3

Operational Issues Associated with an IBS

Laying out the general case for an IBS is one thing. Writing the specifics of such a standard is another. Much of the devil is in the details. In this chapter, I offer specific answers to the following key questions:

- Should the IBS be a unitary or two-level standard?
- What elements of banking and banking supervision should an IBS include?
- Who should set the standard?
- How should compliance with an IBS be monitored and encouraged?

Before addressing those specific operational issues, I will consider eight broad points about what an IBS can achieve and how it ought to be designed.

Broad Features of an IBS

First, an IBS is not a panacea. It would be unrealistic to expect an IBS to eliminate banking crises in developing countries—particularly if these countries do not make significant progress in reducing macroeconomic instability and the size and frequency of exchange rate misalignments. When the macroeconomy is in trouble and the real exchange rate is allowed to get way out of line, the banking system is sure to suffer. An IBS can improve mechanisms that cushion against macroeconomic volatility—bank capital, provisioning for loan losses, etc.—and it can reduce the independent contribution of banking-system weakness to an unhealthy macroeconomic environment. But an IBS *cannot be a substitute* *for disciplined monetary, fiscal, and exchange rate policies*, and it cannot engineer structural changes in the real economy (such as greater diversification in a country's export structure) to reduce volatility.[1]

Also, even in countries with the most developed systems of banking supervision, many future bank failures go undetected during bank examinations. For example, a recent Federal Deposit Insurance Corporation (FDIC) (1996) study found that of the US banks that failed from 1980 to 1994, 36 percent of them had received the highest bank examination ratings (that is, CAMEL ratings of 1 and 2) two years prior to failure.[2]

An IBS should be seen as part of a comprehensive reform effort for banking and banking supervision (that would also include increased training for bank supervisors and improvements in the broader financial and legal infrastructure). A realistic objective for an IBS is that it lead to a lower frequency of serious banking crises in developing countries than would occur in its absence; given the costs of past banking crises in developing countries, this objective—if it can be achieved—would represent an important accomplishment.

Second, if an IBS is going to make a real dent in the incidence of serious banking crises in developing countries, it will need to *encompass an interrelated set of banking system and supervisory reforms*. Changing one or two elements of the banking architecture is unlikely to make a large difference. For example:

- If nothing is done to improve accounting and provisioning practices, neither statements of a bank's financial condition nor measures of bank capital will be accurate; as such, public disclosure will not fortify market discipline, and prompt-corrective-action supervisory measures based on capital-zone tripwires will be ineffective.
- If nothing is done about connected lending, increasing capital requirements for banks will not alter the incentives for excessive risk taking by bank owners.
- If nothing is done to institute prompt corrective action by bank supervisors, there may be little consequence of bank capital—even correctly measured—dropping below the regulatory requirement.

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1. As emphasized in chapter 2, a lack of diversification in the loan book of developing-country banks countributes to their vulnerability.

2. If one excludes types of bank failures that cannot be anticipated by safety and soundness examinations, as well as bank examinations that were more than one year old, the percentage of failed banks that had CAMEL ratings of 1 or 2 two years before failure drops to 16 percent (FDIC 1996). CAMEL is an abbreviation for five components of bank soundness: capital, assets, management, earnings, and liquidity. In an earlier study of the same issue, Benston (1973) found that of US commercial banks that failed from 1959 to 1971, almost 60 percent had been rated "no problem" on the last bank exam prior to collapse. Benston (1973) goes on to argue that the main reason examinations fail to predict bank failures is

- If nothing is done to make government policymakers more accountable for granting ''too big to fail'' assistance to severely undercapitalized banks, then private creditors will not heed any improved public information on banks.
- If nothing is done to reduce the proclivity of governments to use banks as their quasi-fiscal agents, efforts to improve the credit review process are apt to be frustrated.
- If nothing is done to buttress the legal authority of bank supervisors, then tougher prudential standards are not likely to be enforceable.

In other words, there is a critical mass of reforms in developing countries that, if not achieved, may result in little improvement in the bottom line.

One frequent criticism of such a comprehensive approach to banking reform is that some of these elements would go beyond the traditional jurisdiction of banking supervisors (e.g., the Basle Committee of Bank Supervisors). For example, efforts to increase the transparency of government involvement in the banking system (by, for example, including such quasi-fiscal operations in the government's budgetary figures) are more the responsibility of the IMF than of the Basle Committee. Similarly, international accounting standards fall in the sphere of the International Federation of Accountant's International Accounting Standards Committee (IASC). Facilitating bank seizure of collateral on nonperforming loans involves changes in countries' legal codes. And better preparation for financial liberalization will require, inter alia, more training of bank supervisors, which is part of ongoing activities of the World Bank and the regional development banks.

My rebuttal to the jurisdictional argument is that if serious banking reform requires a coordinated effort among bank supervisors and other interested official parties, then a vigorous effort should be made to obtain such cross-agency cooperation. If that means one official institution cannot be solely responsible for designing an IBS, so be it.[3]

Third, an IBS does not imply (full) international harmonization of banking standards. So long as an IBS is designed as a *minimum set of international banking standards*, it represents only a *partial international harmonization* of standards, that is, it still leaves room—beyond the minimum—for individual countries to maintain their national preferences toward risk, as well to maintain some of their institutional diversity.[4] For example, if Argentina wants its banks to disclose more information on their financial

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that a leading cause of failure is fraud or misdealing, and bank examinations are not effective in detecting these kinds of problems.

3. This issue will be taken up again later in this chapter.

4. For a discussion of different levels of harmonization of international regulatory standards, see Herring and Litan (1995). For an analysis of why it is not desirable to impose the same

condition than stipulated in the IBS, it would be free to do so. Likewise, since an IBS would not step into the debate on the securities and insurance activities of banks, it would not stop France and Germany from maintaining their universal banking structures, while the United States and Japan could continue their de jure limitation on such activities by banks. An IBS that stops well short of full harmonization of banking structures and supervisory practices merits emphasis because, as illustrated in appendix C, tables C.1 and C.2, there remain significant differences on these matters even among the G-10 and EU countries.

Fourth, an IBS would not necessarily decrease competition in the banking industry. As highlighted by L. White (1996), in industries where *national* governments act to reduce competition, an *international standard can serve to reduce national protectionism*. Two examples suffice to illustrate the point. If governments provide state-owned banks with cheap capital and routinely bailout such institutions when they suffer large credit losses, an IBS that discourages these subsidies (or taxes) can increase global competition in the banking industry. Likewise, if generous national safety nets induce banks to substitute official (implicit or explicit) safety-net guarantees for private capital, then an IBS that sets a minimum international capital standard can reduce these national subsidies toward banks and increase competition (L. White 1996).

