation (that is, regulation designed to prevent bank failures), Section 3 examines the question of supervisory standards, Section 4 deals with some major issues in protective regulation (the role of deposit insurance and the lender of last resort) and Section 5 draws some general conclusions on the future direction of regulatory cooperation.

Ⅰ. Evolution of Regulatory Cooperation

Until the mid-1970s there was no formal machinery for coordinating national regulation of international banks. However, the disturbances that followed in the wake of Herstatt Bank's collapse in the summer of 1974 focused attention on the interdependence of national banking systems and led, in the following year, to the creation of a standing committee of bank supervisors, under the auspices of the Bank for International Settlements (BIS), comprising the Group of Ten (G-10) countries plus Luxembourg. This Committee on Banking Regulation and Supervisory Practices (called the Cooke Committee", after its first chairman) sought not to harmonize national laws and practices, but rather to interlink disparate regulatory regimes with a view to ensuring that all banks are supervised according to certain broad principles.[1)]

One of the earliest and most far-reaching initiatives of the Cooke Committee was to develop broad guidelines for the division of responsibilities among national supervisory authorities. These guidelines, which were approved by the central bank Governors of the Group of Ten in December 1975, became known as the "Basle Concordat."[2)]

The Concordat embodied the key principle that the supervision of solvency is essentially a matter for the parent authority in the case of foreign branches and primarily the responsibility of the host authority in the case of foreign subsidiaries.

Although the Concordat represented a significant step towards greater international supervisory cooperation, it suffered from a number of defects which began to become apparent from 1978 onwards. In the first place, the primary supervisory responsibility accorded to host authorities for the solvency of foreign subsidiaries ran counter to another

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1) See Cooke (1981)
2) See CBRSP (1975)

important initiative of the Cooke Committee. This was the recommendation, endorsed by the central bank Governors of the Group of Ten in 1978, that supervision of banks' international business should be conducted on a consolidated basis, the object being to limit the opportunities for regulatory evasion. There was a clear danger here that host countries would look to parent authorities to supervise locally incorporated subsidiaries of foreign banks under the principle of consolidated supervision, while home authorities would rely on host countries to exercise their responsibilities under the Concordat.

The controversy surrounding the handling of Banco Ambrosiano's collapse in 1982 was one factor prompting a reappraisal of the original Concordat and the emergence of a revised version, which was approved by the central bank Governors in June 1983.[3)] The authors of the revised Concordat clearly had the Ambrosiano case in mind when they introduced more precise guidelines for the supervision of holding companies. Apart from closing such supervisory gaps, the revised Concordat sought to address directly the question of adequacy of supervision.

The authors of the 1983 Concordat attempted to deal with the problem of supervisory standards by introducing what might be described as a "dual key" approach to the operation of foreign banking establishments. Under the revised guidelines, if a host authority considered the supervision of parent institutions of foreign banks operating on its territory to be inadequate, it should prohibit or discourage the continued operation of such offices, or alternatively impose specific conditions on the conduct of their business. In addition, where the parent authority considered the host authority's supervision to be inadequate, it should "either extend its supervision, to the degree that it is practicable, or it should be prepared to discourage the parent bank from continuing to operate the establishment in question." Each national supervisory authority therefore had to satisfy itself that its banks' foreign operations were being conducted in jurisdictions with sound supervisory practices and that foreign banks to which it was host were subject to adequate supervision within their home jurisdiction.

In April 1990 an addendum to the Basle Concordat (the Supplement) was approved.[4)] This was designed "to supplement the principles of the Concordat by encouraging more regular and structured collaboration between supervisors." The Supplement addressed the information needs of both parent and host authorities, included recommendations on the role of external audit and urged countries whose secrecy laws inhibited the transmission of supervisory information to review these requirements.

In July 1988 the Basle Committee launched a major new regulatory initiative when it announced that the Group of Ten countries had approved guidelines establishing minimum

3) See CBRSP (1983)
4) See CBRSP (1990)

capital adequacy standards for international banks.[5] The purpose of this agreement is two-fold: firstly, to strengthen the soundness and stability of the international banking system; and, secondly, to ensure competitive equality among international banks-the competitive concern being that banks operating on a low capital ／ assets ratio can support a higher level of banking business for any given level of capital than can more highly capitalized institutions.

The Basle Accord on capital adequacy standards should be viewed as an important landmark in international supervisory cooperation. It represents the first move towards global regulatory harmonization-as distinct from the regional harmonization initiatives introduced within the European Community. It also signifies a departure from the original purpose of the Basle Committee which was to coordinate national regulatory regimes but not to seek to impose a common regulatory framework. Common capital adequacy rules, which are considered in more detail below, may turn out to be only the first stage in a more comprehensive program of international regulatory harmonization.

The supervisory weaknesses revealed by the collapse of BCCI in the Summer of 1991 prompted a reassessment of the Basle approach to banking regulation. Accordingly, in July 1992 the Basle Committee, with the endorsement of the central bank Governors of the Group of Ten countries, issued a new set of "minimum standards" for the supervision of international banks which are intended to have greater force than earlier guidelines.[6] These standards have been summarized by the Committee as follows:

1. All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision;

2. The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's, and if different, banking group's home-country supervisory authority;

3. Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor; and

4. If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

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5) See CBRSP (1988)
6) See CBRSP (1992)

The key requirement is that all international banks should be supervised by a home-country authority "that capably performs consolidated supervision." This is further spelt out as meaning that the authority concerned should (a) monitor banks' global operations on the basis of verifiable consolidated data; (b) be able to prohibit the creation of corporate structures that impede consolidated supervision; and (c) be in a position to prevent banks from establishing a presence in suspect jurisdictions.

If the minimum standards are not met, the host authority is called on to exclude banks from the jurisdiction concerned or alternatively to accept responsibility for supervising these banks' local operations, subject to appropriate restrictions (which may, by implication, include mandatory incorporation of such operations).

Finally, in April 1993 the Basle Committee issued a package of proposals intended to extend the scope of the capital adequacy Accord by incorporating market risk and interest rate risk and clarifying permissible netting arrangements.[7)] Under these proposals (which are discussed below) specific capital charges would be applied to banks' trading positions, including derivative positions, in debt and equity securities, and a measurement system would be introduced in order to identify banks that might be incurring exceptionally large interest rate risk. This latest initiative again underlines the emphasis now being given to the establishment of a common global regulatory framework for international banks, in marked contrast to the original Basle approach which specifically rejected harmonization in favor of the much looser concept of regulatory coordination based on an agreed allocation of regulatory responsibilities.

Looking back at the evolution of the Basle regulatory regime over the past twenty years it is clear that the pressures behind regulatory convergence have shifted. Initially the predominant concern was the safety and soundness of the financial system. More recently competitive equality or the "level playing field" has become the main driving force. This helps to explain the new emphasis on harmonization initiatives designed, above all, to remove competitive disparities between rival banking systems.

However, several key issues remain unresolved. What factors should determine the boundaries between regulatory harmonization on the one hand and regulatory competition on the other? Should the Basle regime, like its EC counterpart, be based on legally binding obligations rather than, as at present, on voluntary compliance with broadly drawn guidelines? Given the new concern with ensuring minimum supervisory standards, how are such standards to be assessed, monitored and enforced? And, perhaps most important of all, has the Basle machinery itself been outdated by the globalization of financial markets, bearing in mind that

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7) See CBRSP(1993)

the BIS has no formal supervisory authority over banks which own it or over banking supervisory authorities? Should the IMF or some other supranational agency now become involved with establishing a truly global regulatory framework for international banking? These and other more specific issues are considered in the discussion that follows.

