

INTERNATIONALIZATION: A REGULATORY PERSPECTIVE

by

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As the recent crisis in stock markets around the world showed, internationalization is not without perils. Global markets may result in increased efficiencies from a freer flow of capital across national borders, but they also lead to heightened risks, and these risks are now capturing the public's attention.

The advantages of internationalization are easily understood. Global markets broaden the possibilities for risk diversification by institutional investors, and offer a wider variety of markets and products to facilitate hedging against exchange and interest rate risks. The users of financial markets benefit from cheaper funds provided by additional suppliers, differing regulatory requirements, and innovative financial products, such as swaps, options, financial futures, and floating rate notes.

Internationalization also creates higher profit opportunities for financial intermediaries from increased commissions and fees.

However, internationalization also brings with it a number of risks that have recently come to the forefront. As the stock market tumble showed, panic can travel fast around the world. Panic originating in Tokyo can be felt in New York in a matter of minutes, or the other way around.

Internationalization can bring about greater systemic risk than before due to the interlocking relationships among multinational investors, issuers, and intermediaries. The higher degree of interdependence among participants in the international markets, fostered by both formal and informal linkages, carries the potential risk of crises being contagious and fast spreading. Fortunately, however, there is currently scant empirical evidence on this front.

The increasing use of "securitization," or the practice of converting loans into securities that can be traded freely in the international public markets, has changed the credit intermediation process, with different entities having different roles and responsibilities. By bringing in larger numbers of players, credit risk and market risk are being redistributed. This redistribution may change systemic risk in ways that we do not yet fully understand. Securitization is usually accompanied by guarantees of repayment by financial institutions that may be called upon simultaneously in a crisis. As opposed to acting as brokers as they did in the past, financial intermediaries such as securities houses are now acting more and more as principals in international transactions, thereby putting their own capital at risk. This is one way in which liquidity or solvency problems at a particular institution could spread rapidly across national markets and bring about payments backlogs, reduced credits or no

credits for "problem" institutions, and, in the worst-case scenario, a chain reaction of defaults.

In the event of a major international financial crisis, it is not clear who bears precisely what risk, or which regulatory body is responsible for which market participant. Many of the players in the international markets (securities houses, offshore financial centers, banks from outside the Group of Ten Countries, and futures traders) are not covered by established international financial safety nets. As a result, they have questionable lender-of-last-resort access. National lenders of last resort may not always be willing or able to lend to non-banks, or to banks located in areas beyond their direct supervisory control. If a crisis should occur in the capital market (i.e., non-banking) component of the international financial markets, it is not clear who should provide lender-of-last-resort assistance to the market participants.

In the U.S., the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) are primarily market regulatory agencies; they are not traditional lenders of last resort. Activities in foreign markets by domestic firms are often beyond the purview of the SEC, the CFTC, and the self-regulatory organizations, which rely on the cooperation of foreign regulators. With additional linkages between domestic and foreign clearing agencies, the solvency of the foreign agencies and their

member firms becomes relevant to the domestic clearing organizations to the extent that the latter offer guarantees on international transactions. A major foreign default by an unregistered affiliate could conceivably have an adverse impact on U.S. entities, such as the National Securities Clearing Corporation or the Chicago Mercantile Exchange, since their trust funds may not be large enough to sustain large losses.

Thus, the internationalization of financial markets presents new challenges to regulatory responses to risks, and calls for greater coordination at the international level. Recently, under the auspices of the "Cooke Committee", there has been a great deal of progress on the banking side in the areas of risk-based capital standards, coordinated monitoring of capital ratios, and joint supervision of consolidated statements of banks.

However, securities and futures firms that are also active in the international arena are not yet subject to similar risk-based capital requirements or common regulatory oversight. The SEC's authority to establish minimum capital requirements for brokers/dealers is generally limited to registered entities trading only on domestic exchanges. Yet, many of the players are subsidiaries and affiliates of international financial conglomerates bearing large exposure in multiple markets. Similarly, many people are concerned about the potentially excessive exchange or off-exchange exposure to particular customers or markets that the

futures markets face.

To be sure, there has been progress in recent years in the area of international cooperation in securities trading. There are a number of international organizations dealing with disclosure, enforcement and market regulation, and accounting and auditing standards. Examples of such institutions include the International Organization of Securities Commissions, the International Federation of Accountants, the International Accounting Standards Committee, the International Auditing Practices Committee, the United Nations, the Organization of Economic Cooperation and Development, and the European Economic Community (EEC). But, except the EEC, the guidelines issued by these organizations are voluntary and are not legally binding.

In the case of the EEC, it took ten years to develop the directive on consolidated financial statements, and the EEC allows seven more years for national adoption. While legally enforceable, the EEC's accounting and financial directives will be limited to its member countries as of January 1, 1990.

The SEC has undertaken a number of initiatives to develop a coordinated approach to international market regulation. It recently amended the net capital rule to require U.S. broker-dealers to subtract from net capital their transactions with unregistered affiliates, unless the latter open their books and

records to U.S. regulators. The SEC has been working with the U.K. and Canada to work out a "reciprocal approach" to "harmonization" of disclosure practices for multinational offerings. It has negotiated memoranda of understanding regarding surveillance and enforcement arrangements with Canada, U.K., Switzerland and Japan. It approved a pilot project for exchange of automated quotation information between the International Stock Exchange in London and the National Association of Securities Dealers. It approved several trading linkages between the U.S. and Canadian stock exchanges. It is also discussing with the U.K. Securities Investment Board an information-sharing arrangement.

Irrespective of such progress, there is still considerable international regulatory work to be done with respect to mutually acceptable standards such as capital and margin requirements, accounting and tax treatments, disclosure, clearance and settlement systems, surveillance and enforcement agreements, broker-dealer registration qualifications, information and communication systems, and a variety of other dimensions that can affect regulatory responses to the potential for increased risk transmission across national borders. Major differences continue to remain among the global market regulatory authorities and structures. More than ever before, the time is ripe for greater international regulatory coordination in the securities and futures areas, corollary to the progress made on the banking

side.

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