Financial Regulation in a Liberalized Global Environment

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LIBERALIZED GLOBAL ENVIRONMENT

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PART I; LIBERALIZATION AND ITS CONSEQUENCES

1. Introduction

Over the last three decades, the use of technology has accelerated the process of innovation and brought about changes in financial markets and institutions that have undercut the effectiveness of regulatory frameworks in place in many nations since at least the immediate post-World War II period. The response of public authorities has generally been to accede to pressures from the private financial sector to dismantle the old framework. Thus, most of the changes in financial structure and regulation that have taken place have been driven by market forces rather than shaped through the deliberative processes of law and regulation. With one important exception - capital adequacy requirements for banks - there has been very little rebuilding of a rule-based foundation. And even capital adequacy standards are now being questioned by US regulators as promoting evasive innovation that is making them ineffective, outmoded and inefficient (Greenspan 1998; Meyer 1998). Their preferred strategy for ensuring soundness relies on self-regulation at the level of the individual institution through systems of internal controls. While the Basle Committee on Banking Supervision has played a critical role in providing guidelines and setting standards in many areas of supervision and regulation, the emphasis on internal controls has also been evident in the guidelines and initiatives jointly adopted in the 1990s by its members who are central banks and banking supervisory authorities of the G-10 countries (BIS 1997). However, it is market practice that determines the need for and content of internal controls.
This paper focuses on changes in financial markets and their implications for both the global financial system itself and the global economy. It offers a preliminary set of proposals to adapt prudential guidelines to current market structures and practices so as to moderate systemic risk resulting from liquidity crises associated with financial shocks. The ultimate goal of these or any other proposals for financial reform must be to avoid further falls in real output like those experienced by heavily-indebted countries in the 1980s, Mexico in 1995 and East Asian countries now. In addition, they must contribute to reducing the level of perceived risk in the system that, as Eatwell (1996) points out, produces a bias toward short-term investment in the private sector and a bias toward deflationary policies on the part of the public sector.

2. Liberalization: what and when

a. The role of external (Eurocurrency) markets

The pattern of financial liberalization was established in its initial phase with the acquiescence of regulatory authorities - notably the Bank of England and the US Federal Reserve Board - to the creation of external credit markets denominated in the major national currencies where transactions were conducted outside existing national regulatory and monetary policy frameworks. By the early 1960s, UK banks were accepting deposits and making loans denominated in dollars in London and US banks soon began to do the same. For both UK and US banks, it was an escape from capital controls, permitted on the grounds that transactions in dollars in London did not affect the balance of payments accounts of either country. It was also an escape from monetary and prudential restrictions - quantitative controls on the growth of credit in the case of UK
banks; reserve requirements, interest rate ceilings and deposit insurance premiums in the case of US banks.

By the middle of the 1960s, however, the balance-of-payments effects of the so-called Eurodollar market became clear as credit tightening by the US central bank in 1966 and 1969 pulled dollars out of offshore balances in Europe for investment in New York. As the Federal Reserve (Fed) lost control of the credit supply and pushed interest rates to (then) historically high levels to dampen demand, differences in the impact that domestic credit restraints have on different sectors of the economy when they attract sizable capital inflows also became apparent. Large corporate borrowers that could afford to pay higher rates for short-term credit continued to borrow, operating at high levels of capacity and charging higher prices. Small businesses, the housing sector, consumers and other borrowers that could not pass on the higher cost of credit stopped borrowing. But those that were customers of small and regional banks without external sources of funds lost all access to credit in the disintermediation that followed as domestic investors withdrew deposits from institutions subject to interest rate ceilings and moved funds into government securities (D’Arista 1976).

These waves of capital flows into the US and subsequently into Germany, Switzerland and other European countries in the late 1960s and early 1970s demonstrated how effectively the Eurocurrency markets could circumvent capital controls by making it possible for participants to change the currency denomination of loans and investments outside national markets in response to changes in interest rates and, subsequently, changes in exchange rates. While the abandonment of fixed exchange rates was certainly not desired by Continental European countries, their inability to preserve effective control
over interest and exchange rates as the Eurocurrency markets expanded resulted in acquiescence to the US decision to float the dollar in 1973 and end the Bretton Woods system.

After the 1969 credit crunch, the Fed took the first of many successive steps in dismantling the existing regulatory framework by removing interest rate ceilings on large, negotiable CDs to make them competitive with Eurodollar deposits and minimize incentives for damaging flows between the domestic and external dollar markets. One effect of this action, however, was to enhance opportunities for interest rate arbitrage between the two markets and increase incentives for capital flows. Moreover, as the role of the Euromarkets in recycling OPEC current account surpluses further expanded offshore institutions’ share in global lending, the cost of capital in US markets rose to reflect the requirement that domestic borrowers compete with third world governments in obtaining dollar loans (D’Arista 1994).

It is likely that their role in recycling OPEC surplus funds contributed to the US government’s willingness to overlook these and other negative aspects of the Euromarkets throughout the 1970s. The attraction of the Eurodollar market for US investors - its freedom from exchange rate risk and the higher interest rate paid on deposits absent interest rate restrictions, reserve requirements and deposit insurance premiums - was largely unnoticed as was the degree to which outflows from the US fed liquidity into the external market. Rising inflation was attributed to the oil price increase and overly expansive US monetary policy that was seen as reflecting the government’s decision to fight unemployment. By the end of the decade, however, the falling dollar called attention to the excessive growth in external dollar liabilities and to the fact that the
“round-tripping” of dollar deposits - their investment by US residents in the unregulated market as deposits and reinvestment by foreign branches of US banks as loans to domestic borrowers - had made the Fed’s monetary policy operating targets obsolete.

