

# Commentary: How Should Financial Market Regulators Respond to the New Challenges of Global Economic Integration?

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*Andrew Crockett*

The topic for this session is “How Should Financial Market Regulators Respond to the New Challenges of Global Economic Integration?” The importance of this subject lies in the fact that, while globalisation and economic integration have had overwhelmingly positive effects on balance, the financial disturbances and turbulence of the last ten years have been an undesirable by-product of the process. Not only have these disturbances been problems in their own right, they have threatened to undermine the case for economic integration.

I will focus my remarks on the financial aspects of global financial integration. I will begin with a definition of terms—what kinds of financial integration are particularly relevant for those concerned with regulation? Next, I will review the broad objectives of regulation. Lastly, I will say something about how these objectives are approached.

## **The process of integration (1)**

Global financial integration has at least four aspects. The *first* is the erosion of geographic boundaries. Other papers at this conference have noted the persistent trend for trade to grow faster than GDP and finance to grow faster than trade. There has, thus, been an increasing intensity of cross-border financial transactions. Speaking

in very round terms, in 1970, cross-border transactions in securities by residents of the G-7 countries were approximately 1 percent of GDP. By 1980, they were approximately 10 percent of GDP. By 1990, they had reached 100 percent of GDP—an exponential and indeed explosive growth that is still continuing.

The *second* aspect of globalisation in the financial sector is the blurring of boundaries between market segments. We used to be able to distinguish between the activities of banks, insurance companies, securities issuers, fund managers, and so on. It is increasingly less possible to do that because institutions have either merged or expanded their activities into other segments of the financial industry. Also, because of the ability to transform risk, the risk profile of different categories of institutions is becoming harder to distinguish on the basis of their original line of specialisation.

A *third* phenomenon is the consolidation and globalisation of the major institutional players. Now, a relatively limited number of large financial institutions are active, or even dominant, in all major markets. They deal in an increasingly wide range of financial products. And they manage their books on a globally consolidated basis.

A *fourth* aspect of financial globalisation is what could be termed the growing “completeness” of markets. A broad range of structured derivative products with complex payoff structures have been developed, made possible by financial technology and growing computer power. These have enabled a much wider set of contracts to be made than in the past. Risks can be disaggregated, priced, and traded much more efficiently than ever before.

## **The objectives of regulation (2)**

Against these four aspects of globalisation that impact the activities of financial regulators, let me recall some of the basic objectives of regulation. These objectives remain relatively constant over time, although as I will try to show in a moment, how they are implemented can be significantly affected by changing financial structures.

A first objective, though not one I will spend time on today, is consumer protection — protection against losses due to fraud or imprudent behaviour by financial institutions over which the user of financial services cannot reasonably protect himself or herself. This is certainly an objective by which politicians and the public understandably set high store. But since it does not raise fundamental issues of an economic type, I will not pursue it further today. Rather, I will focus on the three objectives of *efficiency*, *stability*, and *competitive equity*.

Fundamentally, *efficiency* means that the price of risk should appropriately reflect its cost. This, in turn, means avoiding distortions in the financial system due to asymmetric information, lack of transparency, implicit subsidies, monopoly, moral hazard, and so on. The efficiency goal becomes particularly important, and difficult, when official intervention in the system, for example to provide a safety net, distorts the pricing of risk.

*Stability* is, of course, a fundamental goal of financial regulators. But it is not an absolute good. Some instability is not only inevitable but also positive. Systems have to change and adapt. Institutions have to come into existence and disappear. The Schumpeterian process of creative destruction, which Chairman Greenspan recalled in his remarks, has to be allowed to work. Clearly, however, there are types of financial instability that cause unacceptable costs. It has been a long-standing objective of financial authorities concerned with systemic oversight to try to avoid that kind of instability with all its destructive power.