Ⅱ. Issues in Preventive Regulation

The distinction is made here between preventive regulation which is intended to prevent banks from getting into difficulties; and *protective* regulation designed to safeguard depositors and the financial system in the event of bank failures. This section is concerned with preventive regulation, while section 4 deals with protective regulation.

1988 Basle Accord

The central pillar of preventive regulation is capital adequacy.[8)] At the international level this is embodied in the minimum risk-weighted capital ratio laid down by the 1988 Basle Accord that came fully into effect at the beginning of 1993. The Basle ratio has been widely accepted by international financial community as an indicator of banks' financial strength. Indeed, it appears that financial markets have been rewarding banks for achieving capital ratios in excess of the regulatory minimum, thereby encouraging institutions to target ratios well above the Basle norm. For instance, one recent study suggests that US banks' capital raising since 1990, which has taken the industry well beyond the Basle requirements, has been partly prompted by business strategy rather than regulatory considerations - a strategy that has been rewarded by the stock market.[9)] The implication is that the Basle capital ratio may be better viewed as a form of disclosure, valued by the marketplace, rather than as a binding regulatory requirement.

Despite its ready adoption by financial markets, the Basle concept of capital adequacy is open to criticism. The risk weightings encourage banks to substitute government debt for business loans to an extent that gives public sector borrowers privileged access to credit markets at the expense of private borrowers. The fact that residential mortgage loans are

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8) Schaefer (1992) examines the case for capital regulation from a finance theory standpoint.

9) See Cantor and Johnson (1992). However the fact that banks issue capital in excess of the Basle requirements is not necessarily inconsistent with the view that they are capital constrained . For one thing, the Basle ratios are minimum standards and individual banks may be subject to national requirements above the minimum, Secondly, banks may themselves wish to maintain a cushion of capital above the regulatory minimum so as to avoid future supervisory constraints.

given a minimum risk weighting only half that of other commercial loans may similarly give undue preference to the housing sector. More generally, the simple aggregation of risk-weighted assets under the Accord gives no recognition to the potential benefits of portfolio diversification-in marked contrast to the approach of some securities regulators who make allowance for non-covariant risk exposures (although it should also be said that risk covariance is more easily measured in relation to traded securities than it is for non-traded bank loans). Furthermore the Basle distinction between Tier Ⅰ (essentially equity) capital and Tier Ⅱ capital, which includes eligible subordinated debt, has encouraged the growth of complex debt instruments whose contribution to the capital strength of the issuing bank may be difficult to assess.

Some critics have alleged that the phased introduction of the Basle capital adequacy regime, coinciding as it did with recession in much of the industrialized world, held back economic recovery by impeding credit growth through a capital-constrained banking sector. On the other hand, it is difficult in practice to distinguish between the role of capital requirements and other influences (e.g. changing risk perceptions) that could have adversely affected bank credit expansion.

Perhaps the most serious concern about the Basle Accord relates to the uniform 100% risk weighting applicable to commercial loans to the private sector. That is to say, the capital requirement for a loan to a triple A rated multinational company is precisely the same as it is for a loan of similar size to a small unquoted property developer. In this key area of loan quality there are no differential risk weightings. The result is that aggressively managed banks may be tempted to shift their loan portfolios towards high risk borrowers, while cautiously managed institutions are unrewarded for their prudence.

This problem is further exacerbated by the Basle Accord's failure to formulate specific guidelines on provisioning-that is, deductions from profit to reflect anticipated loan losses. The approach to provisioning adopted by the Basle Committee is based on the idea of recognizable asset impairment. Provisions set aside against impaired assets are "specific" and are not eligible for inclusion in regulatory capital. On the other hand, "where ... general loan loss reserves or provisions are not allocated in any way ... to an identified deterioration in any asset or group or subset of assets, and are therefore genuinely available to meet losses which are subsequently identified wherever they may occur.., it would be reasonable to include them in capital."[10] General provisions defined in this way may therefore be included in Tier Ⅱ capital.

One major drawback of this Basle approach to provisioning is that the concept of identifiable asset deterioration is essentially subjective and can therefore result in considerable

10) See CBRSP (1991).

Latitude in banks' provisioning decisions. Indeed, disparities in national regulation, accounting practices and fiscal incentives are reflected in significant variations in provisioning policies as between different jurisdictions (see Table Ⅰ). From a supervisory standpoint the most worrying consequence of variable provisioning practices is that the concept of capital adequacy, which lies at the heart of the Basle regulatory regime, is seriously undermined. For instance, if Bank A has made cumulative general provisions of 3½% on its commercial loan portfolio whereas the provisioning level for Bank B, on a loan portfolio of similar quality, is only 2%, then Bank B's risk-weighted Tier 1 capital ratio may appear to be 1½ percentage points higher than Bank A's. If the difference in provisioning coverage relates to specific rather than general provisions then the distortion would be reflected in the total risk-weighted capital asset ratio.

In either case, the Basle capital adequacy regime will give a false reading of the relative financial strength of individual banks. This point is borne out by US research, which demonstrates that by using examiner asset classifications to identify banks that are under-provisioning it is possible to greatly enhance the ability of risk-based capital ratios to separate high and low-risk banks.[11)]

Market Risk Proposals

The primary objective of the 1988 Basle Accord was to establish minimum capital standards designed to reflect credit risk. In April 1993 the Basle Committee issued supplementary proposals for the supervisory treatment of market risks incurred by banks, covering open positions in debt securities, equities and foreign exchange. For this purpose a distinction is made between a bank's longer-term investments and its trading book, the idea being that the original Basle credit risk weightings should be applied to the former, and the new capital requirements for market risk to the latter.

These proposals on market risk raise a number of controversial issues. Most fundamental of these is the extent to which bank supervisors should adjust their capital adequacy standards in an attempt to achieve competitive equality between banks and non-bank securities firms. According to its authors, the Basle proposals "contain certain features which bank supervisors acting on their own would not necessarily favour but are prepared to adopt in the hope that further convergence with securities regulators will be achieved at some future date."[12)] In other words, the perceived need for a common regulatory framework for banks and securities firms has induced bank supervisors to lower the standards that they would ideally wish to apply to banks. Implicitly, therefore, the prudential goal of safety and

11) See Jones and King (1992).

12) CBRSP (1993: 2).

soundness is being subordinated to the broader objective of establishing a level playing field for all financial institutions undertaking securities business.

The difficulty of reconciling conflicting objectives is most clearly evident in the proposed definition of regulatory capital. The Basle Committee states that "were the Basle proposals to be designed for banks alone, [it] would favour the retention of the present definition of capital."[13)] However, in the interests of establishing common capital adequacy rules for banks and securities firms the Committee proposes that banks should be permitted to employ an additional form of short-term subordinated debt for the sole purpose of meeting part of the capital requirement for market risks. In order to ensure that such short-term subordinated debt is available to absorb losses it is proposed that it should be subject to a lock-in clause which stipulates that neither interest nor principal may be paid (even at maturity) if such payment means that capital allocated to the trading book would fall below a specified threshold level. The difficulty here is that if the lock-in clause were triggered, and it became known that a bank had failed to repay maturing debt obligations, confidence in the bank could be severely damaged and a deposit run could develop. It is presumably for this reason that several members of the Basle Committee do not favor the use of this newly proposed "Tier 3" capital for banks.