Fifth, like other international regulatory initiatives, an IBS needs to confront the test that there be *market failures, externalities (spillovers), or public goods that extend beyond national borders*, and that cannot be handled adequately by national regulation (Herring and Litan 1995; L. White 1996). As argued in chapter 2, I believe an IBS can pass that test: there are nontrivial cross-border spillover effects of developing-country banking crises; there are market failures associated with asymmetric information, with connected lending, and with heavy involvement of national governments in the banking industry; and accurate and timely public information on the financial condition of banks has attributes of a public good. Also, based on the history of the past 15 years, it is unlikely that competition among national banking regulators in developing countries will motivate serious banking reform.

Sixth, an IBS must consider the *costs of regulation and the possibility that flawed or outmoded regulations* could make matters worse. That is, there can be government failure as well as market failure. [5] It is partly for this reason that an IBS ought to be *voluntary.* If countries view the costs of participating in an IBS as higher than the benefits, they need not sign up. Similarly, if they decide that changes in the structure of the banking

organizational structure on financial markets in all countries, see Kaufman and Kroszner (1996).

5. See Merton (1995) for a discussion of the risks associated with implementing the wrong global regulatory standard.

industry have made an IBS outmoded or counterproductive—and agreement can not be reached on a revision of the IBS—they can withdraw. In this sense, countries will vote with their feet as to whether the IBS is a club worth joining.

Seventh, an IBS should include *both quantitative and qualitative elements.* The prescription for some regulatory and supervisory problems (e.g., minimum bank capital ratios, limits on connected lending) can and should be delineated in quantitative terms, but many other problems (improved public disclosure, prompt corrective action on the part of bank supervisors, stricter accounting and provisioning practices, etc.) are best handled primarily in qualitative terms. Indeed, appendix B shows that many of the more useful international guidelines in the financial area have been qualitative in nature. Whether quantitative or qualitative, IBS guidelines need to be *specific enough to serve as benchmarks* for performance evaluation by the monitoring agency (e.g., it will not be sufficient to call for appropriate asset classification unless some indication is given about what ''appropriate'' means).

Eighth, as with the IMF's SDDS, *countries* (not individual banks) *would sign on to an IBS*. Once a country agreed to participate, it would alter its national banking laws (if necessary) to accommodate any features of the IBS not already included; at that point, a country's banks would be covered.[6] But what about banks in a country that chose not to participate in the IBS? In that case, individual banks wanting to distinguish themselves from their less creditworthy competitors could indicate that they voluntarily comply with all elements of an IBS under their control (much in the same way that some derivative dealers advertise that they voluntarily implement the G-30 guidelines on risk management of derivatives). Admittedly, they could not claim that national supervisory practices were subject to international monitoring, but they still might get some market premium by subscribing to a higher code of conduct.

A Unitary or Two-Level Standard?

An IBS could be a unitary standard applicable to all countries, or alternatively, a two-level standard where countries themselves would decide at which level to join. All previous international banking agreements have

6. Should all banks be covered or only internationally active banks? The Basle Capital Adequacy Accord, for example, was directed only at the latter group. The rationale for covering only internationally active banks is that these banks generate the largest international spillovers. The argument for wider coverage is that widespread failures at domestic banks generate (smaller but still) nontrivial spillover effects; domestically oriented banks represent too large a share of vulnerability to ignore; and, as developing countries increase their financial links with the rest of the world, more of their banks will become internationally active. I would argue for the wider definition of participating banks.

been unitary standards. It is argued that a unitary standard ensures all countries receive uniform treatment; it is also easier to administer.

Despite these considerations, I vote for a two-level standard on three grounds: differences in country circumstances, relevant transition periods, and lessons from standards in other areas. Moreover, potential difficulties with a two-level mandatory standard are reduced when the IBS is voluntary instead.

Some of the most widespread and severe banking problems are among the transition economies and developing countries of Africa and Asia. Yet financial and banking structures and the degree of market orientation in these countries are typically quite different from those in the more advanced emerging economies. What is of first priority and feasible in the way of banking reform is therefore likely to be different in say, China, Russia, and India than in say, Hong Kong and Chile. For example, the share of total banking assets owned by the state is almost 90 percent in India, whereas it is zero in both Hong Kong and Singapore. A two-level standard would better accommodate these differences.

A two-level standard would lead to a more desirable transition period than would a unitary one. Note that implementation of the Basle Accord on risk-weighted capital standards took four years for the G-10 countries; similarly, as noted earlier, implementation of the Minimum Standards guidelines has been incomplete and uneven across countries four years after its agreement. The IMF's SDDS, applicable only to countries heavily involved in international capital markets, will have a transition period of two and one-half years. If there is a unitary standard, then a choice must be made between setting it at a high level (i.e., ''best practice'' guidelines) or a low level (i.e., a minimum standard); the former could imply that many developing countries could not meet the standard for very considerable periods of time (perhaps a decade or more), while the latter may not yield much incentive for the emerging market economies to make important further improvements in their regimes.

Looking beyond international banking agreements, two-level standards are more common, especially when such agreements are meant to cover a heterogeneous group of countries. The IMF's Articles of Agreement, for example, specify that countries can adopt transitional arrangements (Article XIV status) before accepting the obligations of current-account convertibility (Article VIII status). At present, more than a third of the IMF's member countries still avail themselves of such transitional arrangements. There is an even closer parallel with the IMF's new data standards, which features a basic, transitional standard that all countries should satisfy, and a stricter standard that would apply to countries that are more heavily involved with international capital markets. Global and regional trade agreements, likewise, often specify longer transitional periods for developing countries. For example, APEC's recent ''free trade'' commitment calls for industrial countries to meet the target by 2010, but gives developing countries until 2020.

A similar arrangement might work for an IBS: an upper level (stricter) standard that would probably attract banks and countries more heavily involved with international capital markets and a basic (transitional) standard that would apply to all participants. The main incentive to sign on to the higher standard would be the market premium attached to having satisfied more rigorous entry qualifications. But other incentives could also be contemplated. For example, in line with supervisory arrangements in the United States, countries and banks meeting the higher standard (including higher capital requirements and stricter disclosure) could be subject to lighter supervisory oversight.

So long as subscription to an IBS is voluntary and qualification for both levels is based on objective criteria rather than merely an industrial-country/developing-country classification, administering a two-level standard might not be much harder than administering a unitary one. Also, claims of ''unequal treatment'' would carry less weight. If countries rather than the monitoring agency choose the level they subscribe to, the monitoring agency need not decide when to ''graduate'' countries from the lower level to the upper one; instead, it would reject or accept a country's application based on objective criteria for a given level.

