Plenary 2

The Rapidly Developing Economies

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CHALLENGES IN RAPIDLY DEVELOPING ECONOMIES

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I am very pleased to be able to be here in Sri Lanka, which I last visited traveling around the beautiful country as a student 30 years ago. To be able to participate in the IOSCO Annual Meetings is a particular privilege. As securities markets come to play an increasingly critical role in economic development, IOSCO has established a truly impressive record as the standard setter for the sector, and the decisions made at this Annual Meeting provide important additions to that record.

I am also pleased to participate in this particular panel. The Malaysian experience may well have important lessons in a number of areas. I myself was asked to talk about the Malaysian experience at a conference in Nigeria last November, where the Governor of the central bank had explicitly referred to the Malaysian precedent as a basis for the ambitious banking sector reform program that he announced earlier in the year. I have a couple of comments on what we heard about Malaysia and would then make a few broader observations about challenges that affect regulators, particularly, in economies that are growing rapidly.

On Malaysia, I found the discussion particularly interesting. I would highlight two points adding to those drawn out by the Chairman: first, that in the restructuring, the authorities separated out the problems of the past through forming two agencies—Danaharta and Danamodal—before recapitalizing and restructuring the institutions of the future. In countries where the legacies of the past have been unaddressed during a restructuring, the results have frequently been disappointing. The second, more controversial point, is that an important element towards the end of the restructuring process was a semi-forced consolidation of the financial institutions, bringing banks and nonbank financial institutions together into a relatively small number of financial conglomerates. While this, too, has been seen as an example in some countries, its general applicability is far from unchallenged.

As regards the role of the IMF in all this, stability of domestic financial systems is essential to both a country's own macroeconomic stability and—in systematically important countries—to the stability of international financial systems.

Financial systems have received increasing IMF surveillance following a series of banking crises in both industrial and developing countries in the 1990s. A key tool for its surveillance functions has been the Financial Stability Assessment Program (FSAP)—a joint program between the IMF and the World Bank developed in 1997 to assess the strengths and weaknesses of countries' financial sectors. An Assessment of the International Organization of Security Commissions' (IOSCO) Principles is a component of the Program. The IMF and the World Bank work with standard setters and national agencies in carrying out this program, which presently covers about 17 countries a year. I know that quite a number of people here have participated in the FSAP, on one or other, or both sides of the table and, I think, have generally found it a very worthwhile experience.

A general conclusion that can be drawn from IMF surveillance work is that although crises are the result of a complex set of issues, frequently, weak regulatory systems have been a contributing factor. Therefore, there is a need for robust regulatory systems that, by addressing systems vulnerabilities, can play a role in the mitigation and/or faster and less costly resolution of crises.

What are the problems in rapidly developing economies that the regulatory system should be able to address?

An important problem of rapidly developing economies is that there are fewer incentives to foresee risks ahead and prepare for them and, indeed, a denial that there are such risks. Experience in the U.K. in the 1980s, and arguments about the "New Economy" in the U.S. in the 1990s are examples. Agents act on extrapolation of current conditions rather than on a thorough evaluation of the acceptable level of return versus risk. For example, in times of economic growth, banks tend to relax lending conditions and/or provide lending to booming sectors without fully understanding their inherent risks. In the securities markets, new products are placed among retail investors without particular consideration to their awareness of the risks involved or their particular characteristics. Because of the increase in asset values, securities markets may experience price bubbles. And, very often, the regulator is lagging behind, either because regulations for new products are nonexistent or because those in place are inadequate to address the risks arising from rapidly developing economies (e.g., investment limits or liquidity coefficients remain at the same level as in "normal conditions").

As long as the economy continues to grow, these practices may not have consequences; however, sudden changes in macroeconomic conditions may affect corporations so severely as to impact the financial sector and endanger economic stability. Banks could find themselves with an increased number of nonperforming loans in their portfolios. Investors may find out that the companies they invested in can no longer pay returns at the levels seen when they launched their IPOs, or, even worse, that those companies are in financial distress. Collective investment schemes could bear significant losses and face significant redemptions, even runs, from frightened investors. In the case of investment firms, they may not bear substantial credit risks, because their positions are short-term and, usually, in securities that can be sold in the market, but they could be exposed to significant market risks (due to changes in the price of securities), liquidity risks, and operational risks (for example, litigation from investors who claim were not provided good advice and information regarding investments). Finally, markets could experience severe price adjustments, leading to volatility, and be exposed to market manipulation.

