The Future of Global Financial Regulation

Sir Andrew Large

Group of Thirty, Washington, DC
Sir Andrew Large is Deputy Chairman of Barclays Plc, and was until late 1997 the Chairman of the Securities and Investments Board in London. This text is based on a speech delivered at the Stern School of Business, New York University, in February 1998. The views expressed in this paper are those of the author and do not necessarily represent the views of the Group of Thirty.

Copies of this report are available for $10 from:

Group of Thirty
1990 M Street, N.W., Suite 450
Washington, DC 20036
Tel.: (202) 331-2472 · Fax: (202) 785-9423
E-mail - info@group30.org · WWW - http://www.group30.org
Occasional Papers
No. 57

The Future of Global Financial Regulation

Sir Andrew Large

Published by
Group of Thirty©
Washington, DC
1998
## Contents

<table>
<thead>
<tr>
<th>I. Introduction</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>II. Regulatory Experience to Date</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>The United Kingdom 3</td>
</tr>
<tr>
<td></td>
<td>The United States 6</td>
</tr>
<tr>
<td></td>
<td>The European Union 7</td>
</tr>
<tr>
<td></td>
<td>Elsewhere 9</td>
</tr>
<tr>
<td>III. Drivers for Change</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>The Financial Environment 11</td>
</tr>
<tr>
<td></td>
<td>Systemic Risk and Banking Crises 12</td>
</tr>
<tr>
<td></td>
<td>Regulation that Fits the Market 15</td>
</tr>
<tr>
<td></td>
<td>The Limits of Regulation 16</td>
</tr>
<tr>
<td>IV. Predictions and Challenges</td>
<td>17</td>
</tr>
<tr>
<td>V. Conclusion</td>
<td>33</td>
</tr>
<tr>
<td>Group of Thirty Members</td>
<td>35</td>
</tr>
<tr>
<td>Group of Thirty Publications since 1989</td>
<td>37</td>
</tr>
</tbody>
</table>
I. Introduction

A great deal of experience has been gained in financial regulation and supervision since the United States effectively invented regulatory processes in the wake of the bank failures and market abuses of the 1930s. Nonetheless, there are still no blueprints for an ideal regulatory structure. In fact, there is limited experience of how regulation can really be made to work.

In order to understand how fully effective supervision and regulation might be accomplished, it is important to recognize that every country is a creature of its own culture, history and national attitudes towards business standards and practices, and that these factors help to shape regulation. In addition, regulation is only one part of the vital infrastructure within which financial activity takes place, sitting alongside legal and accounting systems. Regulators are expected to learn on their feet, and to do so in the face of many conflicting expectations and pressures.

Both consumers and the financial services industry as a whole, with the media looking on, want protection against institutional failure while insisting that it should be cheap. This places demands on regulatory organisations both for excellence and efficiency which can run far ahead of the regulators’ ability to deliver. The financial problems in Asia, the collapse of institutions such as Barings and Peregrine, abuses such as those surrounding copper trading by Sumitomo, pension mis-selling in the United Kingdom and scams
involving limited partnerships in the US repeatedly have underlined the need for regulators to improve their art as fast as possible.

At the same time, it must be recognized that no regulatory system will or should ever be able to prevent all the ills that regulators must oversee. The only way forward will be for both customers, and the financial industry, to take the requisite care to look after their own and their shareholders’ interests. This in turn will create huge pressure for maximum transparency in all areas of financial services. Transparency is the lubricant that permits market mechanisms to function efficiently, rather than placing undue reliance on regulators. Transparency enables customers to make better informed decisions. It enables counterparties to feel confident in their transactions. It enables market commentators to make better informed reports. It enables regulators to do their jobs better. In short, it enhances confidence in financial processes throughout the financial system.

Unless the balance of power and responsibility—between industry and the markets on the one hand, and the regulator on the other—is itself thought through, and better transparency introduced, the security of the world’s financial system will be called into question. Globally active firms have outgrown the nationally based accounting, legal and supervisory systems on which the safety and soundness of the system has hitherto depended. Unless they can rise to the challenges presented, there is a real danger that investors and taxpayers will suffer, and governments will feel obliged to intervene in ways that can only impede international capital flow and development. The only way to find an acceptable balance between that which is achievable by the regulators, and that which can be relied upon because of the natural action of market forces, is to maximize transparency.

The first section of this paper draws on the recent regulatory experience of various countries to describe the challenges ahead. The second section examines the forces that are driving changes in the marketplace. The paper then concludes with some predictions and challenges for the future.
II. Regulatory Experience to Date

The United Kingdom

The United Kingdom is proof positive that there can be no blueprints for financial regulation, or no enduring ones at any rate. Regulation is a dynamic business, and the pace of development of structures, capabilities and expectations in the UK has been quite remarkable. Experience of how to regulate—and how not to do it—has accumulated at a great rate. In the process the realization has dawned of the value of transparency and the market mechanism.

A brief look at recent history may help. Back in the early 1980s, the UK had no professional regulation of a type recognizable today. Today a well-equipped and seriously capable financial regulator and supervisor, the Financial Services Authority, is being assembled. It will straddle the entire breadth of the financial services industry from insurance to banking, from securities to derivatives, and it will cover both the domestic sector and the huge volume of international activity that operates from the UK. The late Professor Jim Gower was sufficiently prescient in the early 1980s to point to the need for a powerful regulatory body. However, getting there has required a rapidly evolving process of capturing hearts and minds. Firstly it required overcoming some innate suspicions and hostility of the financial services industry. Secondly it took time for the public to absorb the notion that regulators—whether self-regulatory, governmental or otherwise—are not, and cannot be,
omniscient nor can they be a substitute for people taking reasonable care.

In the mid 1980s, the UK government of the day struck a deal with the financial industry. There was a clear political necessity to provide a realistic level of protection to hapless retail buyers of life insurance, pensions or fund management services. But the hostility of large parts of the industry to being regulated was strong: some protested that their integrity was being impugned. There were assertions that regulation would prove bureaucratic and stifle initiative.

In response, the government struck the now well known ‘self regulation’ deal. Put simply, this provided that if the industry would put up the resources and help to develop the necessary skills base, the government would minimize state interference in the industry’s own pursuit of regulation. Firms were required to belong to, and be authorized by, one of several Self Regulatory Organisations, or SROs. In turn the SROs were charged with ensuring high standards, and were recognized in this mission by the government regulator, the Securities and Investments Board (SIB). The extent to which the SIB could intervene in the actual affairs of the SROs was quite deliberately restrained. For example, there was no power to direct the actions of the SROs and, although in theory the SROs could be ‘derecognized,’ this was in reality an unusable “nuclear” device.

What has happened in the ten years since that deal was struck? First, the good news: industry did provide the resources and there are, as a result, many high quality people engaged in the regulatory process today. Understanding what does and does not work grew rapidly, as did understanding of what regulatory processes worked best for different parts of the financial services industry. A basic structure was put in place to carry out authorization, supervision of firms, discipline, complaints and compensation arrangements. It is hard to imagine a faster way to have created all that.

But the downside was equally apparent, embodied in the ‘self’ word. Politicians, the public and the media could not believe that the regulators could really be on the side of the investors, particularly when faced with scandals like pension mis-selling. Although the problems were caught and addressed by the regulators themselves, action was a lengthy and the laborious process did little to inspire public confidence. The system appeared to be duplicative and wasteful. Discipline appeared slow and flabby. Public squabbles
erupted amongst the regulators over who was boss, the state or the SROs. In short, the credibility of the system was placed in serious doubt.

