Mr Crockett considers what regulatory consequences should be drawn from the most recent crises in financial markets

Remarks by the General Manager of the Bank for International Settlements, Mr Andrew Crockett, to the European Banking Congress in Frankfurt/Main on 20/11/98.

You have asked me to talk about the regulatory implications of recent crises. Before I do so, it is important that we understand the relative roles of regulators and bank management in avoiding excesses and managing risks appropriately. As you all know, the regulatory and supervisory focus has shifted in recent years from quantitative controls and explicit rules to monitoring bank soundness through the quality of internal controls and the banks' risk management culture. With this, greater emphasis has been placed on responsibility of bank management and stakeholders, through market discipline, to ensure prudent operations. I think we all agree that bank managers and market participants are better equipped and 'incentivised' for this task than supervisors. And there is no going back to a world of quantitative controls.

At the same time, it is understandable that the ability of banks to repeatedly walk open-eyed into massive overexposure should lead to questions being asked about the wisdom of this change in regulatory and supervisory focus. I will not address this question here. But if the banking and wider financial community is to resist pressures for re-regulation, it is necessary that it should pay much greater heed to the responsibilities for prudent operations that are now more explicitly theirs and theirs alone.

What regulatory consequences should be drawn from the most recent crisis in the financial markets?

Coming to the question you asked, I think it is useful to distinguish between the crisis in emerging markets and the recent heightened volatility in financial markets in advanced economies. Even though there are undoubted linkages between them, the regulatory implications to be drawn are rather different.

Concerning what has happened in emerging markets, there are at least three basic lessons from recent experience. The *first* is that structural weaknesses in the financial system can be very costly. The *second* is that there are important feedbacks between macroeconomic instability and problems in the financial sector. And the *third* is that financial instability can spread contagiously from country to country. The Asian crisis began when the overvalued Thai baht had to be devalued. The currency crisis then interacted with financial system weaknesses to produce a deep economic recession. And the difficulties in Thailand were rapidly propagated across the region and beyond.

From this experience, the most important regulatory consequence to be drawn is the need for rapid strengthening of financial systems. Among the most important shortcomings of financial systems in Asia were: severe currency and maturity mismatches; excessive concentration of lending; insider and politically directed lending; inadequate accounting and loan classification procedures; weak capitalisation; and unsatisfactory supervision.

Correcting these fundamental problems will be neither quick nor easy. A strong financial system requires the development of deep-rooted 'credit culture', in which lending instruments are properly related to the risks they are used to finance. Lenders need to become better able to assess borrowers on an arm's-length basis, understanding their businesses and their various risks, matching cash flow to debt servicing obligations and appreciating the appropriate role of

collateral. And supervisors need a strengthened capacity to identify and correct sources of vulnerability.

Fortunately, there now exists a standard by which banking systems and supervisory arrangements can be judged. This is the ‘Core Principles for Effective Banking Supervision’ issued last year by the Basle Committee on Banking Supervision. Virtually all countries have now accepted these principles and pledged to adopt them. This is not the place to go into the Core Principles in detail. But let me just note four aspects of them that are of key importance. *First*, they cover all phases in the life of a bank, from initial licensing, through ongoing supervision, to eventual closure procedures. *Second*, they apply to both domestic and internationally active banks. *Third*, the rules are applicable to banks operating in emerging markets as well as to those of industrial countries. And *fourth*, they have been developed by an internationally representative group of supervisors. The Core Principles therefore have the comprehensiveness and the legitimacy to act as the basis for a thorough-going strengthening of banking systems worldwide.

The difficult part, of course, will be implementation. A major effort will be required involving banks, national supervisory authorities and international organisations and expert groups. The BIS and the Basle Committee will play their part both in implementation and in providing training and technical assistance to help countries bring their systems up to scratch. Although primary responsibility for overseeing implementation of the Principles falls to the IMF, the Basle Committee will be drawing up a compliance methodology for use by the IMF in its surveillance activities. And as regards training, we have recently announced the establishment of the BIS Financial Stability Institute, which will be headed by Mr John Heimann, who is well known in the banking community and Mr Erik Musch, former Secretary General of the Basle Committee. I hope this Institute will make an important contribution to disseminating best supervisory practice and supporting the effort to strengthen banking systems.

