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November 8, 2008

Prudential Oversight of Finance: First Principles for International Cooperation

The prudential supervision and regulation of financial activity, never appearing on radar screens in normal times, is suddenly near the top of worry lists. Many observers deem them a priority problem badly needing to be "fixed." And because financial activity is now global and the financial crisis is worldwide, many jump to the conclusion that prudential oversight has been inadequate not only within individual countries but also in its cooperative international dimensions.

The beginning of wisdom about prudential financial oversight is to eschew extreme perspectives and to recognize that extremist remedies are unlikely to be a net improvement.

It is true that inadequate supervision and regulation of financial activity significantly contributed to the evolution of today's crisis. Banks and nonbank financial institutions were allowed to become badly "overleveraged." Financial institutions moved assets off their balance sheets to avoid having to hold adequate capital reserves. There was insufficient transparency, disclosure, and supervisory monitoring for complex financial instruments such as collateralized debt obligations and derivatives such as credit default swaps. Credit default swaps, essentially insurance contracts, were not subject to regulation acknowledging their insurance as well as derivative character. Hedge funds were not required to disclose sufficient information and were lightly regulated. Internal techniques for evaluating the risks taken on by financial institutions were faulty and were not adequately second-guessed by prudential supervisors. Credit-rating agencies failed to give cogent appraisals of the instruments they rated. Sadly, the preceding is merely a partial list.

Yet it is also true that today's crisis had multiple causes. Inadequate prudential oversight was not the only, not even the primary, difficulty. Imprudent behavior of both lenders and borrowers in projecting housing values and in the origination of mortgages were critically important. First-best supervision and regulation could have mitigated that imprudence, but not forestalled it altogether. As investors became skittish and confidence declined sharply, the crisis became increasingly unanchored from its original triggers. Herd behavior led to a freezing of all lending and borrowing, which in turn threatened even healthy, adequately capitalized financial institutions.

Just as inadequate prudential oversight, both in the United States and abroad, contributed to the emergence of the financial crisis and to the speed with which it worsened, cooperation among national supervisory authorities in recent decades can also be validly criticized. More progress could have been made to improve world standards for the prudential supervision and regulation of financial activity. More cooperation could have led to better monitoring and enforcement of world standards. Again, however, it is important to recognize that failures of international cooperation were not a dominant cause of the worldwide crisis.

As with so many aspects of public policy, ideologically extreme views about financial activity attract disproportionate attention. One polar view emphasizes only the presumptive efficiency of financial markets. The opposite extreme perceives only market failures. But thoughtful analysts have always recognized the inevitable tensions between market efficiency and market failure. The decentralized decisionmaking embodied in market supplies and demands can accomplish allocative feats of great complexity. Yet markets can also malfunction; decentralized, noncooperative decisionmaking can sometimes produce outcomes decidedly inferior to those attainable when decentralized decisions are constrained by collectively agreed guidelines and collective monitoring.

An eclectic and agnostic stance about prudential financial oversight is essentially the same mainstream stance that makes sense in resolving the tensions between market efficiency and market failure. And eclecticism is the most judicious response to extreme views. If you find yourself being lectured about the damaging effects of unfettered free markets and the need for a sweeping re-regulation of financial activity, your mind should flood with the mischief that can be caused by anachronistic and ineffective government regulations, the beneficial discipline of interbank and intercountry competition, the merits of lending decisions decentralized to where information about credit risk is least unreliable, and the potential for improved resource allocation and faster growth that can result from savings being channeled to investment projects yielding the highest return. Conversely, if you find yourself in the company of someone arguing that across-the-board financial deregulation will work supply-side miracles in the national and world economy, your mind should then overflow with thoughts of the bank executives who behave like sheep in choosing a portfolio dominated by securities backed by subprime mortgages, drug-smuggling proceeds laundered through banks in offshore financial centers, stock prices fluctuating in response to false rumors started by market participants in order to make exploitive trades, and competitive laxity between governments trying to attract financial institutions to their jurisdictions by reducing taxation and the stringency of supervision – not to mention the Asian financial crises of 1997-98, the failures of the Herstatt and Franklin National banks in 1974, the Credit-Anstalt in Vienna in 1931, and the South Sea Company in London in 1720.

In the United States and several other developed countries, government policies about supervision and regulation in the last decade tended to drift in the direction of deregulation, away from a judicious middle ground. As new financial instruments were created, disclosure and transparency requirements were not imposed. Out-of-date regulations were not updated. Prudential supervision was not enhanced even though the need for it was increasing.

Inevitably, the current crisis will force the general stance of supervision and regulation sharply in the opposite direction. Getting back to a sensible middle ground is badly needed. But there is significant risk that, as with a pendulum, the middle ground will be overshot.

The risks of overshooting, of adopting ill-considered steps, are especially high in the area of international cooperation. To reduce the probability of future crises, governments and central banks over the medium run do need jointly to improve world standards for prudential oversight. And they do need to support enhanced cooperation to monitor and enforce those standards. But some of the sweeping ideas in the air prior to the November G-20 summit – such as creation of a new "supranational regulator" to

harmonize the supervision and regulation of the activities of the largest, internationally-active banks; or a complete re-design of the international architecture of financial regulation in a "Bretton Woods II" conference – are as yet vague and, at best, highly premature.

Proposals for incremental progress should, at the very least, be closely informed by the merits and deficiencies of the cooperative actions that have already been taken in recent years through groups such as the Financial Stability Forum, the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the International Accounting Standards Board (IASB).

A cooperative approach at the world level for refining financial standards and prudential oversight should be based on the following general principles:

1) *Responsibility for improved standards and prudential oversight should begin and end at home within the individual nation.* Cooperative design of standards and collective international monitoring should shape a world environment that encourages individual national governments to take appropriate actions. "Supranational" institutions will have limited political authority for the foreseeable future. Strengthened standards and oversight within nations cannot be imposed from outside.