As regards equal treatment, there is a strong case against assigning industrial countries ex ante to the upper level and developing countries to the lower one—even though the primary focus of an IBS is on improving banking systems and banking supervision in developing countries and ex post most industrial countries would probably be in the upper level and most developing ones in the lower level (at least to start). Just because the incidence of serious banking crises in industrial countries has been lower than in developing countries over the past 15 years does not mean that banking systems/banking supervision in industrial countries are free from serious shortcomings. For example, ''evergreening'' of bad loans (i.e., poor asset classification) and regulatory forbearance have been prominent features of the ongoing banking crisis in Japan. Heavy and misguided government involvement has been evident in the sizable public bailout of Credit Lyonnais in France. Poor preparation for financial liberalization was instrumental in the late 1980s/early 1990s banking crises in Finland, Norway, and Sweden. Poor internal controls were a key factor in the recent troubles at Daiwa and Barings. And the bitter fruits of an incentive-incompatible official safety net were dramatically illustrated in the US saving and loan crisis.[7] In short, industrial countries

7. See Goldstein et al. (1993) for a discussion of these industrial-country banking problems. Calomiris and White (1994) have calculated that the deposit insurance cost to taxpayers of the US saving and loan debacle exceeded in real magnitude the losses of all failed banks during the Great Depression.

should not get a free ride; they need to satisfy the same objective entry criteria as developing countries do. An IBS can therefore be a vehicle for motivating further improvements in industrial-country banking systems.

Any IBS that discriminated against developing countries would not provide those countries with the proper incentives for reform. For example, if one could make the case on objective grounds that say, Hong Kong and Chile were better placed to qualify for an upper-level IBS than a few industrial countries, that differentiation should not be thwarted by some country-group classification. Following the same line of argument, it would be totally inappropriate to design an IBS only for developing countries. There can be different levels of certification, but qualification for those levels must be nondiscriminatory.

While I believe that a two-level IBS would be superior to a unitary standard, the latter would be much better than having no IBS at all.

What Should an IBS Include?

To be truly comprehensive, an IBS would need to specify guidelines for all the important aspects of banking supervision, including, inter alia: deposit insurance; lender-of-last resort operations; bank licensing and permissible banking activities; external audits; internal controls and internal audits; information requirements of bank supervisors; public disclosure; limits on large exposures and connected lending; capital adequacy; asset valuation and provisioning; foreign-exchange exposures; on-site banking inspections; legal powers and political independence of bank supervisors; the mix between rules and discretion in the implementation of corrective actions; globally consolidated supervision; cooperation (including exchange of information) between home- and host-country supervisors; and measures to combat money laundering.[8] In addition, one would want to offer some guidance on the relevant infrastructure for good banking, including: interbank and government securities markets; payments, delivery, and settlement systems; and the legal and judicial framework.

Clearly, analysis of each of these elements would go beyond the scope of this study. I will therefore concentrate on *eight priority elements of an IBS, selected primarily for their past and potential contribution to banking crises in developing countries.* For each element, I attempt to convey the flavor of what should be required, along with some indication of which provisions might be reserved for the stricter (upper-level) standard (if an IBS were designed as a two-level standard rather than a unitary one).

8. For an excellent analysis of ''best practice'' in each of these supervisory dimensions, see IMF (1997a).

Public Disclosure

IBS participants should be required to publish timely and accurate information on the financial condition of banks so that both sophisticated professional investors and less sophisticated retail depositors can make an informed assessment of bank performance and profitability. At a minimum, such information should include a balance sheet, income statement, large off-balance-sheet exposures, and summary of major concentrations of credit and market risk.[9]

This material should be prepared on a globally consolidated basis, in accordance with international accounting standards, and should be audited by a reliable independent external auditor.[10] There should be enough detail so that readers can gauge the breakdown between interest and noninterest income and expenses, the relationship between nonperforming loans and loan-loss provisions, how well or poorly the bank is capitalized, and how profitable the bank is relative to its competitors (as revealed by traditional indicators, such as the return on equity, the return on assets, etc.). If a common format for such public disclosure of banks could be agreed, this, like a common international accounting standard, would be most welcome (since it would both reduce transaction costs and facilitate comparisons among banks within and across countries). IBS participants would agree to review their legal codes to ensure that banks are liable for serious penalties if they are found to have been issuing false or misleading information to the public.

For upper-level status, banks could also be required to display prominently their most recent ratings from internationally recognized credit-rating agencies (including any downgradings). If they have not been rated, banks should disclose that fact. Upper-level participants would also commit to adopting public disclosure recommendations (jointly agreed by the Basle Committee, IOSCO, and the Eurocurrency Standing Committee) on the trading and derivative activities of banks and securities firms.[11]

Appendix D provides two examples of good public disclosure—one for the banking system as a whole and one for individual banks. The first

9. Later in this chapter, I introduce two additional disclosure requirements for IBS participation, specifically related to the problems of government involvement in the banking system and connected lending.

10. One problem here is that there are presently two competing international accounting standards: International Accounting Standards as drawn up by the International Accounting Standards Committee and Generally Accepted Accounting Principles (GAAP) used in the United States. See W. White (1996) for a discussion of their relative advantages and disadvantages. Discussions are ongoing among accounting bodies in the major industrial countries to see if agreement can be reached on a single international accounting standard. In the interim, use of either GAAP or international accounting standards might be acceptable for an IBS.

11. See Basle Committee on Banking Supervision (1996) for an explanation of this disclosure agreement.

shows the aggregate data published quarterly for 3,000 national banks in the United States, while the second gives the disclosure requirements for individual banks under New Zealand's new supervisory regime.[12]

Accounting and Legal Framework

The aim here should be to move closer to internationally recognized loan classification and provisioning practices and remove undesirable legal impediments to the pledging, transfer, and seizure of loan collateral and to the statutory authority of supervisors to carry out their mandate.

IBS participants would agree to set out clearly the criteria and rules/practices they employ to classify loans, provision for loan losses, and suspend accrual for overdue interest. In classifying loans, participants would agree to give appropriate weight to an assessment of the borrower's current repayment capacity, to the market value of collateral, and to the borrower's past record, and they would not rely exclusively on the loan's payment status.[13] Participants would also pledge to discourage and monitor accounting devices that facilitate the ''evergreening'' of bad loans.[14] The time a loan could be in arrears before it was classified as nonperforming would be no longer than 150 days. For upper-level status, that time period could be 90 days. Each participant should have mandatory provisioning rules against bad loans. For upper-level status, participants would agree to meet an international provisioning standard (if one can be agreed); pending such an agreement, upper-level participants would maintain a provisioning coverage ratio (of loan-loss reserves to nonperforming loans) not more than 10 percent below the Organization for Economic Cooperation and Development (OECD) average for the previous five-year period.