In 1978 the Fed imposed reserve requirements on balances loaned by foreign offices of US banks to US residents. In the early 1980s, the Fed attempted to persuade other central bank members of the Basle Committee on Banking Supervision to join in imposing reserve requirements on all Eurocurrency liabilities of banks. The effort’s failure put US banks at a significant competitive disadvantage. Reserve requirements determine the ratio of total deposits that can be loaned out by a bank for profit. Since US banks were subject to reserve requirements on lending within the domestic market from both domestic and (from 1978 to 1990) offshore offices while foreign banks were only subject to US reserve requirements if loans were made by offices located in the US, a new channel for inflows opened in the 1980s - loans to US businesses by foreign banks from their offshore offices - that was not even captured in balance of payments data until the end of the decade (McCauley and Seth 1992). Foreign banks could (and did) lower rates on credits to US corporate customers, forcing US banks to expand lending to other, more risky sectors such as commercial real estate and for highly leveraged transactions that financed changes in corporate control.

Meanwhile, US banks were also experiencing a loss of competitiveness because their exposure to heavily indebted countries had lowered their credit ratings and raised their cost of funds. Moreover, Congress had added a provision to legislation increasing IMF funding in 1983 that required US banking authorities to impose explicit capital requirements on banks as a cushion against losses and as protection for the deposit
insurance fund. With other national banking systems operating with significantly lower capital requirements and lower funding costs, US banks reshaped their operations, securitizing assets and moving away from traditional banking activities, expanding their fee-generating, off-balance sheet activities such as money management, and providing financial insurance against the interest and exchange rate volatility now embedded in the system.

The Fed’s response to these developments was to shift its regulatory approach. It was a major player in negotiating the capital adequacy standards adopted by the members of the Basle Committee in 1988 and in promoting the adoption of a supervisory framework that placed responsibility on banks themselves to develop and monitor internal controls. In 1990, it eliminated reserve requirements on domestic time deposits and reduced the level of reserves required for demand deposits from 12% to 10% (FRS Bulletin). Given that capital requirements covered banks’ consolidated operations and that all external deposits were time deposits, the only cost advantage remaining for Eurodollar operations was the relatively small premium paid to insure domestic deposits.

While the above narrative illustrates the ways in which liberalization was propelled by the decision to permit an unregulated external market for dollar assets and liabilities to function as a substitute and counterpoint for a regulated market, similar developments took place in other national markets. The continued existence and expansion of the Euromarkets underscored the costs of regulation - e.g., that there is more profit if a bank can lend out 100% of a deposit rather than only the 90% (or less) allowed under reserve requirements; that a given level of lending limits or liquidity or capital requirements similarly restrict growth and profits. Moreover, funding and lending in the Euromarkets
made clear that differences in regulation that applied to banks in their national markets could affect their competitive positions in external markets and, thus, the competitiveness of national banking systems. As conditions for attracting capital to and retaining savings in national markets were increasingly affected by global developments, the competitiveness of a country’s banking system became more important. As a result, pressures for financial deregulation intensified in tandem with competition in the global economic environment.

Pressures for liberalization came from many quarters - including the harmonization efforts of the European Community in later years - and had a strong ideological component. Nevertheless, concerns about monetary control, balance of payments positions and the effects of changes in exchange rates on competitiveness also encouraged monetary authorities in industrialized countries to view reducing the cost advantages of external markets as a means to remove incentives for destabilizing capital flows. By the early 1990s, most of the regulatory restrictions that had made the cost advantages of the Eurocurrency markets so attractive - interest rate restrictions, lending limits, portfolio investment restrictions and reserve and liquidity requirements - had been reduced or eliminated, as had the capital controls that were the original impetus for the creation of the external markets.

b. The shift to portfolio investment

In the 1980s, international credit flows shifted away from loans through large international banks to securities markets; there were larger flows between national markets, markets became “far more closely integrated worldwide”, and capital “much more mobile” (BIS 1986). By the end of the decade, these developments had intensified
as a result of the removal of capital controls by many developed and developing countries; a wave of privatizations of state enterprises initiated by the Thatcher government in the UK in the early 1980s and culminating in the restructuring of Third World economies and formerly centrally planned economies in the 1990s, and the dramatic increase in foreign portfolio investment that these developments facilitated.

The increased dominance of foreign portfolio investment that became apparent in the mid-1980s reflected significant changes in saving and investment patterns in the national markets of the major industrialized countries. These changes were largely due to the growth of private pension plans. Because pooled funds held by such plans are invested primarily in securities, institutional investors - e.g., pension funds, life insurance companies, mutual funds and investment trusts - became more important in channeling savings than banks and other depository institutions in some of the major industrial countries. In the US, for example, the share of total financial sector assets held by institutional investors rose from 32% in 1978 to 52% in 1993, while the share of depository institutions fell from 57% to 34% over the same period (FRS Flow of Funds).

Although the rising dominance of pooled funds as channels for savings is particularly pronounced in the US and UK financial markets, the growth in the assets of institutional investors in Canadian, German and Japanese markets is no less significant. Measured as a percentage of GDP, their assets doubled over the period from 1980 to 1994 in four of these countries and almost doubled in Canada. In 1993, the assets of UK institutional investors rose to 165% of GDP and those of US investors to 125% of GDP (IMF 1995). As their assets expanded, institutional investors’ diversification strategies increasingly included cross-border investments. Cross-border transactions in bonds and
equities among the G-7 countries (excluding the UK) rose from 35% of GDP in 1985 to 140% of GDP in 1995 (BIS 1996). For the US, foreign portfolio investment accounted for over 65% of total US net private capital outflows in 1990, rising to 77% in 1993 and falling to 38% in 1994 (FRS Bulletin), with more than 30% of new international investment by US mutual funds going to emerging markets during 1990-1994 (World Bank 1997). The rise in total industrialized country foreign securities investment flows to emerging markets - from 0.5% in 1987 to 16.2% in 1993 (IMF 1995) - was equally dramatic.

