Mr Welteke examines the extent to which markets need guidance and in which specific areas

Statement given by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the Frankfurt European Banking Congress, held in Frankfurt on 19 November 1999.

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I

To address the main question of this panel: yes, financial markets do need guidance. But this is not a sufficient answer in itself. In a market economy the real question is *the extent to which* markets need guidance and in which specific areas? The differences which may exist in the three areas (accounting standards, electronic money and the New Basel Accord) are mainly a consequence of differences in underlying financial systems, but they are also the result of different traditions. The US financial system relies much more on capital market instruments than the European financial sectors. The issuance of bonds and stocks listed on the stock exchange is a more widely used instrument in raising capital for enterprises. Market capitalisation of outstanding shares as a percentage of GDP amounts to about 180% in the US, compared with 53% in Germany.

Most European financial markets are based on bank/customer relationships focusing on the traditional loan business. In Germany, for example, capital market financing (including shares) amounts to only about 38% of total funds raised by enterprises (in the US this ratio is about 70%). As a consequence, securitisation is not as widespread in Europe as in the US, and both the depth of the European capital markets and the volume of financial transactions cannot yet fully compete with the Anglo-Saxon markets. However, I expect that the euro will gain increasing importance and live up to its full potential as a transaction, reserve and investment currency. This should also contribute to a further narrowing of national financial markets' roles and structures, and, on the whole, strengthen European capital markets.

II

What does this all mean for the issue of guidance for financial markets ?

Let me start with a general principle which is widely accepted: regulations should provide a framework that best suits the specific market conditions. This means that regulations are a reflection of market developments and structures and not a driving force for changing markets. Constraints on markets and developments are only justified where financial stability or issues of competition, protection of depositors and investors, or the functioning of the markets in a more general sense are at stake. As long as differences in financial market structures exist a detailed "one size fits all" approach will not be fully compatible with the goal of creating or even improving the level playing field.

However, it is also clear that the globalisation of financial markets and increased merger activity exert pressure on those markets to adapt, to become more and more integrated, and similar. Firstly, in terms of the kind of financial transactions which are considered "state of the art" and, secondly - this will take more time - also in terms of market structures. Therefore, harmonisation as well as close cooperation between supervisors around the world are highly desirable. This is well understood and already common practice, as is demonstrated by the multilateral cooperation in international forums.

III

Let me now turn to the three specific areas, addressed in the question.

In the area of *accounting*, the G7 assigned the International Accounting Standards Committee (IASC) the task of establishing a worldwide harmonised set of core accounting principles. I strongly support this initiative and very much hope that we move towards a true world standard on this basis. IAS (International Accounting Standards) should in my opinion be the requirement for a listing on all major stock exchanges of the globe. German legislation already allows banks to set up their consolidated accounts on the basis of the IAS.

The IAS are currently reviewed by the Basel Committee, the IOSCO (regulators for securities firms) and the IAIS (regulators for insurance firms). Some differences of opinion still exist, especially on the issue of "fair value" accounting. The IASC obviously prefers "fair values" (which means market values) for all financial instruments including the loan portfolio. The majority of regulators (including Germany) favour such accounting only for instruments traded on financial markets. For traded instruments we can easily calculate "fair values" whereas this is much more difficult for assets and liabilities of the banking book. The European Commission has taken up this issue with the aim of arriving at a common standard for IAS and the European accounting legislation.

IV

With regard to the regulatory framework for *e-money* the US and Europe take a different approach. In Europe, the issuance of e-money will probably be regulated (although the relevant EU directive has not yet passed the European legislative process). Most European countries perceive a need for such regulation in order to ensure sound market practices, to protect those who use e-money, and to take adequate account of both systemic and monetary policy concerns. The envisaged rules will allow for enough freedom for the e-money business to evolve, and technological progress will not be hindered. The United States is taking more of a "wait and see" approach before they issue regulations for e-money. Nevertheless, I would not be concerned about possible competitive disadvantages for Europe resulting from the different speed of regulatory initiatives in this field. The reason is quite obvious: e-money should remain a national or European business for quite some time and transatlantic e-money services may not evolve easily. In addition, the regulatory demands for e-money business should not pose a real constraint for well run e-money systems. Moreover, we must not miss the optimal point of time for regulating e-money. Waiting for too long could mean that we end up with very divergent systems in Europe. This in turn would make it extremely difficult to have a European passport and single market in this area. Against that background the envisaged European directive on e-money is expected to improve market development.

V

The third area you mentioned is the current review of the *capital adequacy framework* by the Basel Committee. Naturally, differences of opinion exist. One prominent example, which has been cited various times in the press, is the use of external versus internal ratings for assessing the banks' credit quality. With regard to the Basel Accord as such, aspects of competition may arise for both the banking sector and non-banks, especially small and medium-sized companies. It is important that the Basel rules do not cause competitive disadvantages for countries or specific sectors of the economy. For this purpose, common European positions should be formulated wherever possible. Without prejudging the negotiations in Basel, there are good prospects that competitive distortions will be avoided by, for example, allowing the use of banks' internal ratings.

Considering the revision of the Basel Accord as a whole, there are still many details which have to be worked out and require our full attention. But, in essence, there seem to be fewer differences of opinion than press reports sometimes suggest. Americans and Europeans alike favour a more risk-based assessment of credit portfolios, the introduction of a supervisory review process to better highlight qualitative aspects of financial oversight, and the strengthening of transparency and market discipline. The recent financial crises in Asia should have revealed to all regulators (and, in my opinion, to the public at large) the need to promote financial stability worldwide.

I am optimistic that the Basel Committee will resolve all outstanding issues by autumn 2000 and propose a harmonised regulatory framework which will be appropriate for capital market-oriented as well as bank-based financial systems. To close, let me underline that the new guidance we are giving to banks in the form of the revised Basel Accord should, to a large extent, reflect “sound market practises”. To obtain an optimum result, it is essential that banks contribute to this regulation by providing technical input.