Concerning *competitive equity*, this has become an increasingly important supervisory objective because of the degree to which boundaries between institutions and geographic jurisdictions are becoming blurred. We often talk about a “level playing field.” This is a misleading term, since it is not obtainable in any sporting sense. But at least we can strive to produce conditions of competitive equity that facilitate genuine competition among institutions and maximise its beneficial consequences.

These three objectives of regulation could, of course, be simultaneously achieved in some hypothetical world of classical perfect competition. We could rely on the hidden hand to promote them without the necessity of official intervention. In the real world, however, there are sources of market failure that are either inherent in market structures or are introduced by public policy. Therefore, some kind of regulatory intervention is needed to achieve the best trade-off among the three objectives.

### **Implementing regulation (3)**

Let me therefore now say a few words more about *how* these three objectives—efficiency, systemic stability, and competitive equity—can be pursued in practice in an increasingly globalised world. In order to strengthen and maintain efficiency, regulation has to work with the grain of market forces. As recently as twenty or twenty-five years ago, this was not the case. Regulation existed in the form of ceilings on interest rates, prohibitions of various activities, restrictions on access to particular aspects of the financial market. We have learned, partly as a result of the process of globalisation, that regulation is more effective if it doesn't try to prevent the operation of market forces but deals, instead, with the sources of market failure that might otherwise result in sub-optimal outcomes. Those sources of market failure are much better understood now than they were twenty or thirty years ago. Game theory has helped us understand better the influences of factors such as moral hazard, asymmetric information, adverse selection, and so on. In turn, these forces underlie the volatility of capital markets, and the weaknesses that can develop in financial institutions. The focus of regulation in a world in which global capital markets are increasingly integrated, has to be on making markets work better through tackling these sources of market failure.

What about the objective of systemic stability? There have been ample examples in the last decade of systemic instability, even as markets have by and large become more integrated and efficient. The first line of defense is the improvement of risk management practices at the firm level. Although that may sound obvious, in the past regu-

lation was often applied through quasi-mechanical ratios that did not take adequate account of the importance of risk management practices.

A second line of defense is the improvement in techniques of supervisory oversight. Supervision is not just a question of measuring ratios. Effective supervision is a matter of understanding the business of the institution. The business of financial institutions is increasingly difficult to compartmentalise into defined categories, such as banking, insurance, and so on. Supervisors thus need to have a less mechanical and more qualitative approach to assessing financial firms' risks and risk management practices. This is going to mean that the nature of supervisors' qualifications will have to change. Working with the grain of markets, and using market forces as a means of reinforcing prudent behaviour, puts more of a premium on economics training than was the case historically, when supervisory agencies were typically staffed by lawyers and accountants. Legal and accounting expertise have an important role, of course. But there needs to be a blend of the different philosophical approaches.

A third line of defence (perhaps it ought to be the first) is market discipline. Counterparties can exert a powerful restraining influence on imprudent behaviour if they have adequate information. This underscores the importance of transparency and robust accounting practices. We should recognise, however, that while market participants are pretty good at judging, and disciplining, *relative* risk, they are less good at assessing the undiversified risk associated with the economic cycle. Market discipline, in other words, may be necessary, but not sufficient to avoid instability.

So far I have been talking about prevention. But the objective of promoting systemic stability is also a matter of having means of dealing with stress and resolving financial crises. I will not have a great deal to say on this topic because it is not specifically a task of regulation. But I do want to note briefly the interface between supervisory norms and the responsiveness of an economy in times of stress.

There are several issues. One could be termed the "aggregation"

problem, or the risk of procyclicality in regulation. What an individual institution might do to protect itself in times of stress might, if collectively followed by *all* institutions, aggravate the original source of the stress. If, in a downturn, all banks attempt to cut back lending, either because of their own risk management guidelines or because of supervisory encouragement, this will tend to increase the severity of the downturn. There is no easy answer to this problem, but it's one that has to be recognised.