Increased capital mobility, the liberalization of domestic financial markets and shifts in credit flows to securities markets outside the direct influence of monetary policy have made implementing monetary policy more difficult in all countries (Federal Reserve Bank of Kansas City 1993). They have eroded central banks’ ability to control the supply of credit, forcing them to rely more on their ability to change interest rates through open market operations to influence the demand for credit. But, as early as the 1969 US credit crunch, it became apparent that efforts to control aggregate demand through open market operations require that “…interest rates generally have to become higher and more variable” (BIS 1995). In the process, they become powerful inducements for procyclical surges of foreign portfolio investment that undermine the policy objectives sought by the change in interest rates. Thus, the most damaging effect of the liberalization of global financial markets may be the loss of central banks’ power to implement countercyclical policies.
3. The gaps in regulation

The shift to portfolio investment as the primary channel for savings has also further undermined regulatory strategies, including capital adequacy standards. Regulatory authorities still give primary attention to traditional banking activities and banks remain the focus for capital adequacy and other prudential requirements. But the shift of savings to pension funds, mutual funds, unit trusts, annuities, etc. has left the average saver without adequate protection or a safety net comparable to that provided by deposit insurance programs. And the corollary role for deposit insurance in protecting the payments system is also inadequate because the limits on insured balances are based on assumptions about the balances of small savers rather than those of, say, the local hospital with daily payments on a much larger scale.

Effective oversight of payments systems and traditional banking activities is and will remain an important focus for regulation. Nevertheless, money management and trading are now the primary activities in the global system in terms of the volume of instruments and transactions. The extraordinary increase in banks’ trading activities since the 1970s reflects this shift. The largest, most active and globally integrated markets are not national equity and bond markets but the over-the-counter (OTC) markets for foreign exchange and financial derivatives dominated by banks. Bank dominance of these markets poses particularly difficult questions in terms of regulatory standards because they have imposed their institutional culture on these markets, adapting market practices to the style of portfolio lenders. Thus, as dealers in these markets, they “hold” instruments even if the “portfolio” in which they are held is “off balance sheet”.

As the style of trading in which banks engage becomes more pervasive across a wider spectrum of assets and institutions, the market system is being pushed backward, recreating conditions like those that prevailed in the US before enactment of the securities laws. OTC markets are opaque, not transparent; they do not conform to the concepts or requirements for disclosure necessary if investors are to make informed decisions. They are not public markets. There is no surveillance of trading practices and no system for making information on prices and the volume of transactions routinely and continuously available to the public. Above all, the instruments themselves are not readily tradable - a critical factor that undermines liquidity and contributes to concentrations of contracts within a relatively small circle of dealers. Concentrations necessarily occur when exposures must be hedged with new contracts because existing positions cannot be sold. Despite efforts to mitigate the potential repercussions of disruptions through netting agreements in derivatives contracts, these particular characteristics of the OTC markets increase the potential that disruptions resulting from inaccurate assessments of credit or market risk will escalate into systemic crises. But can inaccuracy be avoided without transparency?

The proliferation of nonpublic markets prompted regulators to privatize monitoring and surveillance at the level of the individual firm. Beginning in the US in the 1970s with the requirement that banks devise effective checks in systems for recording foreign exchange transactions and positions (D’Arista 1976), these requirements are now a major component of the Basle Committee’s core principles of regulation and apply to all OTC trading markets in which banks participate. The weakness in the strategy is its emphasis on the individual firm. It reinforces the lack of market transparency and
increases the likelihood that, in the absence of effective external checks through clearing houses, systems for routing transactions that permit ongoing surveillance or other forms of systemic oversight, gaps in a firm’s recording and monitoring system may go unnoticed, resulting in large losses (Daiwa) or failure (Barings) and increasing the potential for systemic repercussions.

The increase in banks’ trading activity is an outgrowth of the rising importance of money management and its requirements for ancillary services. Derivatives, stand-by letters of credit and commercial paper guarantees are all innovative instruments devised by financial institutions to provide a privatized system of financial insurance to their customers. Banks are the major players in providing guaranties because they have the power to create deposits by making loans when the guaranty is activated. It would appear that the credibility of these guaranties is supported by the application of risk-based capital requirements to banks’ off-balance-sheet positions. However, support would only be effective in situations involving one or a few customers. In a wider liquidity crisis, banks’ ability to raise new capital to support an expansion of assets and liabilities on their balance sheets would be limited or, possibly, nonexistent. Central banks would still be required to provide the back-up needed to contain a downward spiral in asset prices.

The limited ability of capital adequacy requirements to support the vast system of private financial guaranties created by banks and other financial institutions points up one of the weakness of relying on capital adequacy as the new cornerstone for prudential regulation: like internal controls, they are a rational tool for regulating individual institutions but are irrational in a systemic context. Capital requirements are not only likely to prove useless in a liquidity crisis but are also a dangerously procyclical instrument
of macroprudential policy. The market will supply capital to the banking system in a boom and withhold it in a downturn. Thus, capital requirements will tend to act as a barrier to the effective implementation of countercyclical monetary policies. Efforts either to dampen economic activity by raising interest rates or to jump-start the economy in a downturn by lowering rates will not succeed if this asymmetry between banks’ ability to raise capital and policy objectives persists.

Capital adequacy standards apply to banks’ traditional business and to some off-balance-sheet activities but they do not apply to the money management activities that are now a primary function of almost all segments of financial systems in developed market countries - banks, securities firms, insurance companies, mutual funds and unit trusts. All these institutional segments are competing for opportunities to manage a larger share of pooled savings but there are differences in the products they offer and much larger differences in the ways they are regulated both within and between national markets. While those differences have important consequences for investors in the various national markets, the common thread is the absence of any effort to apply an across-the-board emphasis on soundness regulation to the regulatory structure for money management. Disclosure and the prevention of fraud are the primary objectives of regulation in developed securities markets; prudence, diversification and suitability are the guidelines applicable to individuals and institutions that manage securities investments. But with so large a share of global savings invested rather than deposited - including those of the most vulnerable: the small or lower-income saver whose principal financial assets tend to be held in pension funds - the impact of a loss of confidence on market liquidity will affect
larger and more diverse shares of the populations of many countries and cause greater
economic dislocation.