There are some further potential difficulties associated with the Basle proposals. The distinction between a bank's trading book and its longer term investments is not clear-cut, raising the possibility of regulatory circumvention. Furthermore, the need for such a distinction is open to question: a persuasive case could be made for marking to market all banks' securities holdings and then applying an appropriate capital requirement based on market risk. This would avoid the considerable problems that are likely to arise in defining a bank's trading book.

The proposed minimum capital standard for equity positions held in the trading account is Problematical. The approach used is the so-called "building-block" technique, based on separately calculated charges for specific and general market risk. Specific risk refers to possible adverse movements in the price of an individual security, whereas general market risk is the risk of a broad market movement unrelated to any specific securities. It is suggested that the capital charge for specific risk should be 4~8% (see below) and for general market risk a standard 8%. The Basle Committee acknowledges that the choice of this building block method may conflict with the objective of securing wider convergence with securities regulators, the point here being that the US Securities and Exchange Commission applies a single risk charge or "haircut" to securities firms' equity positions. In order to meet this difficulty it is proposed that national authorities should have discretion to continue to apply

13) CBRSP (1993: 10).

a comprehensive approach, combining specific and general market risks, so long as it can be demonstrated that the alternative method, "by its very nature," requires capital charges equal to or greater than the building block methodology. This issue of equivalence is likely to prove contentious.[14)]

Finally, the Basle proposal on market risk for equities is likely to encounter serious difficulties when it comes to the treatment of specific risk. The Committee suggests that the capital charge for specific risk should be in the range 4% to 8%, depending on the diversification of the portfolio and the extent to which it contains liquid and marketable stocks. However, the Committee has been unable to formulate a clear definition of liquidity or diversification and is therefore proposing to allow national authorities to develop their own criteria. Clearly, the delegation of such a key area of risk assessment to national regulators is in direct conflict with the aim of establishing common capital adequacy standards and must inevitably lead to competitive distortions within securities markets.

Interest Rate Risk Proposals

In addition to applying capital requirements to market risk, the Basle Committee, in its April 1993 package of supervisory proposals, seeks to establish a methodology for measuring interest rate risk. It should be noted that the Basle approach adopted here is quite different to that followed in relation to other types of risk, notably market risk and credit risk. For every type of risk there is a two-stage policy problem: first how to measure the risk and second how to discourage excessive risk-taking through, for example, appropriate capital charges. In the case of market risk and credit risk the Basle Committee has formulated both a measurement system and detailed capital requirements. In the case of interest rate risk the Committee's stated purpose is quite different: namely to develop a measurement system which supervisors can use for observation purposes as a means of identifying "outliers," leaving each authority free to decide how to respond to institutions identified as high risk.

This approach immediately raises two issues. First, is it advisable on the one hand to develop a highly complex methodology for measuring interest rate risk which is to be applied internationally, and on the other hand to leave national authorities with total discretion as to how this information should be used for supervisory purposes? In other words, may not any benefits associated with a uniform system of measurement be entirely offset by variable national treatment of the risks so measured?

A second, and related, point is that it may be dangerous to adopt different supervisory regimes for different kinds of risk. That is to say, if credit risk is subject to specific capital

14) For a critique of the building block approach see Breeden (1992).

adequacy requirements, while interest rate risk is penalized only when a bank's exceptional exposure makes it an "outlier," there could well be a tendency for banks as a whole to substitute interest risk for credit risk. And if banks are prompted to increase interest rate exposure, then the benchmark level of risk in relation to which outliers are identified will itself increase-raising questions about the effectiveness of the outlier approach.

In any event, it seems highly likely that once a measurement system for interest rate risk has been agreed, competitive pressures will eventually induce national supervisors to seek further international agreement on common arrangements for discouraging excessive risk-taking in this area.

In addressing the question of how to measure interest rate risk the Basle Committee has focused on the extent to which the economic value (rather than the current earnings) of a bank is exposed to future changes in interest rates. The proposed measurement system involves the following stages:

(1) all interest-rate sensitive asset, liability and off-balance sheet positions would be placed into one of thirteen time-bands based on the instrument's maturity or repricing characteristics.

(2) The positions within each time-band would be netted and the resulting net position for each time-band would then be weighted by an estimate of its duration.

(3) The duration weights would be adjusted to reflect the relative volatility of interest rates across the term structure.

(4) The net balance of these individual weighted positions would provide the basis for measuring a bank's interest rate risk.

The Committee itself identified several key problems in this formulation which as yet remain unresolved. First, should an institution's interest rate risk be viewed on a whole book basis, embracing both the trading book and the banking book, or should these two operations be assessed separately? In a world of universal banking, where there is no risk segregation between different businesses conducted within a single banking group, economic logic would point to a consolidated approach to risk measurement.[15] However, since a bank's trading book is to be isolated for separate treatment under the proposed capital adequacy rules relating to market risk (which in the case of debt securities incorporates interest rate risk), it might seem inconsistent to combine the trading and banking books for the purposes of

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15) On the issue of risk segregation see Dale (1991).

calculating interest rate risk exposure.

A second problem identified by the Committee concerns the treatment of items where either the interest repricing date or the maturity is uncertain. The most obvious example is non-interest-bearing transaction deposits which, for some banks, may constitute a relatively stable core deposit base, largely insensitive to changes in market interest rates. The extent to which such liabilities should be treated as long-term for interest rate risk purposes has been left open for debate by the Committee.

Finally, there is the question as to what extent, if at all, short and long positions within and between different time bands, and in different currencies, should be treated as offsetting. Again, the Committee has yet to reach a consensus on the extent to which such offsetting is permissible. So far as recognizing hedging between offsetting positions in different currencies is concerned, the Committee is seeking outside views on whether there is a practical method of recognizing interest rate correlations between currencies.

Derivatives

The Basle proposals on market risk incorporate capital adequacy requirements to cover banks' debt and equity derivatives. These requirements embrace forward rate agreements, futures and options on debt instruments, interest rate and cross-currency swaps, forward foreign exchange positions, futures and options on both individual equities and on equity indices, as well as options on futures and warrants. In principle, all derivatives (except for those held outside the trading book) would be converted into positions in the relevant underlying and become subject to the proposals for applying specific and general market risk under the building block methodology.

However, regulators' concerns over derivative products go well beyond the need to establish an appropriate capital adequacy framework.[16] In the first place there has been an explosive increase in the trading of financial derivatives (see Table Ⅱ). In particular the outstanding volume of over-the-counter (OTC) or customized derivatives rose nearly nine-fold in the five years 1986 to 1991 representing an annual increase of well over 50 percent.

The rapid growth of any new financial market gives pause for thought, but in the case of derivatives there are a number of other concerns. It has been claimed that by promoting speculation derivatives increase the volatility of financial markets; that their intellectual complexity impedes effective risk control by senior management and regulators; that

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16) The discussion of derivatives in this section draws on Dale (1993(c)). See also IMF (1993), Deutsche Bundesbank (1993).

derivatives trading creates large off-balance sheet exposures that reduce market transparency; and that the market linkages created by derivatives increase the potential for generalized financial contagion.