There are also particular challenges for regulatory agencies. If an economy is growing at, say, 6 percent to 8 percent p.a., its securities sector may be growing at twice that rate, particularly, if the economy is starting from a low base. Will the regulators have the reserves and skills to match this? Some of their work is forward-looking—licensing new institutions and products, some of which may be marketed quite validly as not yet existing, but providing a useful underpinning for future financial development. Thus, resources may need to be provided to the regulators **in advance** of financial development, to foster the development and ensure that it goes in the right direction. Absence of this prior investment may jeopardize the entire financial development process.

Then what is the challenge for regulators in rapidly developing economies? The challenge is two-fold: (i) from the market participants' perspective: to build a regulatory system that "forces" them to identify, assess, disclose and, when applicable, manage risks (forward-looking approach) and (ii) from the regulators' perspective: to build an organizational structure that allows the regulator to respond rapidly and effectively to changing conditions.

Since investors bear the risk of their investments, the key for the **regulation of issuers** is the establishment of a strong **disclosure** regimen that enables investors to make informed decisions by providing them with full, timely, and accurate information regarding investment choices.

Disclosure requirements should be accompanied by a set of controls aimed to ensure the reliability of the information provided to the market, such as external auditing and mechanisms to promote market discipline, such as credit ratings and financial analysis. Finally, there should be provisions to ensure the issuer's responsibility for the information disclosed to the market (civil liability, as well as administrative/criminal provisions).

It is clear that disclosure is not only a problem for rapidly evolving economies, but also one of many developed industrial economies. At the IMF, we conducted a review of the IOSCO Assessments in FSAPs carried out until October 2004. This shows that principles regarding enforcement exhibit the lowest level of implementation (almost half of the 57 countries showed lack of implementation). So what we see is that most countries have advanced significantly in the adoption of regulations consistent with international standards; but they lack resources and/or expertise to be able to effectively implement those regulations.

From the regulator's viewpoint, it is clearly not enough to enact regulations consistent with best practices. **A regulator must be able to ensure their implementation**. **In rapidly developing economies, particularly critical for implementation is the regulator's capacity to react rapidly and effectively to changing conditions**.

How can this be achieved?

Regulators need to have a supervisory system based on risks, so that they can channel resources to the intermediaries/products/markets that carry the most risk to the sector as a whole. The inclusion of an assessment of the industry's environment is critical for an appropriate measurement of risks, especially in rapidly developing economies. Moreover, as in the case of market intermediaries, the system must be supported by information systems that allow for monitoring, controlling, and reporting. Of course, having appropriate information is the first step, but acting on it is the crucial part. In that regard, it is particularly important that there is an organizational structure that allows the regulator to respond rapidly and effectively to changing conditions, either by enacting new regulations or taking precautionary measures when needed. The regulator must have broad enforcement powers that allow it to investigate, supervise, and proffer sanctions to market participants when necessary.

Finally, one area that is particularly important in a rapidly growing economy is investor education. Investors who are fully aware of the risks inherent to their investments, as well as of the specific role and responsibilities of different market participants, are better prepared to face the consequences of changes in economic conditions. Although investors' education is an obligation that transcends the regulator, regulators should have a key role in that respect. Particularly, in a rapidly growing economy, investors may be new to the activity. Aside from their obligation to ensure that market participants are providing full, timely, and accurate information, regulators should take active steps to make sure that investors have a clear understanding of the nature, characteristics, and risks of the different products available in the market. Those steps may comprise the design of brochures, web sites with information, and warnings regarding critical products and/or participants and, depending on the state of development of the market, even the use of collective media to reach investors. Absence of action in these areas can threaten the markets, causing reputational risks, and threaten to set back financial market development.