There is also concern about the ability of central banks to find an appropriate
channel to exercise their functions as lenders-of-last-resort to contain market disturbances
and halt a free-fall in prices. In the case of the OTC derivatives markets, finding a channel
through which central banks can supply liquidity may be particularly difficult. It is likely
that the Fed’s role in providing liquidity to the foreign exchange market in 1975 by
assuming and executing (at a loss) Franklin National Bank’s foreign exchange book is the
model that would need to be used again (D’Arista 1976).

Henry Kaufman pointed out in 1985 that the pendulum had swung toward an
emphasis on the entrepreneurial responsibilities of financial institutions to reward
shareholders by increasing profits - away from their previous emphasis on exercising their
fiduciary responsibilities to depositors and borrowers and the economies in which they
operate. The relevance of his remarks became even more apparent as the OTC derivatives
markets expanded over the subsequent decade. Undermining the mutuality of the
traditional banking relationship that links the profitability of the financial institution to the
prosperity of its customers, many contracts sold in these markets are based on the premise
that either the financial institution or its customer will accept the losses that result in the
other’s gain. But, as even isolated losses accumulate, the ultimate loss may be public
confidence in the financial system.

These issues point to the final and most difficult issue involved in liberalization:
the consequences of institutional failure. Capital adequacy standards rely on market forces
to discipline banks by withholding capital and curtailing new lending. The market also
determines the cost of institutions’ funding in the global wholesale markets. A bank - or even a national banking system such as Japan’s - will find these forces difficult to counter. Restoring soundness and confidence clearly takes longer and, in some cases, may not be possible. The higher cost of capital and funding for banks in whom markets have lost confidence lowers their profitability, impedes their ability to grow out of problem loans and their ability to compete in attracting better borrowers. As these conditions continue, banks - and even national banking systems - stagnate and many eventually will fail.

This outcome should come as no surprise. The market doesn’t discipline only by withholding rewards. Its ultimate effectiveness rests on its ability to threaten or cause failure. While most national governments have adopted systems of regulation that include reliance on market forces, most nevertheless still view their financial systems as key industries in their economies and understand the disruption that financial failures cause.

As Japan continues to cope with a financial system that, like savings and loan institutions in the US in the 1980s, was not restructured to bear the brunt of global market forces, and East Asian countries confront sudden, dramatic collapses in their systems, there may be renewed interest in reconstituting an institutional and regulatory framework that can either reduce the number and frequency of financial failures or help insulate economies against their impact.

In the meantime, the most dangerous threat to the global financial system - its vulnerability to contagion - is not being addressed. In the past, the primary strategy to deal with contagion was compartmentalization. In countries with developed securities markets such as the US, the UK and Japan, restrictions on functions and products helped insulate different markets from spill-over effects. Thus, as late as the 1987 market decline,
funds withdrawn from equity and derivatives markets in the US could be recycled through banks and loaned back to dealers and institutional investors (with the support of the Fed) to halt price declines. The effectiveness of this strategy in containing the crisis depended on the fact that banks were not significantly involved in trading or holding equities and not subject to the contagion that spreads as confidence is lost.

Compartmentalization also characterized the structure of so-called universal banking systems up through the late 1980s in the sense that these institutions operated in countries with relatively small or underdeveloped securities markets where traditional banking operations were the dominant financial activity. However, as discussed above, securities markets have become more important components of financial systems in almost all developed and many developing countries over the last decade. Thus, the activities of universal banks have taken on some of the characteristics of the US financial conglomerates owned by commercial enterprises such as General Electric and the three major automobile manufacturers. While an informal group of banking, securities and insurance supervisors has made recommendations (BIS 1995) for the improvement of supervisory practices in the area of information sharing among the various authorities and consolidated reporting by firms, the emphasis, again, is on capital adequacy and the adequacy of internal controls within components of the conglomerate. Thus, as in the case of banking, the initial focus of the regulatory framework for conglomerates is structured to address problems at the level of the individual financial function.

The interconnection risks that arise because of the melding of multiple functions within individual firms have already been made explicit by complex derivative contracts that link performance across several markets. It is a new source of risk and one that poses
a uniquely powerful threat to systemic stability. The absence of strategies to deal with the risk of contagion that is inherent in tighter linkages between markets and products constitutes the major gap in regulation in the liberalized global environment.

PART II: REGULATORY PROPOSALS TO REDUCE THE NEGATIVE IMPACTS OF LIBERALIZATION

1. Risk-weighted capital charges for pooled funds

As noted above and discussed more fully in a previous paper (D’Arista and Griffith-Jones 1997), certain soundness strategies for regulating savings held in pooled funds and invested in securities now seem more appropriate than in the past. While requirements for diversification do apply to mutual funds, explicit liquidity requirements such as levels of cash reserves or provisions for insurance coverage to promote confidence do not apply. Nor, until recently, has attention been paid to the impact of national macro-economic developments - known by securities regulators as “market risk” and including variables such as exchange rates and interest rates - on securities markets. However, as institutional investors have assumed a dominant role in financial markets, and as differences between banks and pooled funds blur, some of the strategies used to promote public confidence in banks are beginning to be adapted to the needs of mutual funds in the US.

The most important of these adaptations is contained in legislation enacted in the US in 1991 (12 CFR, 201.3(d)), that permits any individual, partnership of corporation to borrow from Federal Reserve Banks using US government securities as collateral if the failure to lend would adversely affect the economy, and permits loans against collateral
other than US government securities with the affirmative vote of five of the seven members of the Federal Reserve Board of Governors. In short, the 1991 Act not only gives securities markets explicit access to the lender-or-last-resort, it also expands the types of collateral against which the Fed can lend in an emergency to include corporate stocks and bonds - securities in which banks cannot invest depositors’ funds under current US law.

The enactment of this measure resulted largely from the 1987 and 1989 market declines and reflected concern about their potential to damage the US economy. Certainly, as former Federal Reserve Board Chairman Marriner Eccles had already noted in the 1930s, in an emergency there is no source of liquidity “…except that liquidity which can be created by the Federal Reserve or the central bank through its power of issue…” (US Congress, 1935). Nevertheless, central banks historically have used their emergency powers sparingly and the requirement that five members of the Board approve loans collateralized by assets other than US Government securities suggests that interventions to halt a market disruption would be weighed carefully and occur infrequently.