On the legal side, IBS participants would review their legal and commercial codes to certify that laws governing bankruptcy and recovery and pledging of collateral (for bank loans) do not impose undue costs on

12. Note that disclosure requirements for banks in New Zealand are more demanding than those in most other industrial countries, and that New Zealand's new supervisory regime places greater reliance on public disclosure (relative to prudential requirements) to discipline banks than do regimes in other industrial countries. It is sometimes argued that New Zealand can afford to rely so much on disclosure because large banks in New Zealand are foreign owned and thus subject to supervision in their home country.

13. See Meltzer (1995) for a description and analysis of how Chile strengthened its asset classification and provisioning regime.

14. De Juan (1996, 101) highlights three signs of ''evergreening'' and weak repayment capacity: ''. . . (i) the financial statements of the borrower show negative net worth and/or negative cash flow; (ii) the loan has a history of consecutive rollovers, and the volume of each new loan is equal to or above the principal plus interest of the previous loan; and (iii) the principal or interest of previous loans is not paid in cash, but through refinancing facilities extended by the same creditor bank.''

banks. In addition, participants would confirm the legal authority of bank supervisors to carry out their responsibilities (e.g., issuance and revocation of banking licenses, requests for information, setting of prudential guidelines/regulations, conducting on-site inspections, closure of insolvent banks, etc.).[15]

Internal Controls

Because of increased bank involvement in trading activities and the tremendous growth of complex financial instruments over the past decade, it is more difficult for bank supervisors and creditors to monitor accurately the risk profile of banks.[16] During the same period, there have been several notable failures at financial firms (e.g., Barings, Daiwa, Sumitomo) where time-honored principles of prudent risk management (e.g., separation of authority as between front- and back-office operations and awareness by senior management of the size of exposures) were violated (IMF 1996a). These developments underscore the importance of good internal controls at banks as the first line of defense against excessive risk taking—be it market risk, credit risk, legal risk, or operational risk.

Participating banks would agree to have available for inspection a clear written account of what procedures and safeguards are in place as part of their internal risk management. It should address how risks are measured and tracked in real time, which members of senior management and the board are responsible for oversight and for ''pulling the plug'' if actual exposures exceed prespecified limits, how exposure limits in the loan book and trading book are set, how different functional risks within the firm are segregated, how the consistency and accuracy of internal record keeping is cross-checked, the amount of capital that is available to cover losses in various risk categories, what backup there is in case of computer breakdowns or other information technology problems, and what safeguards have been introduced to discourage and detect fraud and money laundering. In addition, IBS participants should certify that a reliable, independent internal audit function is in operation. For upper-level status, participants would certify that banks with significant involvement in derivative markets are implementing the G-30 (1993) guidelines on risk management of derivatives, as well as the recommendations for

15. A particularly important area here is the ability of supervisors to get the data they need to evaluate a bank, including data on off-balance-sheet and off-shore activities; see IMF (1997a).

16. See BIS (1996) and IMF (1996a) for figures on the growth of the over-the-counter and exchange-traded derivative markets during the 1990s. Goldstein (1995b) and Hoenig (1996) discuss the difficulties that financial regulators face in trying not to ''fall behind the curve'' in an innovative global capital market. Garber (1996) provides an account of how Mexican banks in 1994 used off-shore structured notes to evade national prudential regulations on net open currency positions.

combating money laundering promulgated by the Financial Action Task Force on Money Laundering (1990).

Government Involvement

As highlighted in chapter 2, state-owned banks and burdensome developing-country government involvement in privately owned banks have drained public finances and generated inefficient resource allocation in banking services. Despite this dismal track record, it is neither realistic nor desirable that an IBS call for immediate privatization of all state-owned banks or mandate an end to all policy-directed lending in developing countries. After all, almost all countries have at some time intervened to influence the allocation of bank credit for what they deemed socially desirable purposes. Also, there may well be situations in developing countries where some government involvement can be legitimately defended.

But what an IBS can do is bring greater transparency and accountability to government ownership and involvement in the banking system. This should subject such operations to greater public scrutiny and make it more difficult to use the banking system as a quasi-fiscal device to circumvent legislative and political constraints on the budget. Moreover, an IBS can encourage financial institutions that operate with policy-based lending constraints to give greater weight to commercial considerations in their credit decisions, to avoid costly future bailouts. And an IBS can even ask governments to consider more carefully whether privatization of some or most of their state-owned banks would not be in their long-term interest.

Toward this end, IBS participants would agree to

- include in the government budget all government costs and quasi-fiscal operations that involve the banking system (as recently recommended by the IMF [1996b]);[17]
- annually publish data on nonperforming loans in state-owned banks (on a basis that permits comparison with privately owned banks);
- disclose the nature and extent of government instructions to banks on the allocation of credit (be it in state-owned or privately owned banks);
- subject state-owned banks to an external audit by a private independent external auditor and publish the results of that audit; and
- direct state-owned banks to give due attention to creditworthiness in their lending decisions.[18]

17. Mackenzie and Stella (1996) explain how one might define and measure quasi-fiscal operations of public financial institutions.

18. Kaufman (1996a) urges developing countries where state-owned banks account for an important share of total bank assets to recapitalize all banks so that they are market-value

For upper-level status, countries where state-owned banks account for a significant share of total banking assets would agree to review the costs and benefits of their state-owned banks, with an eye toward assessing the scope for privatization of such institutions.

Connected Lending

IBS participants would establish an exposure limit on lending to connected parties, endorse the principle that lending to connected parties should be on terms that are no more favorable than those extended to nonrelated borrowers of a similar risk class, outlaw practices that make it difficult or impossible for supervisors to verify the accuracy of reported connected-lending exposure (e.g., use of fictitious names, dummy corporations, etc.), and publicly disclose the share of loans going to connected parties and the identity of large shareholders and their affiliations.[19] For upper-level status, participants would establish below-maximum-limit threshold reporting limits (to bank supervisors) on connected lending (to give supervisors advance warning of rapidly rising exposure to connected lending).

Bank Capital

Signatories to an IBS would adopt the existing 8 percent risk-weighted capital standard for credit risk, along with the recent amendment for market risk. To reflect the need for higher capital when the operating environment is relatively volatile, countries seeking upper-level status would apply a ''safety factor'' if their recent history of loan defaults, restructured loans, and/or government assistance to troubled banks was significantly higher than the OECD average over say, the past five years. This safety factor could possibly involve multiplying the level I capital requirement by 1.5, so that ''volatile'' countries would apply a minimum risk-weighted capital standard for credit risk of 12 percent. This approach would respect the principle of equal treatment. Any country—industrial or developing—that had a relatively volatile operating environment for its banks would apply the higher requirement if it wanted to meet the upper-level standard. Also, a country's actions to reduce that volatility

solvent, privatize to improve the incentives for banks and to reduce political pressures, put in place an incentive-compatible safety net, and resist or minimize nonprudential regulations that focus on political, social, or other objectives.