I now turn to the lessons to be learned in the industrial countries from the rather extraordinary episode of market turbulence that began in mid-August. The Russian debt moratorium of 17 August sparked a widespread flight to quality, which was followed by a generalised drying-up of liquidity in many markets. This prompted fears that lenders would ‘disengage’, leading to a credit crunch.

Fortunately, markets have more recently gained a certain measure of stability. But we should certainly try to understand what went wrong and how we can avoid such episodes in the future. One problem was that lenders had unrealistic expectations about the extent to which their loans to emerging markets would be protected. It is therefore important that cross-border lending be assessed on a stand-alone basis, and that supervisors make sure that the pricing and management of such exposures are not undertaken on a false basis. In other words, a tightening-up of credit risk procedures is called for.

Another source of difficulty was that the models used to assess market risk were based too simplistically on established statistical correlations. They did not take adequately into account other types of risk, such as liquidity, volatility and event risk. Widely used value-at-risk models caused financial intermediaries to liquidate assets when volatility in asset prices increased. This selling, in turn, caused volatility to increase further and resulted in additional selling. The fact that most market participants used the same basic model led to common reactions, amplifying herd-like behaviour. Consideration therefore has to be given to ensuring that common behaviour by market participants does not exacerbate market instability.

It has to be recognised that all model-based approaches to controlling market risk embody assumptions, explicit or implicit, about market liquidity. The drying-up of liquidity in periods of market turbulence, as market participants seek to disengage from exposure, invalidates a basic premise on which risk management is built. It is therefore all the more important that VaR-based approaches to risk containment are supplemented by stress-testing.

How do you think national governments have fared in implementing BIS rules?

The scorecard in this connection is not very good. If one looks back at the history of the past 10 or 15 years, financial crises have succeeded themselves with depressing regularity. In the emerging markets, there are [15] cases in which the direct resolution costs of banking sector crises have exceeded 10% of GDP. And among the industrial countries, systemic strains have been just as evident. The Savings and Loan debacle in the United States; the Scandinavian banking crisis; financial fragility in Japan; and individual cases of failure or severe difficulty, such as Barings and Crédit Lyonnais: all these episodes show there is much to be done in the advanced countries also.

Let me make a few simple points:

First, capital ratios do not mean much without prudent and consistent accounting practices. Time after time, banks have failed even though they had shortly before declared strong capital ratios. And whole banking systems have been declared sound at a certain moment, only to have severe weaknesses revealed shortly afterwards. The reason, of course, is accounting practices that allow bad loans to be called good. It is of the utmost importance that asset impairment is quickly recognised.

Second, the Basle rules are not just a matter of capital requirements. Banking is about the management of risk. Banks need systems and controls at all levels that foster the accurate measurement and monitoring of risk, and permit risk to be accurately priced and rigorously controlled. This goes well beyond the maintenance of certain balance-sheet ratios which, we all know, are at best an imperfect measure of the riskiness of a portfolio.

Third, good supervision is no substitute for a developed ‘credit culture’. The best supervisors in the world cannot enforce a culture when the basic soil is not receptive. As I noted earlier, the onus here lies squarely with banks’ management and their boards of directors.

Fourth, to keep a banking system healthy, it is necessary to have clear procedures for dealing with institutions that get into difficulties. Too often, troubled banks are allowed to remain in operation as losses mount and their capital erodes. Forbearance is used to put off difficult decisions in the hope that things will somehow get better on their own. Industrial countries have been just as guilty as developing ones in this regard. Early intervention procedures therefore need to be spelled out so that institutions in difficulties are dealt with before they infect the rest of the system.

Let me conclude: the international financial system has had a close shave. With luck, and skilful management from now on, there is a good chance that things will now get better. But there are important lessons to be learned if the system is to be made more resilient on a durable basis.