Meanwhile, market participants are concerned about assuring that sources of liquidity are available under volatile conditions that may not be seen as damaging to the US economy and would not activate the Fed to supply resources. Gaps between the timing of outflows for redemptions of shares and the receipt of funds from sales of securities are frequent and have raised concerns about redemption and settlement risks among US, UK and international organizations and regulators. Particularly in the US, the industry itself has been involved in putting in place back-up sources of liquidity such as interfund lending using repurchase agreements within a family of funds, the creation of
money market “funds of funds” within a family of funds and committed lines of credit from banks. As explained by one large family of funds: “With the increased specialization and internationalization of mutual fund portfolios, the industry is appropriately giving greater attention to alternative methods for funding redemptions during periods of market volatility” (SEC March 1995). The US Securities and Exchange Commission (SEC) has also indicated greater concern about liquidity in this context. It now “…urges money funds to monitor carefully their liquidity needs in light of the shorter settlement period…”, and consider the percentage of the portfolio that will settle in three days or less, the level of cash reserves and the availability of lines of credit or interfund lending facilities (SEC March 1996).

The time gap between redemptions of shares and settlement of securities sold has also focused investor interest on the level of cash reserves of individual funds or types of funds (McGough 1997) and their concern has been heightened by the potential for increased redemptions during a market decline (Kinsella 1996). In such a period, gaps between the timing of redemptions and settlement would create a scramble for funds that might exacerbate price declines. As these developments and discussions involving US mutual funds indicate, finding alternative sources of liquidity for securities investment funds is a priority issue even when a fund’s portfolio is invested in domestic assets. The problem becomes larger when cross-border holdings are involved, particularly holdings in emerging market countries.

The US experience to date suggests two potential solutions to the problem. One would be purely market based, using the “fund of funds” created by the enormous - $416 billion in assets at that time (Gasparino and Jereski 1996) - Fidelity family of funds (SEC
August 1996) as a model for the industry as a whole. This would allow all mutual funds to buy shares in an “umbrella” or “top” fund whose shares would not be sold to the public. The “fund of funds” would invest in highly liquid money market instruments which would be sold to redeem the shares of mutual funds seeking liquidity to fund redemptions by public shareholders. In addition, the “fund of funds” would be authorized to invest for short periods in the shares of funds that had exhausted their redemptions, up to a given amount (proportional to the size of their portfolios), if other means for funding redemptions were not available.

One problem with using the Fidelity model is that market declines and disruptions may affect all participating institutions at the same time. Moreover, its contribution to maintaining public confidence in markets may be limited. Unlike deposit insurance for banks, this type of liquidity facility will not guaranty that shares can be redeemed without losses. Nevertheless, if it were seen as contributing to public confidence that a market recovery would occur, it could reduce shareholder redemptions and cushion the downward spiral of price declines that make a market recovery and the restoration of confidence more difficult. It might also give the central bank more time to assess the situation, making it less likely to miss the point at which prompt action could halt the downward spiral of redemptions, securities sales and price declines.

Another potential solution to the problem of providing liquidity to mutual funds and other pooled funds is to require that some portion of their cash reserves be placed in the form of interest-bearing deposits in commercial banks as a prudential capital charge. The immediate availability of such deposits would reduce market volatility associated with the timing of settlement, particularly in situations involving large redemptions. They
would also constitute a first line of defense for access to liquidity in the event of a significant market decline. As a pre-assessment vehicle, the capital charge proposal is preferable to post-assessment arrangements such as bank credit lines in that deposit withdrawals by pooled funds would likely be redeposited in banks by sellers of securities rather than trigger a credit expansion that would require validation by the central bank without regard to current monetary policy objectives.

The use of the term “capital charge” in discussions of liquidity facilities for mutual funds and other pooled funds refers to their particular structure as intermediaries for direct investment. Because shareholder capital backs 100% of the invested assets, neither the capital or provisioning requirements applicable to banks are directly applicable to these funds. Nevertheless, the need for defined sources of liquidity for pooled funds has become more apparent as their role in financial markets has expanded and concern about the potential for shareholder withdrawals to precipitate serious market disruptions in the form of sharp declines in asset prices has increased.

Imposing capital charges on pooled funds in the form of required, segregated cash reserves deposited in commercial banks to ensure defined sources of liquidity may also contribute to removing distortions in the financial industry by reducing the cost advantage pooled funds now enjoy in competing with banks to attract savings. Making the capital charge comparable to the capital adequacy requirements that apply to banks under the Basle Accord would somewhat lower earnings for some pooled funds that do not maintain adequate levels of cash reserves since interest bearing deposits may earn less than other financial assets in which funds invest. However, bank deposits are payable at par and that,
together with the introduction of an industry-wide standard, might increase investor
certainty and lower the potential for runs.

A capital charge requirement would also provide a structure that would make risk-
weighting - another key element in capital adequacy regulation for banks - applicable to
pooled funds. Risk-weighting would require that money managers perform a more
rigorous analysis of their investments - particularly cross-border investments - and of
market and other risks than have been undertaken to date. Such a requirement should also
be linked to increased disclosure so that central banks would be able to monitor
investment flows for monetary policy purposes, to assess systemic concentrations of
investment that result in “bubbles”, and to change weights as needed to reflect changes in
risk.

2. Creating a public international investment fund for emerging markets

Given the immense growth in the assets of institutional investors in industrialized
countries and the fact that several developing countries - Chile, Malaysia, Singapore and,
prospectively, Mexico - have adopted compulsory saving schemes involving funded
pension plans, it is clear that foreign portfolio investment will continue to be an important
channel for international capital flows. It is also obvious that emerging markets will
continue to need the support of foreign investment even if these countries increase the
amount of domestic savings. Thus, efforts must be made to address the problems
associated with foreign portfolio investment flows - in particular, large and rapid changes
in asset prices and the speed with which outflows can precipitate a crisis affecting both
securities and exchange markets - and to assert control over the procyclical surges in
flows that have weakened central banks’ ability to implement monetary policy.