As you may have already noticed, all the issues that I have mentioned as critical for a robust regulatory system are encompassed in IOSCO's Principles of Securities Regulation. During this Annual Meeting, IOSCO has approved proposals to establish funding for a TA capability. I would conclude by particularly welcoming this initiative. For many rapidly growing economies, high-quality TA may well be critical. The IMF puts significant effort into our TA work, and we welcome IOSCO as a partner in this activity. I look forward to collaboration on technical assistance for the implementation of the IOSCO Principles, including in rapidly growing economies, in the future.

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CHALLENGES IN RAPIDLY DEVELOPING ECONOMIES

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Importance of Financial Systems (1/2)

- Stability of domestic financial systems is essential to macroeconomic stability.
  - Therefore the need for strong monitoring.
- IMF conducts surveillance of financial systems, under the context of Article IV.
  - Key tool is the FSAP = joint program IMF/WB to assess strengths and weaknesses of countries' financial sectors.
  - Assessment of IOSCO principles is a component of the FSAP.

Importance of Financial Systems (2/2)

- A general conclusion from surveillance work is that although crises are the result of a complex set of issues, frequently weak regulatory systems are a contributing factor.
  - Therefore the need for robust regulatory systems.

Rapidly Developing Economies: Problems (1/3)

- There are fewer incentives to see risks ahead and prepare for them (short-term focus).
  - Financial institutions: loosening of lending conditions, lending to new sectors and/or positions taken in products not fully understood.
  - Investors: products are being sold without appropriate disclosure of risk or suitability evaluation.
  - Markets: price bubbles.
  - Regulators: lagging behind (regulation for new products is inexistent, incomplete or inadequate).

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Rapidly Developing Economies: Risks (2/3)

- Sudden changes in macroeconomic conditions could lead to problems in corporate sector and affect financial institutions and markets endangering the stability of the financial sector.
  - Financial institutions and investors: credit risks
  - Securities firms: market, liquidity and operational (appropriate advising) risks.
  - Markets: volatility -manipulation

Rapidly Developing Economies: Challenge (3/3)

- Build a regulatory system that:
  - From the market participants' perspective: forces them to identify, assess, disclose and when applicable manage risks.
  - From the regulator's perspective: allows it to respond rapidly and effectively to changing conditions

Components of a Robust Regulatory System: Issuers

- A strong disclosure system, not only at the moment of authorization (prospectus) but throughout the life of the investment (on going and material disclosure).
- Accompanied by appropriate controls:
  - Strengthening of internal controls
  - External auditing
  - Liability and criminal provisions
- Mechanisms for market discipline (role of credit rating agencies and financial analysts) can also play a role.

Components of a Robust Regulatory System: Securities Firms (1/2)

- Set of prudential regulation (capital adequacy rules, limits on leverage, diversification)
- As well as market conduct rules (adequate advising, management of conflict of interests)

Components of a Robust Regulatory System: Securities Firms (2/2)

- Mandatory risk management systems:
  a) Identify and measure risks (not exclusively based on historic information, but rather forward looking)
  b) Establish guidelines governing risk taking and mechanisms to manage them.
  c) With information systems for monitoring, controlling and reporting.

Components of a Robust Regulatory System: Secondary Markets

- Transparency provisions
- Surveillance mechanisms (with earlier warning tools) that allow for real time monitoring.

Components of a Robust Regulatory System: Regulator (1/2)

- A supervisory system that focus on an analysis of the risks posed by different products/intermediaries, allowing regulator to channel more resources to problematic areas.
    - Inclusion of an assessment of the industry’s environment is critical for an appropriate measurement of risks.

Components of a Robust Regulatory System: Regulator (2/2)

- An organizational structure that allows the regulator to respond rapidly and effectively to changing conditions
  - Enacting new regulations
  - Taking precautionary and enforcement measures

Components of a Robust Regulatory System: Education

- Investor's understanding of risks is key to the health of securities markets.
- Investor's education programs are of particular importance in rapidly evolving economies, where new products not fully understood are being sold to the public.
- Regulators should have an active role in this area (brochures, websites, etc.)

How Can the IMF help?

- FSAP, and its IOSCO component, can help countries to identify areas in their regulatory systems that need strengthening.
- TA assistance can be provided to countries. Assistance may cover a wide range of issues, from guidelines for new regulations to capacity building.