Concerns of this kind prompted the former General Manager of the BIS, Mr Alexandre Lamfalussy, to issue the following warning in June1993:

> ... the phenomenal growth of derivatives and associated trading techniques has reduced the transparency of market participants' balance sheets and has obscured the transmission of disturbances across market segments and institutions. This has severely complicated the assessment of the nature and distribution of risks in financial operations, at the level of both the individual firm and of the system as a whole. The implication is that market participants may not be in a position to impose the necessary discipline on financial institutions to prevent the risk of the build-up of systemic problems.[17)]

Since 1992 there have been three major supervisory reviews of derivatives-from the BIS, the US regulatory agencies and the Bank of England-each expressing concerns about potential risks in the derivatives business. The Group of Thirty(G-30), the New York-based consultancy group, has now sought to redress the balance in the derivatives debate by publishing an authoritative study of the OTC derivatives markets prepared largely by market participants.[18)] Among other matters on which the authors are at pains to offer reassurance, are the following:

(1) *Size of the market*. according to the G-30 the scale of global derivaties activity is "unimposing compared to that of traditional financial activities." For instance, the value of swaps written in 1991 was less than 1 percent of annual turnover in the foreign exchange market and swaps outstanding represented less than a third of domestic and international bonds outstanding. Furthermore, actual risk exposures, measured by replacement cost, typically represent only 1 to 3 percent of the notional principal value of a derivatives portfolio.

(2) Derivative products provide important benefits to users of financial services which are often overlooked. The G-30 study argues in particular that:

> where financial markets are segmented nationally or internationally, whether due to market or regulatory barriers or to different perceptions of credit qualities in various markets, the use of derivatives has delivered unambiguous cost savings for borrowers and higher yields for investors.

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17) Lamfalussy (1993:4).

18) See Group of Thirty (1993).

This assertion is supported by specific examples of the advantageous use of derivatives by corporations, government entities, institutional investors and financial institutions.

(3) While acknowledging that the management of derivative risk exposures is more complex than in the case of traditional banking products, the G-30 study states that these risks (essentially market, credit, operational and legal risk) are not different in nature from those encountered in ordinary bank lending and securities business. Furthermore, a survey of industry practice conducted for the study (involving responses from 80 dealers and 72 end-users) suggests that most dealers have developed rigorous risk management systems for this purpose.

(4) In examining the impact of derivatives on the overall economy, the study points out that academic research strongly indicates that derivatives trading either has no effect on, or reduces, volatility in underlying markets. On the positive side, it is argued that derivatives have expanded risk management techniques, while reducing transaction costs and increasing the liquidity of markets.

While presenting a positive case for derivatives, the G-30 study also makes 20 "best practice" recommendations for industry participants, focusing mainly on risk management. And although it does not examine regulatory issues in any detail (the whole question of capital adequacy is ignored) the study does make four additional recommendations aimed specifically at national authorities. In summary, policy-makers should (1) recognize the benefits and promote the use of netting arrangements; (2) remove legal uncertainties relating to *inter alia*, the enforceability of derivative transactions and bilateral close-out netting arrangements; (3) amend tax laws that impede the use of derivatives; and (4) provide guidance on accounting and reporting of derivatives.

In the light of the G-30 study, where does the debate over derivatives now stand? It should be recognized first of all that the G-30 authors have performed a useful service in demonstrating through clear prose and intelligible examples the considerable benefits that derivatives transactions can offer to borrowers, lenders, investors and intermediaries. Here the balance of the debate needed to be redressed. However, on the key issue of systemic risk the G-30 analysis is much less persuasive.

To begin with, official concerns about the growth, size and concentration of the derivatives market cannot be easily dismissed. A total exchange-traded and over-the-counter (OTC) derivatives market that has come from nowhere ten years ago to a position where its gross value exceeds the volume of banks' international lending(see Table Ⅱ) cannot reasonably be described as "unimposing compared to that of traditional financial activities" (the words of the G-30 authors).

Even when the market is netted down to reflect its replacement cost or market value, the credit exposures are hardly trivial. The G-30 study states that, measured in this way, the 50 leading US banks have an *average* OTC derivatives exposure equivalent to "only" 11 percent of their total assets or 120 percent of their total capital. However, since the study also reveals that the top eight US banks account for nearly 90 percent of this exposure, it is clear that some large banks have exposures far in excess of 11 percent of assets.

Some of the largest participants in the derivatives markets (for example, affiliates of insurance companies) are unregulated but the G-30 authors express confidence that potential counterparties can evaluate the risks of trading with unregulated entities and believe they should be free to do so. This view is in direct conflict with the Bank of England which states in its recent derivatives review that "the unsupervised status of, for example, large swap players represents a supervisory hole at the very heart of the derivatives market."[19)]

The real point about the size and concentration of the derivatives market is surely this. No market can constitute a threat to financial stability merely by virtue of its size (*vide* the $220 trillion per annum foreign exchange market). However, when a certain category of activity represents (on whatever measurement basis) a major segment of some banks' overall business, that activity is certainly large enough to cause systemic problems if it is not conducted in a safe and proper manner.

This observation leads directly to the second major weakness of the G-30 study. The authors take comfort from the fact that their survey of market practitioners demonstrates high standards of risk control within the industry ("the risks associated with complexity, concentration, liquidity, and linkages between markets are manageable and being managed"). The implication is that it is sufficient to rely on market participants themselves to regulate their activities. Yet this is surely too simplistic. For obvious reasons, responses to questionnaires are perhaps not the best way to gauge whether risks are being properly managed. This consideration apart, it only requires some large participants to behave imprudently for the stability of the entire market to be threatened. From this perspective it is insufficient that "most dealers have gone to great lengths to establish sophisticated techniques to manage their exposures" or that there is "nearly universal" (actually 85 percent) reliance on mark-to-market measures for risk management. In short, voluntary compliance with industry-led standards is no substitute for regulatory oversight, a point recently taken up by David Mullins, Vice Chairman of the US Federal Reserve Board.[20)]

The most serious weakness of the G-30 study, however, is that it does not appear to

19) Bank of England (1993 at 76).

20) See Mulins (1993).

recognize, let alone address, the fundamental regulatory problem posed by banks' derivatives trading. Banks are subject to comprehensive regulation because if left to themselves some institutions will always incur risks that are excessive when judged by the damage which their failure can inflict on the financial system and society generally. If a major slice of the banking industry's business becomes too complex and opaque to regulate effectively, then there is a supervisory blind spot which aggressively managed institutions will undoubtedly exploit in order to escape from the regulatory constraints on risk-taking.

Yet in the words of Paul Volcker's foreword to the G-30 study,

> the authors believe that the amount of capital needed to support derivatives exposure is a matter of judgement for individual institutions depending on their appetite for risk and their ability to measure and manage it.

This is not a position that can be easily sustained. The stability of the financial system should not be jeopardized by those (perhaps few) institution whose appetite for risk exceeds an appropriate level, or whose competence to manage risk falls below someappropriate standard. It may be useful to debate what those appropriate limits and standards should be and how they should be enforced; but at the end of the day risk-taking in the derivatives market, like other forms of banking risk, must surely be subject to regulatory constraints.

Ⅲ. Supervisory Standards

As described above, the supervisory weaknesses revealed by the collapse of BCCI in 1991 prompted a reassessment of the Basle approach to banking regulation.[21] Two issues, in particular, had to be addressed. First, a central principle of the Basle Concordat is that the soundness of a bank cannot be properly assessed unless regulators can examine the totality of each bank's business worldwide through the technique of consolidation. Yet BCCI's complex structure enabled it not only to escape consolidated supervision but to confuse regulators deliberately by shuffling its assets between different jurisdictions.