Establishing an investment fund for emerging markets managed by a public
international financial agency would make a substantial contribution toward stabilizing
foreign portfolio investment flows. Structured as a closed-end investment fund, it would
issue its own liabilities to private investors and buy stocks and bonds of private enterprises
and public agencies in developing countries in consultation with their governments. The
proposed fund could be capitalized by purchasing and holding government securities of
the major industrial countries in amounts determined by the percentage of shares in the
fund held by residents of those countries. This would provide a basic guaranteed return to
investors, denominated in their own currencies, in addition to their share of dividends or
returns on investments in emerging market securities.

As a closed-end fund, the proposed fund’s shares could be bought and sold freely
in many markets and many currencies. Although the value of the fund’s shares would
fluctuate, it would not have to sell the underlying portfolio in response to a fall in the price
of its shares. This would protect emerging markets from the abrupt fluctuations in capital
flows that have been associated with foreign portfolio investment in the 1990s and would
help moderate changes in the prices of securities in their domestic markets caused by
external developments. The proposed fund’s investment objectives would focus on the
economic performance of enterprises and countries rather than short-term financial
performance. Meanwhile, the value of the fund’s capital would be explicitly guaranteed by
the institutional investors’ own governments because it would be invested in their
obligations. This would add stability by providing a floor against losses for the beneficiaries of pension and other pooled funds whose savings are at risk.

The creation of a public international investment fund would reduce the need for capital controls to moderate inflows, especially in countries that choose to accept foreign portfolio investment solely through the proposed fund. It would also provide an appropriate channel for capital outflows from developing countries when the objective is a reasonable level of diversification of savings, particularly those held in newly-established pension funds. Moreover, investments in shares of the proposed public international investment fund could help minimize problems that may emerge as public or private institutional investors in developing countries acquire the skills needed to manage large pools of funds. The creation of such a channel could significantly reduce the cost of information needed to put together a balanced and diversified portfolio and contribute to solving the problems associated with lack of disclosure by domestic issuers in these markets.

The powers and functions incorporated in the charter of the World Bank - including its mandate to facilitate private investment in developing countries and its ability to issue its own liabilities in global capital markets - make this institution the most appropriate existing agency to manage the operations of the proposed fund. Creating a public international investment fund is entirely consistent with the original and ongoing objectives of the Bretton Woods institutions and, given the shift in channels for international capital flows and the effects of this shift on the economies of developing countries, a review of current programs for extending assistance to these countries is long overdue.
3. **Reforming and reconstituting public financial guaranty programs**

Federal deposit insurance for commercial banks and thrift institutions was authorized in the US in the 1930s after decades of debate and experimentation with state programs. The success of these funds in restoring confidence in depository institutions after the wave of bank failures in the early years of the Depression was seen by economists as the “most important structural change in the banking system” (Friedman and Schwartz 1963) and a fundamental contribution to US monetary and financial stability (Galbraith 1975). The growing perception of deposit insurance as the cornerstone of financial stability and its record in providing protection at minimal cost led to the creation in 1970 of federal insurance funds for credit unions and securities firms (the Securities Investor Protection Corporation), state guaranty funds for insurance companies and the Pension Benefit Guaranty Corporation in 1974.

The adoption of deposit insurance programs in other industrial counties began in the 1960s with West Germany’s creation of a voluntary private system based on contributions from participating institutions. A compulsory semi-official program was created in Japan in 1971, followed by a series of compulsory, officially-administered programs inaugurated in Holland (1979), Great Britain (1982), Belgium (1985) and Ireland (1989). Spain instituted a voluntary officially administered program (1977) and France (1980) and Italy (1987) covered customers of their state-owned banking systems under private programs - compulsory for France; voluntary for Italy (Dufey and Giddy 1994).

One of the common elements in all these programs is that they insure institutions rather than their customers. As a result, they have become a procyclical influence within
the regulatory framework in an environment of increasing financial fragility. With the focus of these programs on protecting the deposit insurance funds and minimizing losses to taxpayers, charges for premiums are lowered or eliminated in a boom when few banks fail and raised in a recession when the number of problem banks rises. In the US, for example, bank failures and rising ratios of nonperforming loans in the early 1990s prompted a sharp increase in deposit insurance premiums from 12 cents to 19.5 cents per $100 of deposits in January 1991 and then to 23 cents by mid-year 1992. These increases fell most heavily on community and regional banks without access to noninsured foreign deposits, reducing their profitability and/or lowering the interest rates they paid to depositors. The lower interest rates on deposits not only limited banks’ ability to attract funds, but encouraged outflows to Euromarkets where rates on noninsured deposits were higher. Thus they contributed to the stagnation in bank lending that was a factor in prolonging the recession (D’Arista 1994).

The system of insuring institutions has led to distortions in regulatory emphasis as well. Regulatory objectives have tended to move in the direction of fostering institutional profitability. Profitability is certainly an important measure of the soundness of institutions and, in the normal course of events, constitutes an additional umbrella of protection for depositors. But insuring institutions in periods of financial and economic instability or weakness means that institutional profitability is the only source of protection, short of the taxpayer, as profitability becomes the major determinant of the viability of the insurance fund itself. Thus priority status is given to the entrepreneurial activities of depository institutions in pursuit of earnings. And their depositors and shareholders have been assumed to have primarily entrepreneurial objectives as well - to be more concerned with
interest earnings and the rising values of shares than with the safety of principal or the possible consequences of failure for tax liability.

The search for stable profits in an unstable financial and economic environment necessarily requires an unending game of innovation. Financial institutions and their regulators have focused on guessing what new products, powers, or markets are most likely to ensure continued profitability. But financial innovation, whatever else it has done, has not lowered the level of fragility in the system and has not demonstrated that it can guaranty profits in periods of economic weakness.