It needed a change of government in 1997 in order to address these issues. The incoming Labour government had determined prior to the election that it would create a fully statutory system, with a single-minded and powerful regulatory body empowered to eliminate the deficiencies. To do this, the new government had to judge that the mood of the public and industry would enable the necessary legislation to be introduced, without undue delay and complication. This would take courage; legislation in the securities area is never easy. There are no proven blueprints, and there are many vocal interest groups with divergent wishes and views. But legislative and administrative processes are now under way to merge the nine existing regulatory bodies that cover the fields of banking, building societies, securities, exchanges and markets, cash and derivatives together with insurance, into a single new regulator.

This venture demonstrates a determination to build on the experience and resources of the old system. It is quite noteworthy that after only ten years, the government has judged that the will and mood of industry, consumers and the public has shifted so far as to encourage the government to take such robust action. This is a source of amazement to observers, particularly in the United States, but the mood in the United Kingdom seems quite clear.

Without a fundamental shift of attitude towards greater transparency, this overall consensus could not have emerged. For example, although a few still dispute it, it is increasingly clear to firms that informing customers clearly about what is on offer, costs and all, is good for business. This is a dramatic change from the old patronizing attitude of ‘they won’t understand, so we won’t tell them.’ If ever this old attitude was discredited, it was in the pensions incident. In the early days of UK regulation in the late 1980s, respectable firms sold personal pensions in great volume without taking sufficient care to learn their customers’ real needs. This sometimes involved obfuscating the truth, with commission-hungry salespeople pulling the wool over their customers’ eyes. The net result was many hundreds of thousands of disadvantaged customers, reputational damage to the industry, and a bill for compensation payments and administrative costs that seems to be running to many billions of pounds.
It is not only in the area of sales practices, however, that people are beginning to see the benefits of transparency. The same is true for the users of financial markets. The London Stock Exchange, for example, has recently and belatedly moved to an order-matching system that is, in principle, far more transparent than the quote-driven system it replaced. Commentators are better informed in their reporting on all aspects of financial services. Regulators too are learning to be more transparent and to make the cost and benefit, the predictability and the fairness of the regulatory system more easily seen. In short, the virtues of transparency are now beginning to shine through, and statutory backing to underpin and enforce better transparency is generally being welcomed from all sides.

Few people would have foreseen just how fast all this would happen in the UK, or how much it would improve the quality of sales practices. Misleading practices that were once ignored by the industry are now frowned upon, ostracized or punished, while customers have woken up to the fact that they must take some care and interest in their own decisions. This may not be Utopia, but considering the cultural starting point, to have made all these changes in less than half a generation is quite an achievement.

The United States
The history of regulation in the United States is a very different matter. Transparency has been central to the US approach since the very beginning in the 1930s. Today, the wealth of US experience, particularly in relation to market regulation, is a source of knowledge and help to regulators in many other countries. The scars of the 1930s are nevertheless clearly marked both on the structure of the industry and on its regulation. Market and regulatory fragmentation between banks and security houses, as well as between cash and derivatives, is very pronounced. So although US regulators have built up a wealth of experience, the regulatory process has not developed in parallel.

There are a number of reasons for the slow pace of change. The longer a regulatory structure is in place, the more difficult it becomes to change it. Industry will increasingly structure itself to reflect the regulatory structure, and will then tend to resist changes that could affect the competitive balance. Politicians too are wary of change. No one can prove that change will create a better system
for protecting the public, and the political risk of change may be high. In addition, the passionate disagreements between what are often diametrically opposed interest groups, marked by intense lobbying and large political contributions, complicates and lengthens the political process and can submerge the overall public interest.

Furthermore, conservatives point to the great success of America’s financial services’ industry under the existing regulatory system. US firms are vibrant; the US is the world leader in product innovation; its markets are amongst the most transparent (and attract colossal volume); attitudes of firms to the need for compliance are strong; and customers on the whole do not expect regulators to make decisions for them. All this has happened despite the bureaucracy, the expense, the lack of responsiveness and litigious nature of the US system, which is so often heavily criticized.

Finally, even though regulation inevitably introduces distortions, not all of them have been negative. One clearly damaging distortion was the series of restrictions that led the international capital market to develop outside US borders, even though it is largely based on the dollar. On the positive side are the very stiff net capital requirements for positions on the books of securities firms. This is in no small way responsible for the development of a strong culture favoring distribution, risk management and control at the major US securities firms. This culture has, in turn, placed them far ahead of most of the competition in the global arena.

The European Union

The case of the European Union deserves special mention for several reasons. Firstly, as it liberalized financial services the EU recognized that standards of service, behaviour and regulation were too low. Until a few years ago insider dealing was not an offence in many countries of the EU. Practices whereby dealers in banks could put their own interests ahead of their clients’ were widespread; indeed in some cases they provided part of their anticipated remuneration. If Europe was to have a chance at competing—both externally with the US, and internally as between centers in continental Europe and London—it had to get rid of the old practices, open up to competition and develop a regulatory system to suit. To that end, the EU directives lay out a framework for investor protection and prudential supervision on a community-wide basis and were designed to breathe life into the single market.
Secondly, and in a global sense more importantly, the EU has developed a framework for a truly interdependent system of regulation. It is common knowledge that regulation is nationally based, whilst the businesses and markets being regulated are increasingly global. This mismatch will not go away, and indeed will become more marked as the internet and other new technologies break down boundaries yet further. If regulators are to have any chance of supervising firms on an international basis, they have no option but to pursue mutual reliance on each other. The alternative would be a nightmare whereby supervisors in each jurisdiction sought to satisfy themselves on the global condition and operations of individual groups, which would be quite unworkable in practice. There are however no blueprints between individual nation states for developing this mutual interdependence, and up until now precious little agreement on how it could develop. Supervisors are, after all, answerable to national legislatures. They want to avoid the possibility of having to admit that things went wrong because they had placed unwise reliance on their opposite numbers in third countries.

The EU model attempted to find a way round this general problem, and came up with a mechanism that actually requires supervisors in one state to rely on the skills and judgements of their counterparts in other states. Interdependence is not just a matter of enlightened self interest, but is actually required as a matter of law. This is done through the concept of “home” and “host” state regulators.

Under this scheme, the prudential integrity of the firm is the responsibility of the home state regulator; in practice, where the ‘mind and management’ of the organisation is based. It is simply not realistic for regulators in the many states where a financial firm operates to opine on the fitness and properness of a firm to conduct business throughout the EU. Accordingly, each ‘home’ state regulator will have to conduct their work so that the standards which they try to uphold are recognized by and found acceptable to each of the others. Importantly, these others are required to abide by the judgements of the home state regulator, actually enforcing this system of mutual reliance.

In contrast to prudential supervision, the way in which a firm conducts its business and interacts with its clients is a matter for the host state in which it is conducting those operations. There
seems to be general agreement that sales-practice regulation has to be accomplished according to the cultural norms and legal requirements of the host. Over time it is true that there may be convergence that could lead to a common regulatory approach, but such culturally dependent change cannot be legislated. It will come about through contact and communication via TV, travel and the use of the internet. This, in turn, will cause a common view to emerge among customers, industry and the media regarding what sales practice standards are practical and feasible. In the meantime, it makes sense for the host state to have this responsibility.

This is an important experiment which could prove capable of far wider application. Better mutual reliance mechanisms have to be developed between the world’s great financial centers and markets: between the United States, United Kingdom and Japan, for example. In this wider context, and in the absence of global government, the EU experience is likely to provide a useful model.