2) *Standards and oversight at the world level should take the form of core principles rather than detailed codes or fully specified regulations.* It would be premature to try to obtain worldwide intergovernmental agreement on detailed codes and regulations. National governments may be able to accept core principles and guidelines, but typically they will prefer -- often with justification -- to adapt the core to the particular indigenous characteristics of their own situations. Even if detailed regulations were somehow politically negotiable, it could still be undesirable to aim for such detail. Although standards and regulations can err by being too loose and fuzzy, they can also err by being excessively detailed.

3) *The preferred approach at the world level is an encouragement of agreed minimum standards combined with the presumption of "mutual recognition."* This approach differs from the negotiation of "harmonized standards." Explicit harmonization across nations would require substantial departures from national governments making decentralized decisions; harmonization would also require a major overhaul of international financial organizations. Mutual recognition (as understood, for example, within the European Union) does entail intergovernmental cooperation: it requires exchanges of information and consultations among governments that will constrain the formation of national regulations and policies. In contrast with harmonization, however, mutual recognition presumes a continuation of decentralized decisions by national governments.

4) *No financial institution, anywhere in the world, should escape adequate supervision by one or more national prudential authorities.* Since first articulated in 1975, and revised in 1983, a similar principle has been widely accepted -- for banks -- as the "Basel Concordat."

5) *World standards and oversight should, when possible, rely on market incentives rather than direct restrictions.* Within individual nations, prudential oversight that relies on market incentives will usually, if feasible, be preferable. The same principle applies to standards and prudential oversight designed to cover cross-border financial

transactions and the world financial system as a whole. Detailed direct restrictions require large staff resources. Detailed restrictions are difficult to update to changed conditions, and if not updated can easily become anachronistic. Detailed restrictions, though designed to offset market failures, can founder because of government failure.

6) *Standards and oversight designed at the world level should highlight disclosure and transparency.* A close link exists between the degree of disclosure and the ability of supervisors to rely on market-based, incentive-based regulations. Without ample disclosure of institutions' accounts and behavior and without the information being readily available globally as well as domestically, an emphasis on incentive-based oversight instead of direct explicit regulations cannot be successful. Ample disclosure of accurate and timely information helps to reward safe and well-managed institutions while exerting market pressures on institutions that are excessively risky and poorly managed.

7) *Monitoring and enforcement of world standards and oversight are at least as important as sound design.* Even if well designed and fully agreed, standards and guidelines are of limited worth without adequate monitoring and enforcement. Private institutions have strong incentives to innovate to circumvent existing regulations. Such innovations require supervisors to adjust their monitoring and enforcement (sometimes even the design). Monitoring and enforcement is especially difficult when reliance must be placed on direct restrictions rather than on standards and regulations based on market incentives. The greatest risks come from the latent potential for regulatory capture and regulatory forbearance.

8) *The primary mechanisms for monitoring and enforcement of a nation's standards and oversight should be implemented internally within the nation (self assessment), but evaluation from outside the nation (external assessment) should be used as a supplement.* Because responsibility for prudential oversight for a national financial system must be shouldered at home (principle 1), the bulk of monitoring and enforcement activity must also be implemented within the nation. Each nation, acting voluntarily, should strengthen its own indigenous procedures for self assessment. Self assessment alone, however, is unlikely to be sufficient. To ensure rigor, to foster consistent application of world standards across national jurisdictions, and above all to enhance credibility, national self assessments need to be complemented by external verification and probably even by external assessments. Initiatives in recent years, such as reports on the observance of standards and codes (ROSCs) and financial sector assessment programs (FSAPs) carried out under the auspices of the IMF, World Bank, and the BIS, are initial international efforts at external assessment. Evaluations by the Financial Action Task Force in the specialized area of financial crime and money laundering are another illustration of external assessments of nations' compliance with world standards.

9) *No governmental jurisdiction should be accorded the full benefits of participation in the world economic and financial system and its supporting international organizations if it persists in maintaining standards and prudential oversight that are weak relative to world minimum standards.* In a world financial system with nearly 200 separate national jurisdictions, a few may be opportunistic free riders. The most problematic jurisdictions may intentionally have inadequate transparency, weak standards and supervision, loopholes that facilitate tax evasion, and little willingness to cooperate internationally. Such weak-standard jurisdictions, for example a subset of so-

called offshore financial centers, may exploit their supervisory laxity to attract private customers and financial institutions trying to escape sensible tax regimes and high prudential standards elsewhere. The world community should try to discourage the adverse externalities originating from such free-rider behavior. If a jurisdiction makes little effort itself at self assessment, or even actively inhibits self assessment, in such instances the world community has no choice but to impose some form of external assessment. Widespread dissemination of such an assessment for a problematic jurisdiction -- a "name and shame" policy -- may influence the jurisdiction to change its behavior. If a name-and-shame policy proves insufficient, the world community will eventually have to agree on stronger measures.

The preceding principles are "soft" rather than "hard," shaped by a strategy of pragmatic incrementalism. Agreement on more detailed principles and codes, not to mention monitoring and enforcement, will be difficult and slow. But these broad principles are a place to start. They could constitute a feasible foundation for a near-term strengthening of the surveillance of individual nations' financial systems and the world financial system as a whole.

Meaningful progress on international cooperation for prudential oversight cannot be achieved without addressing two difficult underlying issues. Which international forums and institutions should be the locus of the cooperative efforts? How should important countries that heretofore have not been engaged in the existing cooperative efforts be brought into the process? These two issues are discussed in a companion essay.¹

¹ "International Cooperation for Prudential Oversight of Finance: Which Institutions? Which Countries?" (Brookings Institution, November 2008).