Constructing a system that will minimize taxpayer liability in the context of financial and economic instability requires shifting insurance coverage and its cost from institutions to individuals. Posing a choice as to who pays the premiums for deposit and other forms of financial insurance clarifies the issue of who gets protection. If the financial institution pays the premiums, it is insured. It is the client of the insurance agency, and its depositors are relegated to the role of nominal beneficiaries. This has tended to encourage a save-the-institution mentality on the part of insurance agencies and governments. Of course, depositors too are protected in this process. But only up to a point - the point at which the losses of institutions exceed the pool of funds their premiums have created. At that point, the depositors lose because the benefit of their protection will be taxed away.
a. An alternative proposal for protecting savings

A fair and rational system for protecting savings would include several key elements outlined here in a US context that could be adapted to the needs and systems of other countries as well:

• All individuals and households would be required to purchase financial guaranty insurance to cover savings up to a given amount. They would do this by accepting a lower rate of interest on insured assets than could be earned on uninsured assets. The lower rate would reflect the deduction for the insurance premium. A compulsory system is necessary to ensure that all savers are covered, that reserves are adequate, and that liability for losses is fairly distributed.

• Covered assets could be held in a variety of accounts in federally regulated institutions: bank, thrift, or credit union deposits; mutual funds, annuities and pension plans. A financial guaranty program must focus on all channels for savings if it is to offer adequate protection for the average saver whose primary savings are deferred income that may be invested in pools or other vehicles chosen by employers.

• Premiums would be collected from the interest or gains on covered savings assets, offset by a full tax deduction. The amount of the premium would be deducted by the institution and paid directly into the insurance fund before the accrued interest or gains are credited to the saver’s account. Statements on premiums paid would be added to reports on earnings and filed with the individual’s tax return as a deductible item. A compulsory system involving individuals will work only if paying premiums is relatively automatic and painless; that is, if it does not involve earned income.
• The amount of savings in the various accounts of individuals would be reported to the Internal Revenue Service by financial institutions, as is currently done. Records of aggregate savings of individuals and households based on social security numbers would be maintained by the insurance fund.

• Insurance reserves would be invested in US government obligations as they are now in the US. Continuing this practice under a regime in which individuals pay premiums clarifies the relationship between their roles as savers and as taxpayers. Because the assets of the fund are those for which savers-taxpayers are already liable, savers’ premiums will reduce their tax liability if failures are contained. If failures exceed acceptable levels and seriously deplete reserves, the impetus for action to address problems will be enhanced by a tax liability that kicks in earlier in the slide.

This basic framework could be elaborated or modified to add flexibility to meet the needs of individuals and households rather than those of institutions. For example, coverage could be expanded for households on the basis of the number of dependents; small savers could be relieved of all but nominal premium payments for accounts under a certain amount. Obviously, the savings of individuals and households will grow over time and may exceed the maximum amount covered by insurance. This should not be a significant problem for older or more affluent households except in a period of rising inflation. The amount of coverage should be reviewed periodically to ensure that there has been no significant erosion in purchasing power. If there has been, raising the level of coverage will automatically increase the flow of premiums into the insurance fund and maintain the needed ratio of reserves to liabilities.
b. Protecting transactions balances

Before considering a financial guaranty program that protects funds needed for current transactions, one must accept a fundamental premise: it is unrealistic to limit insurance coverage for accounts that are necessary to sustain economic activity. The current limits on coverage in all countries with deposit insurance programs are inadequate in the case of employers, whether it be for large or small businesses, farmers, nonprofit organizations, or state and local governments. If payrolls are not met, the interruption of payments down the line will result in a widening circle of losses. In the case of regional or money center banks that have large customers and hold clearing balances for other financial institutions, inadequate coverage of transactions balances can result in even broader repercussions, causing dislocations to any number of communities or to whole nations. Because these repercussions are so destructive, the too-big-to-fail approach has become a reality under the current system.

But the current system fails to take into account the differences in protection needed for savings and transactions balances and the fact that, in the case of transactions accounts, the criterion for too-big-to-fail responses should be the size and economic functions of depositors. A more effective and, in the context of economic disruption, affordable means for safeguarding transactions balances requires that coverage be unlimited regardless of the multimillion dollars involved; that insured transactions balances be clearly defined as non-interest bearing demand deposits in federally regulated depository institutions that are payable at par with no limit on the number of withdrawals; that interest foregone would be assumed to be equivalent to that on Treasury bills and would be paid by institutions into the insurance fund after deducting a reasonable
percentage of profits on the assets in which these funds are invested; that, like the fund
for savings, premiums would be invested in US government securities and that
transactions balances be invested in segregated pools of loans and investments that meet
the highest standards in terms of quality, liquidity and diversity.

One of the more important benefits of transferring insurance coverage from
institutions to customers is that it better accommodates the current framework in which
market forces play a substantial role in regulating institutional behavior and outcomes.
With individual savers and the payments system adequately and independently protected,
markets can exercise discipline in precipitating failure without interference from
government. Indeed, in the US, the government itself is assumed to have a role in
precipitating failures as it exercises its responsibility under current law to take prompt
corrective action to close institutions whose capital has fallen below a statutory minimum
level. That responsibility could be incorporated into the reform proposal offered here by
requiring that any institution that fails to meet accepted standards within a set period of
time would no longer be licensed to accept transactions balances or insured funds of
savers. Customers would be notified to withdraw funds and would, in effect, participate
in an organized run on the institution.

Admittedly this could be seen as an effect of the proposed reform that might
damage institutions’ ability to attract shareholder capital as compared with the current
system of insuring institutions which encourages the too-big-to-fail protective responses of
regulators and thus reassures shareholders. However, withdrawing an institution’s license
to accept insured funds will heighten awareness of the need for effective regulation to
promote the stability and continuity in financial systems that sustains the confidence of customers, taxpayers and shareholders alike.