Moreover, attitudes towards transparency are also beginning to change. The UK is in the vanguard in the area of sales practices, but attitudes are also changing in continental Europe, particularly as regards markets. Ideas and approaches to improve transparency appear on the agendas of most meetings of EU securities supervisors.

There is, however, a particular problem that has to be overcome if the EU experiment is to succeed; that is, the hitherto widespread reluctance of supervisors in much of continental Europe to consult with the industry they regulate. There seems to be less suspicion and a less dirigiste view in the UK, based on a history of consultation and mutual reliance. It is essential that supervisors pursue a dialogue with those that they regulate.

Elsewhere
Looking at the rest of the world, there are some significant bright spots. In countries like Australia and Hong Kong, a combination of a sophisticated financial system, political will and consumer interests has created transparent and well developed regulatory processes. Equally, however, there are some decidedly dark zones which do not offer so much promise for the international financial system. To be sure, efforts are being made to remedy the situation, but the criticism “too little too late” is all too apt in developed countries like Japan and Korea, as well as in emerging countries such as Thailand and Indonesia. Rapid changes in regulation and
infrastructure will be needed in all these countries. The markets will be truly unforgiving if the necessary political and cultural adjustments are not made, and the world’s financial markets will suffer if this happens. One way in which this could occur is that, under pressure to diversify portfolios and meet performance goals, international portfolio managers will simply avoid poorly supervised and opaque markets.

The lack of transparency in Japan, and the inadequacies of its financial regulatory system, are quite firmly engrained in the culture of the country. The very fact that the legal, accounting and supervisory infrastructure is so underdeveloped creates the need for ‘administrative guidance’ by the government in a whole range of areas. This effectively makes the government responsible for a host of business decisions. Planned economies, particularly developed ones, have been shown ultimately to fail as market forces prevail, and the danger of this happening in Japan is not negligible.

The unravelling scandals in relation to sales practices, the misleading nature of balance sheets, and opaque market practices generally are threatening the substance of the financial system in Japan. Japan badly needs to embrace transparency and to develop sophisticated regulatory techniques and structures. Signs exist amongst the professionals that this is well recognized; the question is whether the political will can be found to achieve it. Japan surprised the world with its dramatic approach to change at the time of the Meiji restoration at the end of the last century, and again in 1945. The burning question at the moment is whether Japan will do so again?
III. Drivers for Change

All of these developments suggest a number of drivers for change in regulatory processes and structures. The direction of change is already clear in some countries and, while the drivers are of universal application, their effects and the speed of change they cause will vary depending on the starting points of the countries and their cultural inheritance. There seem to be four main drivers, all of them pointing to greater transparency: requirements of the general financial environment; concern over systemic risk and banking crises; the need to fit regulation to the market; and recognition of the limits to what regulation can achieve.

The Financial Environment

There is little need to dwell on the changes that are easily observed in the marketplace. Greatly increased competition and technology have helped to create multiple options and choices for firms and consumers alike, and the range of these choices will be compounded by the internet and associated technologies. Those with cherished visions of the sovereignty of the nation state will see that sovereignty increasingly eroded. All of this not only confers huge potential benefits but increases hazards for the investors who provide funds to the markets and the firms that use the markets. It also presents commensurate challenges to their regulators.
In turn the old distinctions between banking, securities and insurance have become increasingly irrelevant as far as the products on offer are concerned, and the way they are created. Loans are increasingly securitized. Deposits and money market funds are increasingly interchangeable. Hedging and insurance techniques and approaches permeate the whole financial services system.

Furthermore, the disintermediation of traditional deposit-taking and lending by securitization and insurance-type techniques will continue. This will squeeze the traditional retail deposit gatherers unless they can find other ways to leverage their strengths and capabilities. There will, in effect, be less ‘banking’ and more ‘securities’ type activity, both at the retail and wholesale levels the impact of which will be significant for regulatory structure.

The pace of change has of course been accelerated by the manner in which the banks themselves have attempted to respond to the squeeze. Many have made quite dramatic forays into areas that they did not really understand, such as investment banking or lending at high margins to poorly understood counterparties. These attempts often ended badly, destroying shareholder value and weakening the banks further. A few are now seeing the wisdom of deviating less spectacularly from their core strengths and traditional lines of business.

At one level, therefore, the distinction between what is a bank, a securities firm or an insurance company has become less relevant. This is a powerful driver of change for regulators who have to organize their structure and resources to respond to these new challenges.

**Systemic Risk and Banking Crises**

The blurring of corporate (and jurisdictional) lines compounds concerns about the sheer size of market participants, the number of new entrants especially from emerging markets, the size and speed of financial flows and the development of new and sophisticated products like derivatives. Not only are they all potential sources of systemic risk, but taken together they pose increasing challenges for the hitherto successful, but rather improvised, system for handling crises. The spectre of a potential shock of large proportions is certainly concentrating minds, and will prove a powerful driver for change.
The reason is that, beyond a certain level, the social cost of failures and their knock-on effects become politically unacceptable, seriously disrupting the financial system and requiring governments to consider using taxpayers money to limit the damage. Sometimes the money may only be needed temporarily to ease liquidity problems. Sometimes the costs become permanent where restructuring is needed, or real economic damage has occurred.

It is paradoxical that, although financial products offered by firms are now interchangeable, the systemic significance of the various firms offering them differs significantly. This is, in part, because of the differences in expectations people have about deposits, securities and insurance policies. For example, bank depositors expect to get their money back in full and on demand, while investors in securities accept an element of risk in the value of their assets, and life policyholders regard the long term promise of payment as absolute.

These expectations, and the contagion that can arise if the general public believes they might not be met, are a source of systemic risk. In the old days, coping with systemic risk was the exclusive preserve of the banking supervisors. Because of their operational capabilities to inject liquidity and cope with failed banks, this was often in practice the central bank. Today, the understanding and ability to deal with systemic concerns need to be more widely spread, particularly with securities supervisors. Many deposit-taking institutions are also big players in the securities world and their soundness could be affected by securities losses, as was discovered in the case of Barings. The size of the big securities firms is now so great as to give rise to genuine systemic concerns if there was to be a failure. These developments were a factor in the decision to bring banking and securities supervisors together in the UK. Other countries, including the United States, are feeling similar pressures.

Few supervisors have developed and been able adequately to test the structures needed to cope with this new environment. The intermingling of securities and banking activities has caused the transmission mechanisms for systemic risk to became ever more complex. These changes have outpaced the ability of the regulators to keep up, not least because they are dependent on legislative authority to restructure, and to hire and train staff. Nor have they been able to ensure a flow of information adequate to provide early
warning of impending dangers so that timely remedial action could be taken.

These problems and complexities are difficult enough in a single economy, within a cohesive legislative environment. On an international scale, they become even more intractable. The freedom of financial firms to operate globally only emphasizes the mismatch between the scope and scale of their operations and the reach of supervisors whose powers are national. The concern that taxpayers in one country might find themselves paying for failures in another heightens systemic concerns while limiting the scope for cooperation between nations.

In considering how significant the risk is, it is worth remembering the disturbing history of accidents over the last fifteen or twenty years. On a domestic level the banking failures such as those in Scandinavia, the US S&L disaster and Japan’s present travails speak for themselves. Internationally, however, the LDC debt crisis of the 1980s, the more recent Mexican crisis which spilled over into the rest of Latin America and the continuing and spreading emerging market problems that developed in Asia demand international attention. Indeed, the problems in emerging economies are exposing the frailty of today’s regulatory system, making clear the limits of a purely regulatory approach to the problem. There is a growing need to develop mutual dependence between regulators in a way that is acceptable to national governments and legislators.