Another issue arises in the application of new risk management methodologies, such as value at risk. Value at risk depends upon particular assumptions, for example with regard to liquidity, that may not hold in times of stress. This too is a problem to which there is no easy answer, but again is one about which regulatory authorities need to be aware. It increases the importance of sensitive stress-testing as an important weapon in the risk management and supervisory armoury.

Competitive equity is the third goal of regulation. In a global world, there is a clear need for regulatory requirements in different jurisdictions to be compatible. This may, however, not be enough. Regulatory or supervisory rules may differ among different types of institutions (e.g. banks, securities firms, and insurance companies) doing comparable types of business. Or the environment for financial business may differ across different jurisdictions, say because of differences in accounting conventions, legal codes, and so on. We need to recognise the complexity of the level playing field question. There needs to be an awareness of the implications of different rules in different jurisdictions for competitive equity. If there are differences that create an incentive for regulatory arbitrage, this can have implications, in turn, for systemic stability issues.

#### **Some practical issues**

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Having looked at the objectives of regulators, let me, in conclusion, talk about some of the practical issues that arise if we are going to promote the goals of efficiency, stability, and equity in a world in which the global capital market is more integrated and competitive. As some of the papers presented here have reminded us, there is still

some way to go before international capital markets can be considered fully unified. But that is clearly the direction in which things are moving. Let me touch on two or three issues.

*First* should there be a single set of rules for all institutions and all countries? As a practical matter, this is not in the realm of the politically feasible for the foreseeable future. But even if it was, would a single set of regulations be efficient? My answer is: not necessarily. There is a role for regulatory competition—not, it has to be stressed, in terms of competitive laxity but in terms of the regulatory approach pursued. For the reasons I have just discussed, it is important that we encourage regulation that is sensitive and incentive-compatible. That is more likely to be the case with a variety of supervisors. So, perhaps it would not be ideal to have a single regulator. The best approach may lie in cooperative setting of minimum standards among regulators in different jurisdictions coming together in groupings like the Basel Committee.

I will not say much more on how these standards are set because Howard Davies, speaking next, will be able to contribute much more as somebody who is involved practically as a national regulator. But let me just say that it would be problematic to try to develop minimum standards in a forum that included all countries. Strong standards are more likely to emerge from an approach such as the one adopted by the Basel Committee, where the leading jurisdictions develop standards of best practice, which can then act as a focus for market-driven peer pressure to apply in other countries.

*A second* question is the coverage of the standards that are developed. There is a growing realisation that a strong banking system involves more than just capital requirements, and a robust financial sector involves more than just strong banks. All major financial *institutions*—banks, insurance companies, fund managers, securities issuers—need to be prudently run and sensitively supervised. In addition, financial *markets* need to be open and transparent. And the financial *infrastructure* (accounting conventions, legal structure and law enforcement, payments and settlements systems, and so on) needs to be adequately adapted to the needs of economies in

which financial markets have become the principal allocator of real resources.

On the Web site of the Financial Stability Forum, there are a total of sixty-six codes or standards. Although there are still some gaps, taken together, these standards define the state of the art of what constitutes an efficient and stable financial system. But there remains a huge task of promoting the implementation of those standards across jurisdictions at significantly different levels of financial development.

*Third* and last, “What is the role of central banks?” This question was posed by Charles Goodhart earlier. It is a bit of a minefield for a central banker to get into and I will be circumspect. Currently, the tide in the developed countries is running in favour of putting regulation in an independent agency, outside the central bank, and having broad supervisory powers over a spectrum of financial institutions. But in most, the central bank retains an overall responsibility for financial stability, incorporating all of those aspects that impinge on the efficiency and stability of the financial system. Whatever the formal legislative position, it is hard to see how the central bank can avoid such a responsibility. So, central banks are bound to retain a close interest on how supervisory policy is developed and how it is applied at the institutional level. How this broad interest is translated into practice, while recognising the independence and unique competence of other supervisory bodies, is part of the unfinished business of regulatory reform.