4. **Strategies to improve monetary control**

Among the more radical outcomes brought about by liberalization is that procyclical forces have reemerged as determinants of developments in financial markets after half a century of public sector commitment to moderating their effects. The evolution and refinement of effective tools to moderate the supply and demand for money and credit in the post-World War II era contributed to financial stability by preventing excessive increases/decreases in debt and wide fluctuations in interest and exchange rates, and supported other public and private sector initiatives that contributed to the remarkable increase in economic growth that characterized that period. As the effectiveness of these tools has weakened, the ability of monetary authorities to implement countercyclical policies has been undermined, eroding the stability of financial markets and creating conditions that impede economic growth. To reinstate the degree of monetary control necessary to reestablish financial stability in both national and global markets, central banks will need to recreate or adapt existing tools that directly influence the supply side of money and credit markets.

As discussed, liberalization has weakened central banks’ leverage in implementing policy objectives by removing quantitative restrictions on bank lending - reserve requirements, lending limits and interest rate ceilings. In the US, for example, monetary strategies included substantial reliance on reserve requirements to influence both the supply of and demand for bank credit and thus banks’ ability to create money. Since the
volume of aggregate reserves in the banking system could only be changed by actions of
the central bank in paying sellers or charging buyers for government securities in
transactions conducted in the open market or, less frequently, through discount
operations, the Fed exercised considerable influence over the availability of bank credit
and the deposits it created and their cost. Moreover, since its open market purchases and
sales changed the composition of portfolios of bank and non-bank investors and the price
of Treasury bills, they also had the effect of changing demand for private securities and
their price. With the removal of reserve requirements on savings deposits and a lower
reserve rate for demand balances, reserve requirements are obviously a less important
component of the monetary mechanism now than before these changes were completed in

But the removal of reserve requirements is not the only development that has
eroded the effectiveness of policy initiatives. Innovations such as repurchase agreements
and cash management accounts have been used for many years to evade reserve
requirements on demand balances and the increased volume of offshore transactions also
made banks a less reliable channel for the transmission of policy over the last several
decades. Finally, the decline in the importance of bank credit in financing the economy as
savings flows shifted to securities markets administered the final blow to the supply side
of monetary control in the US. The Fed must rely on its ability to influence the demand
for credit, using open market purchases and sales to induce changes in interest and
exchange rates.

In the US case, these changes initiate capital flows that move in the same direction
as policy initiatives - that is, inflows in periods of rising interest and exchange rates;
outflows as interest rates fall and the dollar declines. In countries whose currencies are not widely used in international transactions and are more subject to loss of confidence than the major OECD currencies, the reverse may occur - that is, rising interest rates may result in capital outflows and a falling exchange rate, while falling interest rates may signal increased financial stability, inducing inflows and currency appreciation. But for many OECD countries, procyclical capital flows have resulted in surges in credit expansion and contraction, and in bubbles in asset prices followed by price deflation such as the widespread collapse in real estate values in the early 1990s.

Moreover, the procyclical inducements to capital flows in the major market countries have also influenced the direction of flows to and from emerging markets. As discussed above, the fall in interest rates in the US in 1990 prompted outflows that reflected a substantial increase in foreign portfolio investment by US residents, a rising share of which was invested in emerging markets over the next several years. In 1994, however, rising US interest rates slowed that flow, helping to set the stage for the Mexican peso crisis at the end of the year (FRS Bulletin).

After the 1995 crisis, recognition of the damaging effects of capital flows for emerging markets prompted reconsideration of the appropriateness of the use of capital controls for these countries by the Bank for International Settlements (BIS 1995) and the International Monetary Fund (IMF 1995). However, the 1995 BIS view - that: “…It is now widely agreed that prudence in liberalizing capital inflows implies that short-term operations should not be free until the soundness of the domestic financial system is assured”. - was dismissed by the private global financial sector which continued to press for liberalization.
While the use of capital controls by developing countries may offer some protection and should not be dismissed as a tool of stability, it is doubtful that global stability would be regained by attempts to reimpose capital controls in the major market countries. Only the reassertion of monetary control - defined as influence over both the supply and demand for money and credit - will create the conditions necessary for global financial stability. Reimposing quantitative restrictions on the growth of money and credit is a necessary beginning for that process. It is clear, however, that central banks must begin to identify and influence monetary and credit aggregates within the context of global - not national - credit markets. They must also create new policy tools that take into account the shift in investment and borrowing from banks to securities markets and ensure that they have better control over total credit by expanding their direct influence over the supply of credit provided by all major sectors of the financial system.

A proposal that would achieve these objectives would undoubtedly require a greater degree of harmonization of monetary policy tools and strategies among OECD countries. Since most central banks now conduct open market operations in foreign exchange markets as well as national money markets, it would be reasonable to propose that reserve requirements be reinstated as the primary tool for influencing the supply of money and credit. But requirements must apply to financial institutions’ consolidated balance sheets, including off-shore and foreign currency liabilities. This would ensure that the effectiveness of reserve requirements would not be eroded again by the transfer of intermediation to offshore markets. It would also give central banks a far more effective tool for stabilizing exchange rates than intervention alone can provide, given the limited
amounts of foreign exchange reserves available to central banks for use even in concerted actions.

Reserve requirements must also apply to a wider variety of institutions - not just banks - to broaden the so-called “transmission belt” for policy implementation. All financial institutions or sectors whose operations result in flows or holdings of instruments that aggregate more than a given percentage of total financial assets/liabilities - 5% to 10%, for example - would be required to hold reserves with central banks and in cash deposits with banks as described above. Thus, reserve requirements would cover all existing activities of both universal banks and financial conglomerates - banking and non-bank finance, securities and other trading operations, insurance and pooled funds - and could be extended to cover new, innovative instruments or activities as they emerge and assume importance in national and global markets.

In summary, the objective of this proposal is to set a global standard for effective policy tools, increase the leverage of monetary authorities and prevent evasions of policy constraints by some institutions/markets at the expense of others. Such a proposal is justified by the fact that the increasingly integrated and deregulated global financial marketplace that now dominates national markets and policy initiatives responds only to market performance. Its procyclical bias has a destructive potential that undermines stability and impedes sustainable growth. Efforts to restore stability can only succeed in an environment in which monetary policy regains its effectiveness as a countercyclical influence on financial markets.
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