While the systemic driver for change is becoming increasingly compelling, the question remains as to what sort of change is required.

- One serious school of thought argues that financial risks have become so complex that the best course of action is a reduction in intervention by supervisors. This school argues that it is best to let the market sort out problems: let firms fail and restructure, and let the tough lessons that people will learn mitigate the problems in the future. However, it is inconceivable that governments could afford to stand back in all cases. The economic disruption and potential social conflict may be so great that the balance of argument is to intervene.

- Sound judgements about when intervention is necessary must recognize that significant failures are indeed salutary. The judgement to let Barings fail was clearly right, and much was learnt from the episode, both by the industry and by the
regulators. But what about Credit Lyonnais? There is little doubt that too much—or perhaps too predictable—a level of intervention creates moral hazard and ultimately can weaken the very system it seeks to support. Equally, effective market discipline requires the possibility of failure: knowing you can fail is a powerful motivator of responsible behaviour.

- Thirdly, there is a big premium on developing prophylactic measures to foresee when the volcano is preparing to erupt. The best protection of all is information, produced through transparency. If the Korean authorities had made known the dramatic increase in foreign currency debt of the private sector, by publishing information or advising authorities elsewhere, market forces and pressure from other supervisors might have produced remedial action before the collapse. Similarly, if the true extent of Japanese bad debts had been exposed earlier, perhaps the end result would have been less painful.

When authorities in different countries share basic information, the informal mechanisms that exist have been pretty effective at finding solutions. In the same way, if the market has better information and gets sufficiently early warning of problems, it takes corrective action in relatively less disruptive ways. So far such informal actions have contained the damage, even in spectacular cases such as the Latin American debt crisis. The question is how good can they be at fending off problems in the new environment.

Regulation that Fits the Market

The need to ensure that regulation affords the proper level of protection for users of financial services, and is suited to their level of sophistication, is a further driver for change. A case in point is the continued demand for improvements in sales practices. Different countries begin from sharply different starting points, with the UK, US and Australia having strong consumer movements in the vanguard. But more broadly, the pressure by governments, media and consumers to address information asymmetry, to ensure that customers are offered a fair deal, and to improve sales practices will be relentless. Companies must anticipate and respond to those demands in ways which customers support, whilst supervisors have to develop more sophisticated supervisory approaches, including dealing effectively with abuse when it is discovered. In the UK, a very large proportion
of regulatory effort has been expended in this area; other countries are likely to feel similar pressure.

Similar pressures arise in the essential distinction between wholesale and retail activity and the sophistication of the customers involved. More and more supervisors have made this distinction and are trying to find ways of applying strong controls on retail sales practices, but with a lighter hand in the wholesale area. In the UK much effort has been devoted to getting the balance right: tightening up sales practices in the retail arena but setting those requirements aside for the sophisticated players.

The Limits of Regulation

The increasing realization that regulators cannot ‘do it all’ will itself be a driver for change. If the regulators are to deliver what is expected of them, there must be a partnership between the power of the regulator and the forces of the market. From this can emerge acceptable and reliable standards, both of sales practice and of prudential and market supervision.

To achieve this, the regulator must be able to understand the way the market forces work. Finding where the balance should lie as between regulatory pro-activity on the one hand, and the passivity of letting market forces work on the other is a real challenge. What is clear however is that the greater is transparency, the more market forces can play a role. Growing understanding that this is so will be the driver for change.
IV. Predictions and Challenges

Given the issues and conditions facing regulators, it is possible to offer some predictions as to what lies ahead. These conditions also suggest a few paradoxes and areas where definitive solutions do not exist. First, there are a number of areas in which convergence of approach is likely.

Convergence

Structure. As the artificiality of existing regulatory boundaries becomes a burden on efficiency, the fragmentation of multiple regulatory bodies should be reduced. The example of a single centralized regulator in the UK will be scrutinised very carefully; there are already moves in the same direction planned in Australia. The US will feel increasing pressure in this area, and there has been speculation that a merger of the SEC and the CFTC could one day take place. In the banking arena a lot will depend on the speed with which the repeal of the Glass-Steagall legislation takes place. This may be slow, given the strength of vested interests, but a serious financial disruption could encourage the politicians to act. Countries like Korea may well make very rapid moves towards a more centralized structure as they respond to the present crisis. Japan has already announced the creation of a Financial Supervisory Agency, but the practical effect of the change remains uncertain.
There will be several major challenges in managing regulatory consolidation: to prevent bureaucracy; to ensure responsiveness to actual conditions facing the industry; and to prevent arrogance and abuse of power. Every country will need to seek its own balance, and the UK is certainly very aware of these dangers. What does seem clear is that the more modest in size is the financial services sector, the easier it is to centralize. Examples include the Scandinavian countries and Singapore, which moved ahead of the UK’s decision. The US, with its vast number of players is likely to move neither as fast nor as far as smaller economies.

**Philosophy.** This is the ‘how’ of regulation. Here again there is likely to be convergence, as regulators in different countries face the same problems and begin to learn from each other about the best ways of dealing with them. At present, however, there is a fundamental difference of approach between the US and the UK with respect to securities regulation.

- The US approach sets out to be completely objective. Any firm that meets set and stringent criteria—strong capital, no personnel with criminal records, etc.—is allowed to register and can then carry out its business as long as it continues to obey the relevant rules.

- The UK requires the firm to be deemed, that is judged, ‘fit and proper’ before it can operate. Naturally the regulator uses objective facts as far as possible to assist the decision. But at the end of the day, although the judgement can be appealed, the judgement is for the regulator to make.

The need to rely increasingly on regulatory judgement seems to be inexorable, particularly as differential supervisory treatment becomes a more important technique.

**Objectives.** The underlying aim or purpose of regulation has historically differed among countries. For example, in the 1930s the emphasis of US regulation was on abuse of the markets, such as false prospectuses and scams of various types. In the UK the basic thrust was rather different, focusing on sales practice rip-offs and scams in the fund management industry. Little wonder that the UK developed its approach to sales practices much earlier than it did towards market integrity, in which area regulatory legislation has been pretty threadbare.
Over time, convergence is taking place. The consumer movement in the US has identified poor practices that are now being pursued by the regulators: in the sale of participations in limited partnerships, insurance mis-selling and stockbroker discipline. On the other hand, in the UK the integrity of the markets is now attracting regulatory attention. Other countries will experience similar stimuli in the future. In Japan, for example, the need to improve sales practices may become an issue partly because of foreign investors, who will shun the Japanese markets if they are not confident of getting a fair deal.

Legal approach. There are several aspects to the issue of law. First is the manner in which market abuse is addressed. In the UK, if a company director indulges in insider dealing, the civil regulator has few if any sanctions available; it is a matter for the criminal courts. Yet the criminal prosecutors find it difficult to convict people for such offences because of the requisite high burden of proof necessary for the courts to deprive someone of their liberty. So the integrity of the market suffers. In the US the powers of the regulator range much wider, leaving open a certain ambiguity as to whether a civil, a criminal or conceivably elements of both sort of penalty will be attempted by the relevant prosecutor. This contributes to the higher proportion of cases that are disposed of with some penalty for the perpetrator, and raises the respect in which the system is held. The UK is looking with interest at the US system, and although there would be no question of transporting it wholesale to the UK, there is likely to be convergence over time between the two approaches. Aspects of change in this direction have been included in the draft Financial Services and Markets Bill, now published for consultation.