19. Exposure limits on connected lending should be additional to those on maximum exposure to a single borrower. According to a recent survey of the Basle Committee (Padoa-Schioppa 1996), 90 percent of countries do not allow lending to a single customer to exceed 60 percent of the bank's capital, and roughly two-thirds of countries maintain the stricter exposure limit of 25 percent of capital. See Goldstein and Turner (1996) for the exposure limits on single borrowers in a group of emerging economies.

(e.g., more stable macroeconomic policies) would, if sustained, eventually be reflected by a lower capital requirement. Much of this parallels the Basle Committee's approach to determination of regulatory capital for market risk (Basle Committee on Banking Supervision 1996; Padoa-Schioppa 1996).

An Incentive Compatible Safety Net and Resisting Pressures for Regulatory Forbearance

The aim here should be to retain the positive features of an official safety net for banks (i.e., discouragement of bank runs and limitation of systemic risk) while reducing its negative (moral hazard) effects (i.e., less market discipline from bank creditors, excessive risk taking by banks, increased costs for taxpayers, and delay in enforcing corrective actions on undercapitalized banks by financial regulators). To do that, the safety net must incorporate incentives that tilt the behavior of the main players in the right direction.

The most promising approach to date for designing an incentive-compatible official safety net is the system of structured early intervention and resolution (SEIR), put forward by Benston and Kaufman (1988) in the late 1980s and incorporated with some modifications in US banking legislation in the early 1990s.[20] The losses (at least $150 billion) incurred in the saving and loan debacle and the prospect of similar difficulties for US commercial banks supplied the political motivation for reform. The key legislative vehicle was the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. The underlying strategy has two pillars: first, to maintain deposit insurance for banks but to use regulatory sanctions to mimic the penalties that the private market would impose on banks (as their financial condition deteriorated) if they were not insured, and second, to reduce greatly the discretion that regulators have in imposing both corrective actions and closure of a bank.

The safety-net reforms embodied in FDICIA legislation can be summarized as follows: (1) government deposit insurance is retained for small depositors;[21] (2) deposit insurance premiums paid by banks are risk weight-

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20. Benston and Kaufman (1996) argue that while FDICIA was a big step forward in deposit-insurance reform, it should have set the capital-zone thresholds higher, used a simple leverage ratio to measure capital (rather than using both this ratio and the Basle risk-weighted one), embraced market-value accounting, established stiffer penalties for Federal Reserve lending through the discount window to banks that subsequently failed, made wider spreads between the deposit insurance premiums paid by the safest and riskiest banks, and given even less scope for discretion in applying prompt corrective action and least cost resolution.

21. The rationale for covering small depositors is that they might otherwise run into currency when banks get into trouble, they are generally less adept than large bank creditors in evaluating the true financial condition of banks, and they have enough political muscle

ed (depending on their capital and bank examination rating); (3) banks become subject to progressively harsher regulatory sanctions (e.g., eliminating dividends, restricting asset growth, and changing management) as their capital falls below multiple capital-zone tripwires; (4) by the same token, well capitalized banks receive ''carrots'' in the form of wider bank powers and lighter regulatory oversight; (5) regulators' discretion is sharply curtailed (with respect to initiating ''prompt corrective actions'' and resolving a critically undercapitalized bank at least cost to the insurance fund (least cost resolution); (6) effective 1 January 1995 the insurance fund is generally prohibited from protecting uninsured depositors or creditors at a failed bank if this would increase the loss to the deposit insurance fund; and (7) provision is made for a discretionary, systemic-risk override to protect all depositors in exceptional circumstances (when not doing so ''would have serious adverse effects on economic conditions or financial stability'')—but activation of this override requires explicit, unanimous approval by the most senior economic officials and subjects any bailout to increased accountability (Benston and Kaufman 1988, 1996; Kaufman 1996a, 1996b). Table 3.1 summarizes the prompt-corrective-action features of FDICIA.

Proponents of SEIR argue that it improves incentives on at least five counts (Benston and Kaufman 1996; Kaufman 1996b). Because uninsured creditors of banks realize they will be at the end of the queue if a bank gets into trouble, they will monitor banks more assiduously, thereby enhancing market discipline. Because bank owners and managers know the penalties in advance if losses are sustained and banks become undercapitalized, they will be less inclined to engage in excessive risk taking and will not allow bank capital to fall too low. Because bank supervisors are largely obliged to prompt corrective action and least cost resolution, they will be less susceptible to pressures for regulatory forbearance. Because the most senior economic officials know that granting ''too large to fail'' assistance requires unanimous approval and involves increased public scrutiny, they will be dissuaded from doing so unless there is a clear systemic threat at hand. And because the explicit closure rule calls for resolving a failed bank while it still has positive net worth, losses to the deposit insurance fund should be small (thereby making it less costly to keep the fund fully funded).[22] In contrast, safety-net regimes that do not incorporate SEIR often leave a key question unanswered: What happens when bank capital drops below the regulatory standard?

anyway to force the government to bailout their losses if they were not covered by insurance (Kaufman 1996a).

22. If the deposit insurance scheme lacks sufficient financial resources, even insured depositors may be tempted to run during periods of bank weakness; moreover, regulators will be more inclined to grant regulatory forbearance because there are insufficient resources to liquidate the bank.

Table 3.1 Summary of prompt-corrective-action provisions of the federal Deposit Insurance Corporation Improvement Act of 1991

Zone	Mandatory provisions	Discretionary provisions	Risk-based total	Risk-based tier 1	Leverage tier 1
1. Well capitalized			>10	>6	>5
2. Adequately capitalized	1. No brokered deposits, except with FDIC approval		>8	>4	>4
3. Undercapitalized	1. Suspend dividends and management fees 2. Require capital restoration plan 3. Restrict asset growth 4. Approval required for acquisitions, branching, and new activities 5. No brokered deposits	1. Order recapitalization 2. Restrict interaffiliate transactions 3. Restrict deposit interest rates 4. Restrict certain other activities 5. Any other action that would better carry out prompt corrective action	<8	<4	<4
4. Significantly undercapitalized	1. Same as for zone 3 2. Order recapitalization[a] 3. Restrict interaffiliate transactions[a] 4. Restrict deposit interest rates[a] 5. Pay of officers restricted	1. Any zone 3 discretionary actions 2. Conservatorship or receivership if it fails to submit or implement a plan or recapitalize pursuant to order 3. Any other zone 5 provision, if such action is necessary to carry out prompt corrective action	<6	<3	<3

5. Critically undercapitalized	1. Same as for zone 4 2. Receiver/conservator within 90 days[a] 3. Receiver if still in zone 5 four quarters after becoming critically undercapitalized 4. Suspend payments on subordinated debt[a] 5. Restrict certain other activities	<2

a. Not required if primary supervisor determines action would not serve purpose of prompt corrective action, or if certain other conditions are met.