Secondly, the BCCI collapse demonstrated the ease with which a fraudulent bank could exploit weakly regulated offshore centers in the absence of any machinery for ensuring the adequacy of supervisory standards. On this point the Bingham report on BCCI concluded that "the need for some independent monitoring of supervisory standards is in my view clear" and that hosts supervisors "must be reassured by some form of independent verification that the home supervisor is really doing his job."[22]

The Basle Committee has attempted to meet these concerns by introducing the requirement

21) For an assessment of the national and international supervisory response to BCCI see Dale (1993(a)).

that all banks should be supervised by a home country authority "that capably performs consolidated supervision." However, the effectiveness of these new guidelines depends on the ability of national authorities to monitor each others' quality of supervision, so that they can exercise an informed judgement as to whether banks from a particular jurisdiction should be either excluded from their territory or, alternatively, subject to special restrictions imposed by the host authority.

Under the Basle guidelines one country is called upon to assess another country's quality of supervision on the basis of the latter's statutory powers, administrative practices and supervisory record. But there is no new multilateral machinery to assist in the monitoring process and it is difficult to see how bilateral relationships can provide adequate information about supervisory standards in particular jurisdictions. In order to overcome this problem, the Bank of England has proposed a system of peer group review under which each country's supervisory arrangements would be assessed by a panel of supervisory authorities from other countries. However, it is as yet unclear whether this kind of approach would have the broad support among non-G-10 countries that would be needed to make it viable. If the Basle approach proves inadequate to the task then there may eventually be pressure for the International Monetary Fund (IMF) to conduct formal supervisory reviews as part of its country surveillance procedures.[23)]

Supervisory Responsibilities

The issue of supervisory standards is often discussed as if the supervisory function were the exclusive concern of regulatory authorities. Yet this is not the case. There is indeed a vigorous debate about the respective supervisory roles of regulators, market participants and bank auditors and there are also varying national practices in this area.[24)]

At one extreme there are those who believe that systemic banking instability is typically the consequence of excessive regulation which raises expectations of official intervention and depositor protection in the event of bank failures. That expectation, so it is argued, undermines the disciplinary role of financial markets and removes the normal market penalties for excessive risk-taking. Accoring to this view, bank safety and soundness would be enhanced if primary responsibility for monitoring banking risks were placed firmly with depositors. Under this regime bank regulation would be aimed mainly at enforcing stringent disclosure requirements so as to enable depositors to assess the relative riskiness of individual institutions.

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22) Bingham (1992 at 3.27).

23) On this point see Office of the Comptroller of the Currency (1991).

24) For a general discussion of these issues see US Treasury (1991).

The Reserve Bank of New Zealand's recent proposals on banking supervision come closest to this free market model. In setting out its proposals the Reserve Bank explains its general approach in the following terms:

> "... we see scope to shift the emphasis towards more market scrutiny and away from direct prudential regulation. We consider that regular scrutiny of registered banks by the marketplace can, and should, play an important role in promoting prudent banking practices. The maintenance of prudent banking practices can also be enhanced by increasing the involvement of private sector monitoring agents, such as external auditors and rating agencies. Prudential regulation and official monitoring have complementary roles to play, but are not the principal mechanism, nor substitutes for market-based private mechanisms. Our general thinking is that a re-balancing of policy which brings market-based mechanisms a little more to the fore, would enhance the overall soundness of the banking system, and at the same time afford banks greater scope to prudently respond to customer needs."[25)]

In essence, the Reserve Bank's proposed regulatory regime consists of six key elements:

(1) The Basle capital adequacy rules will continue to apply.

(2) A US-style scheme of corrective action will be imposed, involving automatic penalties for banks with a capital deficiency.

(3) Strengthened disclosure requirements for banks, including public disclosure of mandatory credit ratings.

(4) A reduced role for prudential regulation by the central bank, with discontinuation of banks' existing prudential returns and residual monitoring based largely on banks' public disclosure statements.

(5) An increase in the ability of the financial system to withstand individual failures by, for example introducing a more robust payments system.

(6) Limiting the role of the lender of last resort and reducing the perception that the government underwrites the prudential soundness of banks.

The underlying assumptions behind the Reserve Bank's new emphasis on market surveillance are that (a) depositors are in a position to make a realistic risk assessment of individual banks and (b) the market response to changed risk perceptions will not be seriously

25) Cited in Financial Times Financial Regulation Report (1993: 3).

destabilizing. However, there must be serious doubts about both propositions.

First, it is optimistic to expect financial markets to form a realistic view of the financial standing of banks - given the difficulties of assessing either the quality of banks' loan portfolios or the adequacy of provisioning policies (see above). The second area of doubt concerns the question of confidence. It is well-established that when a bank runs into difficulties financial markets tend to respond by rationing credit. Put another way, the emergence of a large risk premium on a bank's borrowings may deter rather than attract potential lenders. Therefore market discipline may become destabilizing. Furthermore, if markets were heavily dependent on credit rating agencies for their risk assessments, a publicized downgrading could become the trigger for a bank run.

Notwithstanding these potential pitfalls, the New Zealand experiment in market-based supervision could provide important insights into banks' behavior in a deregulated setting. In the meantime there is continuing debate at both national and international levels about the most appropriate balance between official intervention and reliance on market discipline.

The controversy over market self-regulation versus official intervention extends to the role of auditors. There are two questions here: what obligations should bank auditors have towards the supervisory authorities; and should bank auditors owe a duty of care not only to shareholders but also to depositors, general creditors and other stakeholders? On the first point, the UK Government has followed the recommendations of the Bingham report by introducing proposals for imposing a statutory duty on bank auditors to report to the regulators information relevant to a bank's fulfilment of the authorization criteria set out in the Banking Act of 1987.

On the second point, UK case law has established that an auditor's duty of care is confined to shareholders.[26)] This may leave depositors, as the predominant suppliers of funds to banks, in an unsatisfactory position since the interests of shareholders and depositors may not be the same. Furthermore, if auditors reported and owed a duty of care directly to depositors, the burden of supervision could be shifted away from the regulatory authorities. On the other hand, such a move would probably have to be accompanied by a ceiling on auditor legal liability in order to prevent the costs of professional indemnity insurance from becoming prohibitive.

To the extent that supervisory responsibility is retained by the regulatory authorities, there remains the issue of whether this responsibility should be discharged by the central bank or

26) In AI Saudi Banque v. Clark Pixley (1989) it was held that the company's auditors owed no duty of care to lending banks. In Caparo Industries v. Dickman (1990) the House of Lords determined that the auditor's duty of care is confined to the general body of shareholders.

by a specialized regulatory agency. A recent analysis of this issue showed that the functions of banking regulation and supervision on the one hand, and monetary policy on the other, were separated in about half the countries reviewed, but that because of the increasing scale of government support for failing banks there was a tendency for the regulatory/ supervisory function to shift away from the central bank to an independent body more directly under political control.[27] However, there appears to be no overwhelming argument in favor of one particular approach, and, as the Bank of England has itself pointed out, where the supervisory and monetary functions are separated there still has to be very close cooperation between the two.[28]

Ⅳ. Protective Regulation

Having considered a number of international supervisory issues arising out of preventive regulation, this section addresses some key problems associated with protective regulation in the form of deposit insurance and lender of last resort arrangements.