A second area of difference is in the approach to litigation. The UK has been keen to avoid what it perceives to be the highly litigious approach in the US. The legislation in the UK certainly provides for litigation where unsophisticated investors become aware that firms have overstepped regulatory bounds. Nonetheless publicized litigation cases, whether shareholder class actions or accusations of improper conduct between professional parties, have been less visible in the UK although this may change over time. Again, there does seem to be some convergence. For example, the Maxwell pensioners were to a large extent made good by out-of-court settlements, where the threat of litigation (and the attendant
reputational damage) was very much on display to the firms involved. There is likely to be more general use of litigation, or the threat of it, as the legal profession and the courts themselves feel more comfortable in basing judgements on regulatory principles.

Efficiency of Regulation
There is strong pressure for regulators to be more efficient and ways are being sought to help to measure efficiency in different countries. Again, there is likely to be convergence as regulators share their experiences on the best ways to deal with what are often very similar problems. The whole area of cost-benefit analysis in regulation is likely to become far more developed.

Differential Supervisory Treatment and the Use of Judgement
This is a very difficult area, but differentiating the level of regulatory attention to firms will become more important as regulators are forced to focus resources where they will have the greatest impact. It only makes sense to say ‘we will spend less time on you if you can demonstrate that you conduct yourselves appropriately.’ Why expend scarce regulatory resources where they are not needed instead of where investors’ interests are really likely to be threatened? Surely the intensity of regulation can be adjusted for those who have been able to demonstrate a strong ethical and compliance culture? But it is not easy for regulators to judge who is good and who is not, certainly looking into the complex future.

Nonetheless, these sorts of judgements will have to be made and if such judgements are to be respected both by the firms involved and the public, people of very high quality will be required. Who will pay for them and where will they come from is a real problem area for regulation today. The skills needed to make these judgements credibly are often the same skills as those needed by the industry itself: particularly within the area of operations and controls. The industry pays increasingly well for people in these areas, yet in many countries regulators are locked into civil service pay scales or something quite close to them. In this circumstance, it needs a strong sense of public service to get people to stay in regulation. Naturally this problem can be mitigated by the challenge and interest of the work, and the fact that a stint as a regulator is increasingly seen as a career enhancing move. Perhaps in addition,
the industry itself may be persuaded to make good people available through secondments.

There are already some moves towards employing differential techniques in the soon-to-be-merged UK regulatory bodies. Overall risk ratings are being devised for banks and firms, that inform both the firms about what standards are expected of them and the regulators about how much resource to devote to the firms. Differential capital requirements are being used in some cases based on the judgement of the regulator as to how sophisticated the firm is in its risk controls. Penalties will tend to be more severe and public in the case of firms that have demonstrated flagrant and wilful non-compliance compared with generally compliant firms who have made a mistake.

A further dilemma arises in this area because of the systemic dimension of financial regulation. A firm may be very sophisticated in its use of capital and hence feel entitled to request a lower capital requirement compared to other firms. But systemic concerns could point in the opposite direction. If the bank is very big, its failure could be dramatic, and expensive for the taxpayer. So even though the chance of failure may be very low, the regulator may demand higher capital to support a given quantity of assets than it would require for a smaller, less sophisticated firm. This would be very strong medicine to swallow for big organisations with sophisticated management controls: being effectively penalized for size and potential systemic risk. Moreover, the possibility of signalling to the institution that it is regarded as being of systemic importance can trigger moral hazard.

More will be heard on this subject, particularly as the concept of ‘precommitment’ is developed further. And while some supervisors may fear that differential standards imply lower standards, there are likely to be significant advances in the sophisticated use of differential techniques in the future.

**Complex Groups and Lead Regulation**

As noted earlier, the absence of global government in the face of large, globally active groups, presents difficult challenges for national supervisors. Confronting these challenges successfully will require particular effort, determination and judgement. But it is an area where a great deal of effort is being deployed, and real progress can be expected.
The basic challenge is to create a system of mutually interdependent and reliant supervisors in the absence of a global authority. The challenge has two parts: assigning leadership, and providing an agreed basis for action. Developing effective leadership roles for particular supervisors requires that the other supervisors see the leadership role as both necessary and informally “legitimate.” In addition, an agreed framework is needed as a basis for such “leaders” to act. This framework is really a set of standards to which firms are expected to adhere, encompassing common understandings and shared views on acceptable behaviour. Furthermore this system needs to function both in time of crisis and in normal times.

Accepting another supervisor’s leadership is actually easier in times of crisis when the need for quick action forces co-operation, and the adrenaline of the moment often provides solutions. In practice, informal cooperation has worked quite well once a crisis has hit; take for example the handling of the Mexican crisis and the international actions being taken in relation to Asia. The question of the hour is whether today’s informal arrangements will continue to work as groups get more complex, money flows grow larger and market swings become more volatile and unpredictable. Increasingly the view is that the status quo is not satisfactory.

In “normal” times, accepting another supervisor’s leadership is more difficult. There is no adrenaline; no sense of urgency; no grim determination. Problems often lie hidden, even where flashing amber lights would be all too visible with sharper vision and better understanding of the global firm. How can an international approach be crafted that would both detect the amber lights in the first place and then stop them turning red and precipitating a crisis? That is the question to be answered in order seriously to mitigate systemic risk and to reduce to acceptable levels the costs of the disruption that results. Today’s informal arrangements are simply inadequate to the task.

In order to develop the concept of international lead regulation, it is helpful in the first instance to look at how this is done in the domestic context and then to move across borders. First, within any given country, the parties that are responsible for handling systemic risk are basically three in number.

- The government. Normally the leading role would be played by the Treasury or Ministry of Finance. If a systemic accident
occurs, someone has to decide whether taxpayer money should be used to stem its effects, and that agency must have the power to make it available.

- **The regulator or supervisor.** In many cases this will be the banking supervisor, although supervisors of securities and insurance firms may also have a role to play because these firms are increasingly seen as potential sources of systemic risk alongside banks.

- **The central bank.** In many countries the central bank and the supervisor are one and the same. This was formerly the case in the UK but ended with the transfer of banking supervision into the Financial Services Authority, now the consolidated regulator. Central banks will nevertheless remain as the agencies with the capability to actually handle a systemic event: by injecting liquidity and advising whether the event is a liquidity problem or one that may require longer-term injection of taxpayer funds.

Suffice it to say that as soon as there is a systemic event, there will be three vitally interested parties. To the extent that the regulatory process is fragmented, as in the United States, the number of interested parties will increase. In the domestic context, practical ways are being found to handle the problem of cooperation. In the UK, for example, a memorandum of understanding has been drawn up among the Treasury, the Financial Services Authority and the Bank of England, setting out the relationships and responsibilities for systemic events. This may become a model for other countries.

Matters become even more complex once the international dimension is introduced. If a systemic event has occurred, in which country did it occur? Which country’s taxpayers should pay? Who is best equipped and has the relevant expertise to handle it? Who has the necessary information? In short, who should call the shots? Should the same leadership apply in time of crisis and in normal times? It is no wonder that institutions like the IMF and World Bank are being drawn in to act as proxies for governments, and that a vigorous debate has been joined in the Joint Forum to find ways of approaching these questions.