Source: Board of Governors of the Federal Reserve.

As acknowledged by Benston and Kaufman (1996), FDICIA has been in operation for only five years, the US economy has not undergone a major cyclical downturn during that period, and no US money-center bank has become critically undercapitalized during this period. In addition, broader economic factors have no doubt contributed to the recovery of the US banks and S&Ls. It is, therefore, too early to come to a definitive verdict on the effectiveness of FDICIA. Nevertheless, the preliminary signs are encouraging. Not only are bank failures and bank problems down and bank capital and profitability up, but as shown in table 3.2, a much higher share of uninsured depositors has gone unprotected since FDICIA came on stream. This is a strong signal that market discipline is beginning to bite.

Some exporting of FDICIA is already going on. In drawing lessons from its recent/ongoing banking difficulties, Japan plans to establish a prompt-corrective-action system in April 1998, and the banking laws of some developing countries (e.g., Chile) contain significant precommitment features. With no superior alternatives out there for reforming official safety nets, FDICIA-like features (to combat moral hazard and regulatory forbearance) ought also be included in an IBS. For example, IBS participants could agree to make some corrective actions mandatory if bank capital dropped below the regulatory minimum, ensure there is a well defined closure rule/procedure for banks, make it publicly known that uninsured creditors (including sellers of interbank funds) stand behind insured depositors and the deposit insurance fund in being protected from bank losses, and require that granting of ''too large to fail'' emergency financial assistance to banks be publicly approved by both the governor of the central bank and the minister of finance.

Consolidated Supervision and Cooperation Among Host- and Home-Country Supervisors

The Basle Committee on Banking Supervision has been on target in insisting that (1) all international banks be supervised on a globally consolidated basis by a capable home-country supervisor; (2) home-country supervisors be able to gather information from their cross-border banking establishments; (3) before a cross-border banking establishment is created, it receive prior consent from both the host- and home-country authorities; and (4) host countries have recourse to certain defensive actions (e.g., prohibit the establishment of banking offices) if they determine that conditions (1)-(3) are not being satisfied (Basle Committee on Banking Supervision 1996). Participants in an IBS should therefore agree to implement the 1992 Basle Minimum Standards.

Could an IBS be Agreed on?

So much for the makeup of an IBS. But wouldn't an IBS represent such an ambitious extension of existing international banking agreements as

Table 3.2 FDIC banks' resolutions, 1986–95 (by protection of loss of uninsured depositors)

	Number of banks				Total assets (billions of dollars)			
Year	**Total**	**Protected**	**Not protected**	**Percentage not protected**	**Total**	**Protected**	**Not protected**	**Percentage not protected**
1986	145	102	40	28	7.6	6.3	1.3	17
1987	203	152	51	25	9.2	6.7	2.5	27
1988	221	185	36	16	52.6	51.3	1.3	3
1989	207	176	31	15	29.4	27.2	2.2	8
1990	169	149	20	12	15.8	13.3	2.5	16
1991	127	106	21	17	62.5	60.9	1.6	3
1992	122	56	66	54	45.5	25.0	20.5	45
1993	41	6	35	85	3.5	0.2	3.3	94
1994	13	5	8	62	1.4	0.6	0.8	57
1995	6	0	6	100	0.8	0.0	0.8	100

Source: Benston and Kaufman (1996).

to preclude agreement? After all, several of these items were no doubt raised in the Basle Committee in previous years without garnering the requisite support. If agreement could not be reached among the G-10 countries, wouldn't it be unrealistic to expect agreement on a wider list of banking reforms among a broader group of countries?

I find this criticism unpersuasive. Prior to the Mexican economic crisis of late 1994 to 1995, few would have anticipated reaching agreement on an international standard for publication of economic and financial data (the IMF's SDDS), or on doubling the IMF's line of credit from the General Agreement to Borrow and its extension to 14 new member countries, or on establishing a concerted official position on the rescheduling of sovereign bank debt (the so-called ''orderly workout'' issue). Yet, barely two years after the onset of the Mexican crisis, the international community has reached agreement on all three (Goldstein 1996b).

In analyzing past international agreements in the area of financial stability, Kapstein (1992) identifies three underlying factors: a shared recognition of a common problem, some agreement on how the financial system should function and how problems might best be addressed, and the continuing exercise of state power to make it happen. It is only within the last year or two, with the publication of several comprehensive studies, that the scope and severity of banking problems in developing countries has come to be more widely appreciated, particularly by observers in the G-10 countries (Lindgren, Garcia, and Saal 1996; Caprio and Klingebiel 1996a, 1996b; Honohan 1996). And, it is only recently that research has produced a reasonable consensus on the factors behind these banking crises and the policy changes that would help to alleviate the problem (Caprio and Klingebiel 1996a, 1996b; Goldstein 1996a; Goldstein and Turner 1996; Kane 1995; Kaufman 1996a; Meltzer 1995; Rojas-Suarez and Weisbrod 1995, 1996a, 1996b, 1996c, 1996d). As regards leadership from the official sector, it was only at the Lyon Summit in June 1996 that G-7 heads of state (G-7 1996, 3) put the ''. . . adoption of strong prudential standards in emerging economies'' on their crisis prevention agenda, and it has been primarily during the past six months that senior international policymakers have begun to stress the need for a coordinated international approach to banking problems in developing countries (G-7 1996; Camdessus 1996; Summers 1996; Pou 1996). In short, each of Kapstein's (1992) criteria for agreement are considerably closer to being satisfied now than they were even three years ago. What could be agreed then is not necessarily what can be agreed now.

Who Should Set the IBS?

Since more robust banking systems and more effective banking supervision would be in their common interest, an IBS ought to be sponsored jointly by the international financial institutions (the IMF, World Bank, and BIS), the Basle Committee on Banking Supervision, regulatory and supervisory authorities from the developing world, and representatives of the banking industry. But who should set the specific guidelines for an IBS?

The main expertise needed to draft an IBS is banking supervision. This suggests that the Basle Committee on Banking Supervision should play a key role in the exercise, that is, they should draft the key provisions of the IBS that relate specifically to banking supervision. The Basle Committee's leadership would give the IBS a brand name and provide a sense of continuity with earlier international banking agreements.

But the Basle Committee should not be the only group working on an IBS, for at least four reasons.

First, as outlined above, a good IBS would be somewhat broader in design (e.g., international accounting standards, greater transparency for government involvement in the banking system, etc.) than the confines of traditional banking supervision; as such, other groups that have more direct responsibility for these adjacent issues (e.g., the IASC or IMF) should be involved and their contributions folded into the final product. Such interagency collaboration would be even more essential if the ultimate aim were not merely to produce an IBS but rather to a produce a minimum international standard for, say, banking and securities activities; in that case, the guidelines of securities regulators (i.e., IOSCO) should be folded into the IBS into the broader standard. In either case, some international umbrella group at a higher level than the Basle Committee (e.g., the Interim Committee of the IMF or a working group of ministers of finance and central bank governors from larger industrial and developing countries) would need to coordinate the assembly of the final product.