Coordination or harmonization of national deposit insurance schemes is not currently on the Basle agenda. Nevertheless, the EC's adoption of a directive on deposit insurance, establishing a minimum level of deposit protection in all member states, raises the question of whether there is a need for a global initiative in this area. Alternatively, is it preferable to permit or even encourage a multiplicity of competing national schemes that widen depositors' choice?

The answer to this question is partly dependent on the policy objective underlying deposit insurance. If, as in the UK, deposit insurance is viewed mainly as a form of consumer protection then it would seem unnecessary to harmonize territorially-based national deposit protection schemes. As the Bank of England recently put it:

> "So far there has been no international convergence of deposit insurance schemes. This is unsurprising given that they are generally a matter of social policy, which remains a national sovereign prerogative."[29]

If on the other hand, deposit insurance is intended to act as a safeguard against systemic risk, the case for harmonization is somewhat more persuasive. Because of the close inter-linkages between financial markets, there is a common interest in the stabilization of the deposit base within the international banking system.

However, the case for harmonization also depends on whether or not national authorities

27) See Goodhart and Schoenmarker (1993).

28) See Quinn (1993).

seek to protect depositors in other ways. In particular, where there is a tradition of sustaining banking *institutions* through officially organized support operations, deposit insurance may be largely redundant. Under such circumstances, harmonization achieves little and may, indeed, only serve to emphasize national differences in the handling of troubled banks.

A recent survey of bank failures demonstrates very clearly that, outside the US, deposit insurance arrangements are seldom invoked - the preference being to recapitalize failing institutions through combined official and private sector support.[30] That being the case, the prudential argument for harmonization of deposit insurance schemes would seem to be weak. Nevertheless, some degree of harmonization might be desirable if this were accompanied by arrangements designed to give home country authorities an incentive to perform adequately their responsibility to undertake consolidated supervision (see below).

Prudential questions apart, it might be considered desirable to harmonize deposit insurance arrangements in order to avoid competitive distortions. But here again the issue is not straightforward. In the first place, the presence and extent of any competitive distortion will depend on precise arrangements for resourcing the insurance fund and on the level of premiums charged. For instance, it is quite possible that banks subject to a scheme offering relatively low insurance coverage for depositors could enjoy a competitive advantage over banks subject to a more protective scheme - if insurance premiums under the two schemes fail to reflect potential claims on the insurance fund. In other words, the pricing as well as the *coverage* of deposit insurance is crucial to the question of competitive distortion. Furthermore, even if both schemes were funded on an actuarial basis, depositors might well prefer to place their money with banks offering higher deposit interest rates, albeit with less insurance coverage.

A second complication, as explained above, is that deposit insurance may be largely redundant in those countries where other forms of protective intervention are the preferred method of dealing with bank failures. Under these circumstances, even identical insurance schemes identically priced may disguise serious competitive distortions associated with different levels of *de facto* protection for depositors. Put another way, competitive distortions arising from alternative protective arrangements can only be eliminated by standardizing national procedures for handling troubled banks - which is hardly a practical proposition at the present time.

In summary, the case for harmonizing deposit insurance schemes internationally, as the EC has done regionally, is not persuasive. Nevertheless it is interesting to note that while both

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29) Bank of England (1991: 12).

30) See Goodhart and Schoenmaker (1993).

the US and the EC have recently introduced new policy initiatives on deposit insurance, these moves are in opposite directions.[31] The US authorities, faced with increasing financial instability, have sought to neutralize the "moral hazard" consequences of what is now seen as excessive protection for depositors. This they have done by introducing automatic penalties for banks with capital deficiencies; exposing depositors to greater risk through a limitation on the Federal Deposit Insurance Corporation's powers to protect uninsured depositors; and imposing a regime of risk-related deposit insurance premiums that seeks to penalize high-risk institutions. By contrast, the EC has adopted a Directive that largely ignores the moral hazard issue by extending the scope of deposit protection within the Community without imposing any limit on the coverage offered by individual member states. While recognizing that a move towards common international standards of deposit protection may not be appropriate at this time, it is surely disquieting that different financial regions are following such divergent policies on deposit insurance.

Lender of Last Resort

Historically, central banks have preferred not to articulate their lender of last resort (LLR) policy, except in the broadest terms, on the principle that to do otherwise is tantamount to "showing the cat the way to the dairy." Yet from an international perspective cooperation in this area is important since in the absence of guidelines there is a danger that troubled institutions could be denied liquidity support in circumstances that might lead to systemic instability.

There are three key parameters governing the LLR function: the conditions that must be met before support is provided; the institutions that are eligible for such support; and the allocation of LLR responsibilities between national authorities.

The traditional role of the LLR is to provide short-term, secured credit to solvent banks experiencing temporary liquidity problems. However, there has been a growing tendency in recent years for governments, if not central banks, to provide capital infusions to insolvent institutions - the most notable recent example being the large-scale official support provided to Scandinavian banks (see Table Ⅲ). The Bank of England, on the other hand, has stated that it will "not ordinarily" provide support to a bank facing solvency problems but it concedes that the distinction between solvency and liquidity problems is not always clear, that losses may therefore be incurred in exercising the LLR function and that its capital and reserves are therefore available for this purpose.[32] In some other countries, notably the US, attempts are being made to curb the LLR function with a view to instilling greater discipline

31) See Dale (1993(b)).

into financial markets, but no national banking system of any significance has been able to dispense altogether with LLR facilities.

There is also controversy as to which institutions should be eligible to receive LLR support. This issue has come to the fore with the fusion of banking and securities business within conglomerate corporate structures.[33)] Where such businesses are combined within the same legal entity the LLR cannot avoid supporting the securities side of the operation as well as the bank. Where a bank's securities business is conducted in a separate subsidiary it may, in theory, be possible to segregate the risks and to confine the LLR role to the banking entity. However, in practice a bank would no doubt be obliged to support a troubled securities subsidiary or affiliate as a matter of commercial self-interest - a view that has been upheld by the Swiss Federal Supreme Court in a recent legal ruling on the question.[34)] If a bank is obliged to underwrite its securities unit's risks, then again the LLR is drawn into supporting securities activities.

Where securities and banking business is conducted by unrelated firms, the LLR function is typically confined to the banking sector. For instance, the Bank of England has argued that LLR assistance should not be extended to non-banks, on the grounds that banks are distinct because their liabilities are uniquely volatile and only they supply the ultimate means of payment - money.[35)] Against this it could be argued that the liabilities of securities firms are also liquid, that banks are heavy lenders to the securities industry, and that the failure of a major securities firm could have destabilizing consequences for the banking system. It is no doubt partly for these reasons that the Japanese authorities have been reluctant to witness the collapse of large or even middle ranking securities firms (vide the rescue of Yamaichi Securities in 1965 and Cosmo Securities in 1993).

The third aspect of the LLR function to be considered is the allocation of LLR responsibilities between national authorities. In the past this has been a source of contention, particularly in relation to banks' foreign subsidiaries.[36)] However, now that the principle of consolidated supervision has been firmly endorsed by the Basle Committee, there would appear to be an implication that the foreign offices of multinational banks (whether branches or subsidiaries) should look to the home rather than host country authorities for LLR support. This division of responsibilities is unhelpful where, as in the case of BCCI, the home country has no LLR capacity and it may therefore be appropriate for host authorities to insist that a branch or subsidiary of a foreign bank should have access to an LLR in its country of

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32) See Quinn (1993).