Beyond who will lead, there is the question of functions for which “leadership” would be exercised. It could be something as
simple as gathering information, or a more active role as disseminator of information to other supervisors. It could imply the responsibility to take disciplinary action against firms in case of bad behaviour, or it could be more passive, relying on others to act. It could involve acting in times of crisis only, or having a continuing role in normal times. It could cover only selected international financial groups or involve more comprehensive coverage of firms.

Complicating matters is the fact that each of the supervisors has duties laid down by its legislature and, given the piecemeal fashion in which these duties are set down in law, there are bound to be gaps, overlaps and the potential for turf disputes. Few if any countries have legislation that could serve as a blueprint for coping with systemic risk. Naturally supervisors are reluctant to take on duties for which they have no authority, or where their involvement gives the false impression that they are so empowered. In practice, therefore, handling systemic events requires pragmatic solutions, relying on a mixture of fear and goodwill to sort them out.

Again, the UK experience is instructive because forms of lead regulation have been followed for some years. The Bank of England had authority for the prudential supervision of banks and acted as their lead regulator. At the same time, the Securities and Futures Authority was responsible for their securities activities, the Personal Investment Authority for sales practices and Investment Management Regulatory Organisation for fund management. The Financial Services Authority now brings all those organisations under one body and, within the FSA, there will be a coordinated approach to regulation of big, complex financial groups. Equally, the EU experience with home/host country division of labor is relevant in the international context.

There is likely to be increasing experimentation with lead supervisors or co-ordinator mechanisms. The models tested are likely to vary from firm to firm, from business sector to sector, and from country to country.

Standards

Regardless of who is in the lead, a set of standards is needed to provide a yardstick for measuring firms’ behaviour and a trigger for action in the case of deviation. But many questions arise in devising international standards, just as in deciding the leadership
question. What areas should be covered and how should standards be drawn up? What should be done in the case of violations?

In the first instance, agreed prudential standards are needed for capital, internal control procedures and risk management. Supervisors will want to be confident that global firms have established procedures to control the market, credit and operational risks they face, and satisfied that the control procedures actually work and have been verified. Among the operational risk requirements is a set of professional standards to limit the reputational and financial damage that can be done by improper or illegal conduct.

This is an area that deserves special attention because it is all too often neglected. The challenge is to direct human nature in a realistic way to control and mitigate business risks rather than exacerbate them. Ensuring the people do the right thing is a complicated undertaking, requiring investment in people and controls and attention from both management and boards. It is going to get more difficult as organisations become larger and more complex. But the reputational risks for a firm when there is a lapse of professional standards are high.

Standards in all these areas would be helpful, firstly because deviations from the norm would signal problems at an early stage, before a crisis emerged, offering supervisors a chance to assess whether there was cause for concern and action. Secondly, they could be helpful in determining trigger points for action as concerns mounted, indicating where action should be taken and by whom. To be fully effective, the standards would have to be adopted both by globally active firms and by their supervisors, who would require the firms to conform to them. A widely accepted set of standards, embodying shared understandings about proper firm behaviour, would be essential if supervisors are to build faith in the judgement of a lead supervisor.

The question then is how such widely accepted standards can be devised. One possibility would be for supervisors themselves to establish a set of prudential standards covering capital adequacy, control structure and the like and simply insist that these be met by the industry. In practice, however, this would never be possible without the industry and market telling supervisors what to look for; the relationship between supervisor and supervised is to this extent symbiotic. Therefore, industry leaders themselves must develop the standards, based on the realities of their business and the
prudential concerns of the participants. After all, it is they who know the dangers they face and it is they who have had to develop the necessary controls.

Work along these lines is already underway in various countries and is being pursued globally by the Group of Thirty, which proposed an industry forum to propose a set of standards in its report entitled “Global Institutions, National Supervision and Systemic Risk.” Under this plan, supervisors would ask the firms themselves to develop proposals and, once they felt comfortable with them, supervisors would monitor and supervise the firms based on their adherence to the standards. A key problem in carrying out this procedure will be to avoid even the impression that industry is calling the shots. That would obviously be unacceptable, and supervisors must clearly be in the driving seat.

Given the growing enthusiasm of supervisors to consult with industry, a greater role for industry in regulatory standard setting, if not an industry-inspired set of standards, is sure to emerge. At a minimum, the process of dialog is likely to produce a common vocabulary and widely accepted supervisory concepts. But leadership will be needed to bring the process to fruition.

Reliance on Market Mechanisms

A theme of this paper has been the need to improve transparency so that supervisors can rely more on market mechanisms. The pressure to move in this direction is strong, providing a driver for change. The challenge for the supervisor is judging how far to go in relying on the market.

Some governments may follow the example of New Zealand, which has eschewed a supervisory role for government in new legislation, placing reliance on the full financial disclosure required by law and effectively telling the country that ‘caveat emptor’ prevails. There has been little enthusiasm to follow this route elsewhere and regulators will be understandably cautious in this area. Experimentation will be needed to build a base of experience and strike an acceptable balance between reliance on the market and direct oversight.

Sales Practice and Market Regulation

The driver here will be towards higher standards and better practices. Disclosure, transparency and plain language will be the way in
which this is delivered. These will even become a basis for competition. *Tradepoint*, a privately owned exchange, was set up to compete directly with the London Stock Exchange and, in the process, encouraged the LSE to move vigorously towards greater transparency. This episode caused many exchanges worldwide to review their ownership structures and ensure that competition is based on market forces, rather than the club-like, dealer-owned mutual or co-operative structures from which many of them sprang.

**Financial Infrastructure**

An area that has attracted relatively little public discussion is the supervision of the infrastructure, or “plumbing,” within which financial services operate. This includes institutions that constitute the infrastructure, such as clearing houses, and payment and settlement systems as well as the legal, accounting, and insolvency framework that supports the system in each country.

Looking first at the institutions, the fact that payment systems in particular have been well supervised by central banks does not mean there are no challenges ahead. The robustness and integrity of the systems must be examined, to say nothing of the ways in which such organisations are governed and controlled operationally. The fact is that a failure in this area could produce systemic consequences as serious as the failure of a major firm or the closure of a major market. Supervisors will see the need for standards in this area too, and will require the input of the people running such systems as to what they should be.

Turning to the legal and accounting framework, unless it is both sophisticated and reliable, not only will business development be hampered but the potential for systemic disruption will rise. The serious inadequacies found in Japan and Korea have focused attention on the issue. In addition, work is underway in the International Accounting Standards Committee, which is trying to devise a set of universally acceptable accounting standards, and IOSCO, which is encouraging governments to clarify the legal status of netting, default procedures and the segregation of client funds from those of the firm which is holding them. While considerable energy is likely to be devoted to achieving progress in these areas, progress is also likely to be slow.
Transparency

The need for greater transparency has been the main theme of this paper, but it must also be recognized that there are limits to transparency. And there are forces at work making it more difficult to achieve.

Derivatives. The accounting treatment of derivatives, and the difficulty of tracking their effects on a firm’s financial position in real time, are thorny problems. For all the benefits they offer in identifying and hedging risks, it is as though the use of derivatives itself keeps the attainment of full transparency just out of reach. This is a problem for management because it not only makes internal control more of a challenge, but undermines confidence that they can know the true financial position of their counterparties. In consequence, supervisors find it hard to be confident that acceptable control standards are being achieved or a strong financial position maintained.