Second, and pointing in the same direction, because an IBS introduces some issues not raised by earlier international banking agreements (e.g., international monitoring of national supervisory regimes), enlarges the intersection between the microeconomic and macroeconomic aspects of financial regulation, and would require large changes in banking practices in some countries, the Basle Committee's collaboration with other interested parties should be more extensive and intensive than normal. For example, if the international financial agencies (the IMF, World Bank, and regional development banks) were assigned the tasks of advising countries on how to alter their banking and supervisory arrangements to conform to an IBS, of monitoring participating countries' compliance with the standard (as discussed later in this chapter), and of intensifying their normal financial surveillance and financial-sector restructuring work, then their views ought to be sought as to whether any guidelines drawn up by the Basle Committee are sufficiently specific and comprehensive. Their views would be particularly valuable on whether any consensus on an IBS reached in the Basle Committee had ducked some of the tough issues (e.g., whether countries with volatile operating environments should have higher regulatory capital requirements, whether an IBS includes incentives that will reduce over time government involvement in the banking system, etc.) that are apt to be crucial in reducing the vulnerability of developing-country banking systems. Given BIS's considerable expertise in the intersection of the micro and macroeconomic elements of financial regulation, it should likewise be accorded an important role in reviewing any draft IBS guidelines produced by the Basle Committee.

Third, the banking industry needs to be given ample opportunity to record its views on what elements should and should not be included in an IBS; after all, it is the banking industry that would need to absorb any costs associated with meeting the requirements of an IBS. The influence of their input should not be minimized. For example, the decision by the Basle Committee to permit banks to employ their own internal risk-management models to help calculate regulatory capital requirements for market risk occurred only after banks in several larger industrial countries expressed their dissatisfaction with the earlier proposal to base these capital requirements on a preset formula.[23]

Fourth, the group that sets the IBS should have strong representation from developing countries. Since developing-country banking systems and banking supervision are the primary focus of the IBS exercise, the drafting group needs to have firsthand experience with developing-country banking supervision issues. Without that experience, the IBS guidelines are not likely to be as well suited to the practical banking problems faced by developing countries as they could be with strong representation from these countries. Without adequate support from the developing countries, an IBS is unlikely to get off the ground. Some groups in developing countries are likely to resist the banking reforms necessary to qualify for IBS admission; some may even argue that an IBS is a scheme by industrial countries and their banks to reduce the competitiveness of developing-country banks by imposing onerous prudential standards—standards that many industrial countries will already have met or exceeded. Spokespersons for banking reform in developing countries will be better able to overcome opposition and convince their publics and their banking industries that such (voluntary) reforms are in the best interest of their country if they can legitimately say that they were full participants in drafting an IBS. Although the Basle Committee presently includes only bank supervisors from G-10 countries, there is no reason why the working group that drafts the IBS should not include significant representation from developing countries. Developing-country representatives should also serve on any other working groups that are contributing to an IBS.

23. See IMF (1995) for a discussion of this background to the recent amendment of the Basle Capital Adequacy Accord to cover market risk.

In the end, after the interagency collaboration is complete, there must be full agreement on the guidelines in an IBS. If, for example, the IMF and World Bank had a different view on minimum standards for accounting and provisioning than did the Basle Committee, countries participating in an IBS would not understand their obligations and the monitoring process would be unnecessarily complicated. When the smoke clears, there can be only one IBS.[24]

How Should Compliance with an IBS Be Monitored and Encouraged?

This is probably the single toughest operational issue facing an IBS. There are basically two approaches.

The traditional one, at least in the field of international banking agreements, is to have international recommendations ratified by ministers and governors, incorporated into national law or regulation, and then monitored/enforced by the national banking supervisor (W. White 1996). This approach has its advantages. By maintaining home-country control, the chances that reforms are ''owned'' by the home country are maximized, and the criticism that conditions are being imposed by an international agency are avoided. Also, national supervisors are apt to be more knowledgeable about local banking conditions than an outside group would be.

The rub is that exclusive home-country control will weaken the implementation/credibility of an IBS in those countries where weak banking supervision is part of the problem. In those cases, an independent outside monitor should render an objective evaluation of whether an IBS is being implemented as agreed. A hint of the complacency that might be associated with home-country monitoring is offered by a recent Basle Committee survey (Padoa-Schioppa 1996), which covered 129 countries: two-thirds of the countries reported that the supervisory agency is independent from the government; only 13 countries acknowledged that their banks grant loans in compliance with governmental directives; 72 percent of nonindustrial countries responded that they do not allow lending to a single customer to exceed 25 percent of the bank's capital; and over 90 percent of all countries reported that supervisors verify the adequacy of bank's accounting systems. It makes you wonder. Either all those studies showing political pressures on supervisors, government-directed lending, connected lending, and weak accounting systems to be major factors in banking crises were wrong (BIS 1996; Caprio and Klingebiel 1996a, 1996b;

24. This is not to say that in their financial surveillance and financial restructuring work, the IMF and the World Bank should not address areas that are not covered in an IBS. But for the areas that are covered, everyone has to be singing from the same hymn book.

Folkerts-Landau et al. 1995; Goldstein and Turner 1996; Honohan 1996; Lindgren, Garcia, and Saal 1996; Meltzer 1995; Rojas-Suarez and Weisbrod 1996a, 1996b, 1996c, 1996d; Sheng 1996), or there has recently been a tremendous improvement in supervision.

The second approach is to entrust at least part of the monitoring to an international agency. This has been a long-standing practice in the areas of trade policy, macroeconomic stabilization, and sectoral reform (including the financial sector); note the roles of the General Agreement on Tariffs and Trade (GATT)-World Trade Organization (WTO), IMF, World Bank, and regional development banks (e.g., European Bank for Reconstruction and Development, Inter-American Development Bank, Asian Development Bank, etc.). Here, countries have decided that, despite the dilution of home-country control, evaluation by an international agency is critical to the agreement's credibility.

But which international agency or agencies should do the monitoring? I believe the IMF and the World Bank group are the most logical candidates. Only they have the universal membership that would include all potential participants in an IBS. Also, monitoring compliance with an IBS would require on-site inspections and discussions with local supervisory authorities and local banks. The IMF and the World Bank already send missions to countries and only they currently have enough personnel to make on-site visits throughout the developing world. I envision the Bretton Woods institutions carrying out at least three functions associated with an IBS.