33) For a general discussion of the LLR implication of the mixing of banking and securities business see Dale (1991)

34) For a summary of the Court's decision see IBCA (1991).

35) Quinn (1993).

36) See Dale (1984: 178),

origin as a pre-condition for authorization.

V. Conclusions

The initial focus of the Basle Committee was to reach agreement on the division of regulatory responsibilities between national jurisdictions. Subsequently attention shifted to the need to establish minimum supervisory standards. More recently concerns about competitive equality have been the driving force behind regulatory harmonization initiatives. Are we then moving towards a global framework for international bank regulation and supervision, or is there still scope for national autonomy in these matters?

In examining this question it is perhaps helpful to review alternative regimes aimed at safeguarding stability within the international banking system. Essentially, there are three possible approaches.

Firstly, countries hosting foreign banks (whether branches or subsidiaries) could rely on an incentive system designed to encourage home country authorities to "capably perform consolidated supervision" (the key Basle requirement). The necessary incentive could be provided by making the home country responsible for insuring the worldwide deposits of both branches and subsidiaries of banks headquartered on its territory. This approach, which has been followed by the EC in respect of branches only,[37] would however involve international agreement on minimum standards of deposit protection in order to ensure that the incentive scheme operated effectively. Under this regime the costs of supervisory and regulatory failures would be at least partly borne by the authorities responsible for carrying out consolidated supervision.

A second approach would be to subsidiarize banks' foreign operations so that the host authority could satisfy itself as to the financial soundness of foreign banks located within its jurisdiction, while also insulating local depositors from risks originating in the parent institution. This possibility has been examined both by the US and UK authorities, who have concluded that mandatory incorporation of local offices of foreign banks would impose heavy costs on the international banking system without necessarily insulating local depositors from risks associated with the parent bank.[38]

The third approach is to harmonize both regulatory and supervisory standards in all major banking jurisdictions. This is the route currently being followed by the Basle Committee which has sought to achieve regulatory harmonization through the Basle Accord and recent

37) See Commission of the European Communities (1993).

supplementary proposals. But there remain important areas of national discretion (notably on provisioning against loan losses) which create the potential for regulatory anomalies. Furthermore, harmonization of supervision remains a long way off. The BCCI collapse, which reflected supervisory rather than regulatory failures, has demonstrated very clearly that harmonization of regulation without harmonization of supervisory standards is of limited value, since capital adequacy requirements become meaningless when capital cannot be reliably measured or monitored. The logic of the present Basle approach therefore points to continuing harmonization initiatives aimed at a more complete alignment of both regulatory and supervisory arrangements.

These alternative regulatory regimes have been discussed from a prudential standpoint. However, as pointed out above, in recent years the objective of competitive equality has tended to displace prudential concerns as the main driving force behind international regulatory cooperation.

Within the international banking system the problem of competitive equality has three distinct dimensions. First, competitive equality may be applied to the relationship between rival financial centers. Here, there has been little attempt to establish a level playing field through harmonization initiatives. Instead, market pressures have brought about a gradual liberalization of monetary reserve requirements, stamp duties, withholding taxes and other key regulatory determinants of the location of international financial activity. In this area we have seen global convergence through regulatory competition rather than regulatory coordination.

Second, the concept of competitive equality may refer to the relationship between national banking industries. The elimination of competitive distortions in this sense has been a major concern of the Basle Committee and a prime objective of the Basle Accord on capital adequacy. Yet it is worth noting that the potential for competitive distortions between banks of different nationality arises partly because of the official safety net (deposit insurance and LLR support) that underlies all banking systems. If the risks incurred by highly leveraged banks were reflected in higher default rates, correspondingly poor credit ratings and higher risk premia on deposit rates, then poorly capitalized institutions would enjoy no obvious competitive advantage over their more heavily capitalized counterparts. Viewed in this way, it is the official protection afforded to banks and their creditors, rather than differential capital requirements *per se*, that is responsible for competitive distortions.

Recent history suggests that most, though not all, national authorities are inclined to strengthen rather than weaken the official safety net (above). Against this background it seems likely that the Basle Committee will come under pressure to extend the boundaries of

38) Bank of England (1992).

regulatory harmonization in an attempt to remove any remaining sources of competitive inequality between banks of different nationality.

The third dimension of competitive equality concerns the relationship between banks and non-banks undertaking similar business. Here, the main focus is on securities operations, regulators having made it an explicit objective to establish a level playing field between institutions undertaking securities business in the belief that to allow securities firms to compete on more favorable regulatory terms than banks, or vice versa, would be both inequitable and damaging to the efficient operation of financial markets. The reasoning here is open to criticism, since the objectives of bank regulators and securities regulators are quite different. A troubled securities firm is expected to wind down its business - which can generally be accomplished quite rapidly because of the marketability of the firm's assets. By way of contrast, a bank is most emphatically not expected to respond to financial problems by going out of business since if it were to do so its non-marketable assets could be sold quickly only at a heavy discount which would leave depositors and other creditors exposed to losses. Therefore the main objective of bank regulators is to sustain banks as going concerns and in the event of capital impairment to allow them time to raise new capital, strengthen management and conserve financial resources by, for instance, cutting dividend payments.

Partly for the above reasons, threats to bank solvency are more damaging socially than threats to the solvency of securities firms. Therefore there is a case for saying that securities business should be more highly regulated when undertaken by banks. By insisting on a level playing field regulators must either relax their preferred regulatory requirements for banks (as the Basle Committee has acknowledged in relation to its market risk proposals) or else impose needlessly stringent controls on non-bank securities firms. Either way, the emphasis on competitive equality gives rise to operational inefficiencies and social costs. If, at the same time, banks and their creditors are given official LLR protection that is denied to non-bank securities firms, there is a further inducement for securities business to be routed through the banking sector.

In summary, because banking is a protected industry national differences in regulatory arrangements and supervisory standards are not reflected in banks' funding costs. Uneven prudential regulation may therefore give rise not only to systemic concerns but to concerns about competitive equality between rival national banking industries. It is against this background that the Basle Committee has shifted its focus from regulatory cooperation to regulatory harmonization. To date these harmonization initiatives have not prevented the emergence of potentially important regulatory anomalies. In the case of the 1988 Basle Accord the unitary risk-weighting for commercial loans and the scope for divergent provisioning practices are hardly consistent with the notion of common capital adequacy standards. The Basle Committee's proposals on market risk fail to address the concepts of diversification and liquidity which have a key bearing on capital adequacy; and the

Committee's proposals on interest rate risk develop a methodology for measurement without considering an appropriate regulatory response. The policy of partial harmonization has therefore resulted in important gaps which, over time, may have to be addressed. On the supervisory side the Basle Committee is still feeling its way, the major question here being whether a more formal mechanism for assessing national supervisory standards may have to be introduced in due course. These issues, together with intractable problems associated with the attempt to create a level paying field for banks and non-banks, are more than enough to fill the regulatory agenda until the end of the millennium.