This is another area where there will be increasing supervisory attention. Possible solutions to the problem range from descriptive statements on derivatives exposures, already an increasing feature of the annual reports of financial services organisations, to independent verification of accounts to certify changes in market values. A major problem is that the more derivatives a firm has on its books, the closer the information requirements of the market and regulators come to real-time verification, and no one has figured out the best way to accomplish that. Verification, in turn, puts added pressure on the accounting firms. No wonder supervisors have questioned the reduction in number of big public accounting firms through actual and proposed mergers.

The internet. The advent of the internet has introduced a new set of challenges that permeate all areas of regulation. Among the challenges, paradoxically, is reduced transparency. At the level of the retail public, the internet empowers. It puts a wealth of financial information and products at individual fingertips, and the immediacy of interaction enables the customer to satisfy him or herself fully, online, about products on offer and to purchase them directly. In itself, this is no bad thing, although it will be a powerful force for further financial disintermediation going forward. However, internet transactions give rise to two concerns for supervisors with respect to fraud.
First is the prospect that the public may fall for a scam on the internet. People’s innate caution may make them careful about dealing with unknown parties, but they may also place faith in the internet’s capacity to rapidly spread the word of a rip-off. On balance, it is not clear that there is any greater cause for concern here than the danger of people falling victim to scams in the mail or over the phone.

However, if people do fall victim to scams, it is not clear how regulators will be able to intervene or provide a satisfactory level of protection to consumers. Some very basic questions have to be answered. Where was the intermediary located? Who, if anyone, supervises it? Who had an opportunity to take a view on whether its promises were deliverable? From whom could the investor seek redress if cheated? These problems are challenging supervisors and may at first appear intractable. But as with control of pornography on the net, solutions will be found.

*Moral hazard.* A further twist arising out of the supervisor’s duties with respect to systemic risk is that their intentions need to be opaque rather than transparent. Safety nets, once in place, create the danger of discouraging necessary care by managers and customers. If it is clear that the government will bail everyone out in case of a problem, people are likely to be less careful: the age-old problem of moral hazard. To avoid it, there has to be some ambiguity about the authorities’ intentions, a fact that legislatures—with their increasing insistence on openness and public accountability—sometimes find hard to accept. This is a real dilemma in a world which, in all other respects, needs increased transparency.

Indeed this paradox is a general feature of prudential supervision. If the advice provided to a firm is that the supervisor is entirely content with its systems and controls, will this necessarily encourage the firm to continue that way? Human nature being what it is, moral hazard may intervene, with the result that the firm becomes arrogant or lax and deteriorates accordingly.

*Attitudes towards transparency.* Although there is clearly pressure for greater transparency from a number of quarters, the actual course of events in this area is hard to predict. When people who have been used to opacity get into financial difficulty, they do not want to tell the world about it. A major advance in transparency, and the cultural shift that goes with it, usually will not happen
without the commitment of both the government and legislature—or worse, a big crisis—to bring it about. For example in the UK, legislators gave regulators authority to require full disclosure of costs and commissions on life insurance policies, something that market forces themselves were never going to bring about. Similarly, it was legislation encouraging establishment of new market exchanges that provided the incentive, and eventually the necessity, for the LSE to adopt a more transparent approach. Once again, this would never have happened as a result of market forces alone. It is likely market forces will encourage general improvement in this area, but progress will be a lot slower than market theorists would like.

Asia

Events over the last year in Asia have illustrated very clearly the dangers of a free capital market with new and inexperienced players encountering weak supervisory, legal and accounting infrastructure, in a culture that has questioned the need for transparency. In fact, the entire litany of concerns discussed above comes together in the Asian crisis. It seems clear that addressing Asia’s problems will hasten global regulatory change. In addition to the pressure that individual countries, notably the United States, will bring to bear, there will be pressure for change from the IMF, the World Bank and other institutions with influence in the region.

There are a large number of areas which need attention, even in the most advanced economies. Japan is lacking both a sophisticated legal system and adequate accounting practices and standards, allowing weaknesses that would have shown up in the disclosures of western firms to remain long hidden. In addition, supervision of both securities houses and banks has been deficient. Who was monitoring the domestic, non-performing loans of the banks which now stand in excess of 70 trillion yen by official estimates? Who was watching the exposures of those same banks to the banks in Korea, and in turn the exposures that those same banks had to Indonesia? If Japan’s “Big Bang” reforms are successfully to reform the financial sector along market lines, a massive change in attitudes will be needed.

In the major emerging markets, there were huge gaps in information. In Malaysia, markets were apparently unaware that short-term, foreign currency indebtedness of the private sector doubled from $18 to $35 billion between early 1996 and late 1997.
In Korea, money poured into banks whose supervision was woefully inadequate, and the huge indebtedness of the private sector was completely invisible. There are many other similar gaps. If confidence in the world financial system is to continue, such gaps must be identified and filled.

While a great deal of work is being done on these issues, there is a disturbing possibility that could arise out of the problems in Asia. The big Asian economies may simply be unwilling to go as far as the devotees of the free-market may wish, and insist instead on retaining a government role in the economy with corresponding opacity. Beyond a certain limit, this could give rise to political tension. Time will tell whether self-interest and the knowledge that market forces will work against them are sufficient to encourage these countries to undertake substantial improvements in transparency. But a reaction against these pressures and a desire to do things their own way would be understandable.

A big question will arise from China. Several years ago, before the convertibility of the renminbi was under way, the tiny domestic bond market had to be closed because of massive speculation on the uncontrolled Shanghai bond futures market. This collapse had no impact outside China itself because of the lack of convertibility. However, there were two messages from this event. The first is the absolute necessity to hasten the development of a sophisticated Chinese supervisory structure, something that the authorities are trying to do. The second is for the rest of the world to note the ability of the increasingly well-off 1.25 billion Chinese to take massive positions which could cause significant disruption to the world economy, particularly if investments are undertaken with poor information.
V. Conclusion

Rapid change is taking place in global financial supervision as supervisors attempt to adjust to a rapidly changing financial environment and as market forces assert themselves. Market liberalization and increasing competition between financial service providers are posing new risks and challenges. The emergence of large and aggressive financial market players supervised by inexperienced regulators, highlighted in the Asian crisis, shows the clear need for strong supervision and appropriate financial infrastructure. The systemic implications of these developments must be considered at the same time as greater demands are arising for better sales practices and standards of market integrity.

It is this set of challenges that led to the changes now taking place in the UK, to the new framework of regulation in the EU and to the “Big Bang” anticipated in Japan. Hopefully, these challenges are beginning to produce a realization among Korean and Indonesian authorities of the need for a transparent, competitive and well regulated financial services industry. They certainly underscore the importance of regulatory cooperation and the need for regulatory interdependence.

Looking to the future, real efforts will be made to create a cooperative and interdependent global regulatory framework. However, unless someone creates a global government, there will be limits to what supervisors can do on their own. Therefore,
achieving the benefits of free capital flow while limiting the risk of systemic failure to acceptable levels will demand significant reliance on the power of the market. For that purpose, striving to secure maximum transparency will remain the key.
Group of Thirty Members

Rt. Hon. Lord Richardson  
Honorary Chairman, Group of Thirty  
Former Governor, Bank of England

Mr. Paul A. Volcker  
Chairman, Group of Thirty

Mr. Geoffrey L. Bell  
Secretary, Group of Thirty  
President, Geoffrey Bell & Company

Sir Roderick H. Carnegie  
Chairman, Newcrest Mining Limited & Hudson Conway Limited

Dr. Domingo Cavallo  
Congressman of Argentina  
President of the party Acción por la República

Mr. E. Gerald Corrigan  
Managing Director, Goldman Sachs & Co.