First, the World Bank and regional development banks could incorporate the IBS guidelines into the training, technical assistance, and financial restructuring advice that they already provide to many countries. In this sense, the IBS would help guide banking system reform in developing countries and delineate the banking-system preconditions that are necessary for developing countries to benefit from greater financial integration.[25]

Second, the IMF could carry the primary responsibility for determining whether countries voluntarily subscribing to the IBS were meeting their obligations. They would base that determination on off-site analysis and information obtained during missions (on-site) to the country. During those missions, they would hold discussions with national bank supervisors and a sample of local banks. National banking supervisors would continue to have the primary oversight responsibility for their banks but the mission would seek to reach a view, inter alia, as to whether national banking supervision itself was implementing faithfully the IBS guidelines. If a determination was made that a country was not meeting its IBS responsibilities, it could be given a fixed period of time to remedy the

25. See the recent World Bank report (1997) for an extensive discussion of the preconditions for successful financial integration.

situation. If the country displayed serious and persistent nonobservance of the IBS guidelines, then the IMF would indicate publicly that the country's subscription to the IBS was suspended. Like the IMF's SDDS, an electronic bulletin board could be established on the internet listing those countries that subscribed to the IBS and were in good standing; persistent noncompliance would be signaled by taking a country ''off the board.''

This option of taking a noncomplying IBS member off the board is necessary to give the IBS credibility with private capital markets. If there are no significant penalties for not behaving as a good club member, then club membership will not yield a market return. That said, it would be a mistake for the IMF to create the impression that an IBS member of good standing is immune to banking problems. As laid out in chapter 2, banking-sector vulnerability depends on a number of factors in addition to banking supervision, including the state of the macroeconomy and the appropriateness of the country's exchange rate policy; the IBS does not address those sources of vulnerability and implying otherwise would only lead to a downgrading of the monitoring agency's credibility. Instead, the IMF should make it clear that being an IBS member in good standing carries a much narrower interpretation—namely, that the country is meeting IBS minimum standards of good banking supervision.

Third, the IMF and the World Bank could provide further incentive for signing on to the IBS and honoring its obligations by factoring compliance with the IBS guidelines into their policy conditionality decisions and/or by publishing their analysis of banking-sector developments.

By including compliance with IBS guidelines as an element of policy conditionality, the IMF in its stabilization programs and the World Bank in its financial restructuring programs would give those countries seeking financial assistance a further incentive to undertake banking reform. From the perspective of the international financial institutions (IFIs), there is good reason for such conditionality: if nothing is done to overcome banking-sector fragility, other elements of stabilization and financial reform could be rendered ineffective and the IFIs' chances of being repaid on time diminished. Also, at least in crisis situations, some banking system reforms are presumably already part of Bretton Woods conditionality; the IBS guidelines would just bring a more widely accepted framework to that element of conditionality. On the negative side, the more the IBS guidelines become a requirement, the less one captures the aforementioned advantages of a voluntary standard. Also, this additional source of leverage would only apply to countries seeking financial assistance from the IMF and the World Bank. On top of that, the potential ambiguities of judging compliance with an IBS that contains many elements should not be underestimated.

Rather than simply conveying an ''on-off'' signal to the private capital markets about IBS membership (i.e., country x is or is not a member in good standing of the IBS), the IMF could publish a more informative signal—its analysis of banking-sector developments and the quality of banking supervision in individual countries. The IBS guidelines could then serve as a useful organizing device for such reports. Presumably, such an analysis would be included with an analysis of monetary, fiscal, and structural policies, in the IMF's Article IV consultation report for the country. Again, such a monitoring role would affect incentives via its effect on information flows to private capital markets and ultimately on the country's cost of borrowing in those markets.

Whether it would be desirable to release to the markets that part of IMF consultation reports containing the staff's analysis of economic policies and prospects has been hotly debated for at least a decade, and publishing an assessment of banking system soundness focusing on IBS benchmarks raises a similar debate; that is, enhanced market discipline versus concerns about precipitating crises and reducing the frankness of IMF consultations. Although the choice is not an easy one, I have concluded elsewhere (Goldstein 1995a) that, on balance, there is much more to be gained than lost from publishing Article IV reports, and I would extend that conclusion to analyses of banking systems as well.

At least three criticisms might be leveled against such a monitoring role for the IFIs.

For one thing, it can be argued that IFIs do not have enough personnel with the requisite training and experience to make reliable evaluations of banking systems and banking supervision. This criticism carries some currency but should become less relevant over the medium term. Both the World Bank and the IMF have gained valuable and wide-ranging experience in assessing and providing technical assistance on developing-country banking systems. Yet, if an IBS were agreed on, their increased responsibilities in this area would no doubt require additional staff with banking supervisory expertise. This will take some time. In the interim, some assistance might come from short-term loans of bank supervisors from G-10 countries and from those emerging-market economies with more advanced supervisory systems.

A second line of criticism is that the IFIs are too politicized to make the hard decision of taking a nonperforming IBS member country off the board. But the IFIs have shown a willingness over several decades to interrupt their loans to countries under stabilization and restructuring programs when the latter have failed to meet agreed on performance criteria (a decision that can also generate significant effects in private capital markets). Why should suspension from the IBS be different in kind?

Yet a third objection is that having the IFIs comment—perhaps even publicly—on the performance of national bank supervisors would compromise the latter's independence and effectiveness. I find this argument unconvincing. To begin with, there *is* something to criticize. As detailed in chapter 2, there is no precedent for the wave of severe banking crises that have enveloped developing countries over the past 15 years; likewise, there have been some serious breakdowns in banking supervision in industrial countries, including that surrounding the current Japanese banking problem. Moreover, the contention that banking crises had little to do with banking supervision does not seem to be supported by existing analysis. Caprio and Klingebiel (1996b), for example, studied the factors contributing to 29 severe developing-country banking crises from 1980 to 1996 and concluded that poor supervision and regulation (broadly defined) were instrumental in more crises than were any other factor (e.g., recessions, declines in the terms of trade, fraud, lending to state enterprises, political interference, and deficient bank management). Also, one should not confuse independence with immunity from IFI criticism. For example, IMF and OECD publications have long provided an assessment of national monetary and fiscal policies (including evaluation of the monetary policies of independent central banks), without any claims that such assessments reduce the effectiveness of national authorities. Why then should national banking supervision receive a ''special'' exemption from such international surveillance?[26] Indeed, with serious banking problems continuing to surface at disarming frequency (note the recent problems in South Korea and Thailand) and with weak national banking supervision identified as an important contributory factor, it seems incumbent to ask, ''Who's supervising the supervisors?''

26. Another possible instrument for international assessment of national supervisory policies would be ''peer review'' within the Basle Committee. While this would probably be some improvement over what we have now, such an exercise could easily succumb to ''nonaggression pacts'' that essentially eliminate criticism. See Bergsten and Henning (1996) on how such nonaggression pacts have reduced the effectiveness of peer pressure within the G-7.