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Table I Commercial Banks: Net provisions (per cent)

		1986	1987	1988	1989	1990	1991
Australia (1)	a.	0.25	0.35	0.38	0.51	0.86	1.20
	b.	5.26	7.40	7.77	10.96	19.13	24.24
Austria	a.	-	-	-	0.39	0.50	0.52
	b.	-	-	-	16.35	19.49	19.62
Belgium	a.	0.31	0.28	0.40	0.43	0.20	0.31
	b.	14.18	13.93	20.46	23.61	11.54	17.13
Canada	a.	0.75	0.68	0.60	1.16	0.36	0.54
	b.	20.57	17.49	13.68	25.56	8.28	11.93
Denmark (2)	a.	0.39	0.70	1.09	0.87	1.21	-
	b.	18.27	20.82	24.87	26.64	40.51	37.66 (4)
Finland	a.	0.21	0.48	0.40 (4)	0.24	0.19	-0.01
	b.	6.14	13.65	10.51 (4)	7.43	5.86	-0.42
France	a.	0.61	0.53	0.52	0.53	0.50	0.52
	b.	21.25	19.03	19.31	21.57	21.05	22.16
Germany	a.	0.55	0.44	0.25	0.42	0.53	0.47
	b.	15.05	13.26	7.77	13.07	16.51	15.03
Greece (3)	a.	0.32	0.25	0.24	0.36	0.50	0.82
	b.	10.61	8.91	8.06	11.54	13.68	16.70
Italy	a.	0.58	0.49	0.56	0.51	0.54	0.50 (4)
	b.	12.18	11.12	12.41	11.49	11.69	10.51 (4)
Japan	a.	0.04	0.03	0.05 (4)	0.04	0.03	0.07
	b.	2.42	2.16	3.34 (4)	3.36	2.37	5.72
Luxembourg	a.	0.66	0.51	0.37	0.37	0.52	0.42
	b.	46.05	39.66	29.54	32.37	44.06	36.87
Netherlands (1)	a.	0.34	0.19	0.42 (4)	0.36 (4)	0.30 (4)	0.29
	b.	10.68	6.13	13.26 (4)	12.19 (4)	11.72 (4)	11.48
Norway	a.	0.92	0.85	1.58	1.58	1.96	4.50 (4)
	b.	20.69	24.12	40.16	36.04	55.14	146.01 (4)
Portugal	a.	0.84	1.35	1.43	1.59	-	1.79
	b.	24.90	32.35	32.07	32.36	34.43 (4)	29.35
Spain	a.	0.79	0.91	0.80	0.61	0.59	0.72
	b.	17.20	18.38	15.13	11.88	11.55	13.80
Sweden	a.	0.84	0.81	0.93	0.86	0.40	-3.42 (4)
	b.	20.94	23.45	27.20	28.64	14.10	-122.09 (4)
Switzerland	a.	0.51	0.51	0.47	0.54	0.55	0.96
	b.	19.00	19.06	17.82	18.90	20.70	30.26
Turkey	a.	0.67	1.62	1.69	1.20 (4)	1.08	1.15
	b.	12.02	22.14	20.58	16.23 (4)	11.76	12.55
United Kingdon	a.	0.54	1.53 (4)	0.31	1.60	0.95	1.32
	b.	10.95	29.98 (4)	6.03	31.48	19.55	26.32
United States	a.	0.78	1.27	0.56	0.97	0.95	1.01
	b.	16.34	26.30	11.14	18.90	18.57	18.50

a. As per cent of average balance sheet total

b. As per cent of gross income

1. All banks.
2. Commercial banks and savings banks
3. Large commercial banks.
4. Break in series

Source: OECD, Financial Market Trends, June 1993, p.63

Table Ⅱ Markets for selected derivative instruments
National principal amounts outstanding at year-end, in billions of US dollars equivalent

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National principal amounts outstanding at year-end, in billions of US dollars equivalent

	1986	1987	1988	1989	1990	1991
Exchange-traded instruments[1]	583	725	1,300	1,762	2,284	3,518
Interest rate futures	370	488	895	1,201	1,454	2,158
Interest rate options[2]	146	122	279	387	600	1,072
Currency futures	10	14	12	16	16	18
Currency options[2]	39	60	48	50	56	59
Stock market index futures	15	18	28	42	70	77
Options on stock market indices[2]	3	23	38	66	88	132
Over-the-counter instruments[3]	500[e]	867	1,330	2,402	3,451	4,449
Interest rate swaps[1]	400[e]	683	1,010	1,503	2,312	3,065
Currency and cross-currency interest rate swaps[4,5]	100[e]	184	320	449	578	607
Other derivative instruments[4,6]	—	—	—	450	561	577
Memorandum Item:						
Cross-border plus local foreign currency claims of BIS reporting banks	4,031	5,187	5,540	6,498	7,578	7,497

e=estimate
1) Excludes options on individual shares and derivatives involving commodity contracts.
2) Calls plus puts.
3) Only data collected by ISDA. Excludes information on contracts such as forward rate agreements, over-the-counter currency options forward foreign exchange positions, equity swaps and warrants on equity.
4) Contracts between ISDA members reported only once.
5) Adjusted for reporting of both currencies.
6) Caps, collars, floors and swaptions.

Source: Bank for international Settlements, Recent Developments in International Interbank Relations, 1992, p.49.

Table **III**

Bank support operations in selected countries

Countries	Recipiencs			Total support[1]			Government support[2]	
	number		assets as % of industry	as % of reci-pients' assets	as % of GDP	in billions of local currency units	as % of total support	as % of govern-ment deficit[3]
	absolute	as % of industry						
Norway[4]								
1988	2	1.0	2.5	5.4	0.1	0.8	25.0	1.3[5]
1989	7	3.8	3.9	16.5	0.6	3.9	14.6	6.5[5]
1990	9	5.3	4.5	6.8	0.3	1.9	—	—
1991	17	10.5	59.4	4.1	2.0	14.0[6]	59.8[6]	298.9[6]
1992	11	7.4	69.8	2.8	1.7	12.0[6]	100.0	50.6[6]
Finland[7]								
1991(individual)	28	6.3	15.7	3.7	0.9	4.6	84.5	13.2
1992(individual)[8]	22	6.0	23.8	15.1	5.7	28.2	86.2	58.9
1992(general)[9]	135	33.0	92.4	1.1	1.6	7.9	100.0	19.2
Sweden[10]								
1991	1	0.8	18.2	1.5	0.3	4.2	100.0	19.8
1992	3	2.7	26.9	7.1	2.0	29.3	100.0	26.0
1993[11]	1	0.9	4.4	50.7	2.4	34.0	100.0	24.1
Japan								
1991−92[12]	2	0.3	0.1	3.3	0.0	28.0	—	—

1) Total support provided to institutions in distress by private guarantee/insurance funds or by governments. It includes guarantees but excludes the acquisition of bad assets. 2) Including the central bank. 3) Scaling factor only: the support granted represents in part the acquisition of assets whose eventual contribution to government revenues is difficult to quantify. 4) Around one-eighth of the support in the form of guarantees. 5) Surplus. 6) Excluding a concessionary loan programme for which all banks were eligible amounting to some N.kr.15 billion. 7) No support in the form of guarantees. Authorised support up to end-1993 not utilised by end-1992 amounts to some F.mk.25 billion, or around 5% of 1992 GDP. 8) A single joint stock company was formed through a merger of forty-one savings banks, some of which were in distress. 9) General capital injection. 10) Around one-third of the support in the form of guarantees. 11) Industry assets, total number of banks, GDP and government deficit in 1992. 12) Only mergers assisted by the bank deposit insurance fund.

Source: Bank for International Settlements, 63rd Annual Report, June 1993, p.172