Mr. Andrew D. Crockett  
General Manager, Bank for International Settlements

Mr. Richard A. Debs  
Advisory Director, Morgan Stanley

Sr. Guillermo de la Dehesa  
Consejero Delegado, Banco Pastor

Professor Gerhard Fels  
Director, Institut der Deutschen Wirtschaft

Dr. Jacob A. Frenkel  
Governor, Bank of Israel

Dr. Victor K. Fung CBE  
Chairman, Hong Kong Trade Development Council
Dr. Wilfried Guth  
Emeritus Member - Group of Thirty  
Deutsche Bank AG

Mr. Toyoo Gyohten  
Senior Advisor, The Bank of Tokyo-Mitsubishi, Ltd.  
President, Institute for International Monetary Affairs

Mr. Gerd Hausler  
Member of the Managing Board, Dresdner Bank

Mr. John G. Heimann  
Treasurer, Group of Thirty  
Chairman, Global Financial Institutions, Merrill Lynch

Mr. Erik Hoffmeyer  
Former Governor, Danmarks Nationalbank

Professor Peter B. Kenen  
Director, International Finance Section, Department of Economics, Princeton University

Mr. Mervyn King  
Chief Economist and Executive Director, Bank of England

Professor Paul Krugman  
Professor of Economics, Massachusetts Institute of Technology

Mr. Yoh Kurosawa  
Chairman of the Board of Directors, Industrial Bank of Japan

M. Jacques de Larosière  
Former President, European Bank for Reconstruction and Development

Mr. Shijuro Ogata  
Tokyo, Japan

Dr. Sylvia Ostry  
Distinguished Research Fellow, Centre for International Studies, University of Toronto

Dr. Tommaso Padoa-Schioppa  
Member of the Executive Board, European Central Bank

Mr. William R. Rhodes  
Vice Chairman, Citibank

Sir William S. Ryrie KCB  
Baring Private Equity Partners Ltd.

Mr. Ernest Stern  
Managing Director, J.P. Morgan & Company

M. Jean-Claude Trichet  
Gouverneur, Banque de France

Sir David Walker  
Chairman, Morgan Stanley International Inc.

Dr. Marina v N. Whitman  
Professor of Business Administration and Public Policy, University of Michigan
Group of Thirty Publications since 1989

Reports:

International Insolvencies in the Financial Sector
Study Group Report. 1998

Global Institutions, National Supervision and Systemic Risk
Study Group on Supervision and Regulation. 1997

Latin American Capital Flows: Living with Volatility
Latin American Capital Flows Study Group. 1994

Defining the Roles of Accountants, Bankers and Regulators in the United States
Study Group on Accountants, Bankers and Regulators. 1994

EMU After Maastricht
Peter B. Kenen. 1992

Sea Changes in Latin America
Pedro Aspe, Andres Bianchi and Domingo Cavallo, with discussion by S.T. Beza and William Rhodes. 1992

The Summit Process and Collective Security:
Future Responsibility Sharing
The Summit Reform Study Group. 1991

Financing Eastern Europe
Richard A. Debs, Harvey Shapiro and Charles Taylor. 1991

The Risks Facing the World Economy
The Risks Facing the World Economy Study Group. 1991
Perestroika: A Sustainable Process for Change
John P. Hardt and Sheila N. Heslin, with commentary by Oleg Bogomolov. 1989

The William Taylor Memorial Lectures

Global Risk Management
Ulrich Cartellieri and Alan Greenspan. 1996

The Financial Disruptions of the 1980s:
A Central Banker Looks Back
E. Gerald Corrigan. 1993

Special Reports:

Derivatives: Practices and Principles: Follow-up Surveys of Industry Practice
Global Derivatives Study Group. 1994

Global Derivatives Study Group. 1994

Global Derivatives Study Group. 1993

Global Derivatives Study Group. 1993

Derivatives: Practices and Principles
Global Derivatives Study Group. 1993

Clearance and Settlement Systems: Status Reports, Autumn 1992
Various Authors. 1992

Clearance and Settlement Systems: Status Reports, Year-End 1990
Various Authors. 1991

Conference on Clearance and Settlement Systems; London, March 1990: Speeches
Various Authors. 1990

Clearance and Settlement Systems: Status Reports, Spring 1990
Various Authors. 1990
Clearance and Settlement Systems in the World’s Securities Markets
Steering & Working Committees of the Securities Clearance and Settlement Study. 1988

Occasional Papers:

56. Reinforcing the WTO
   Sylvia Ostry

55. Japan: The Road to Recovery
   Akio Mikuni. 1998

54. Financial Services in the Uruguay Round and the WTO
   Sydney J. Key. 1997

53. A New Regime for Foreign Direct Investment
   Sylvia Ostry. 1997

52. Derivatives and Monetary Policy
   Gerd Hausler. 1996

51. The Reform of Wholesale Payment Systems and its Impact on Financial Markets
   David Folkerts-Landau, Peter Garber, and Dirk Schoenmaker

50. EMU Prospects
   Guillermo de la Dehesa and Peter B. Kenen. 1995

49. New Dimensions of Market Access
   Sylvia Ostry. 1995

48. Thirty Years in Central Banking
   Erik Hoffmeyer. 1994

47. Capital, Asset Risk and Bank Failure
   Linda M. Hooks. 1994

   Hal S. Scott and Shinsaku Iwahara. 1994

45. The Impact of Trade on OECD Labor Markets
   Robert Z. Lawrence. 1994

44. Global Derivatives: Public Sector Responses
   James A. Leach, William J. McDonough, David W. Mullins, Brian Quinn. 1993
43. The Ten Commandments of Systemic Reform  
Václav Klaus. 1993

42. Tripolarism: Regional and Global Economic Cooperation  
Tommaso Padoa-Schioppa. 1993

41. The Threat of Managed Trade to Transforming Economies  
Sylvia Ostry. 1993

40. The New Trade Agenda  
Geza Feketekuty. 1992

39. EMU and the Regions  
Guillermo de la Dehesa and Paul Krugman. 1992

38. Why Now? Change and Turmoil in U.S. Banking  
Lawrence J. White. 1992

37. Are Foreign-owned Subsidiaries Good for the United States?  
Raymond Vernon. 1992

36. The Economic Transformation of East Germany: Some Preliminary Lessons  
Gerhard Fels and Claus Schnabel. 1991

35. International Trade in Banking Services: A Conceptual Framework  
Sydney J. Key and Hal S. Scott. 1991

34. Privatization in Eastern and Central Europe  
Guillermo de la Dehesa. 1991

33. Foreign Direct Investment: The Neglected Twin of Trade  
DeAnne Julius. 1991

32. Interdependence of Capital Markets and Policy Implications  
Stephen H. Axilrod. 1990

31. Two Views of German Reunification  
Hans Tietmeyer and Wilfried Guth. 1990

30. Europe in the Nineties: Problems and Aspirations  
Wilfried Guth. 1990
29. Implications of Increasing Corporate Indebtedness for Monetary Policy
   Benjamin M. Friedman. 1990

28. Financial and Monetary Integration in Europe: 1990, 1992 and Beyond
   Tommaso Padoa-Schioppa. 1990

27. Reciprocity and the Unification of the European Banking Market
   Douglas Croham. 1989

26. Japan’s Savings and External Surplus in the World Economy
   Masaru Yoshitomi. 1989

25. 1992: The External Dimension
   David Henderson. 1989