Charles Dallara *has served as managing director of the Institute of International Finance since 1993. Created in 1983 in response to the international debt crisis, the IIF has more than 320 members headquartered in more than sixty countries. These members include most of the world's largest commercial banks and investment banks, as well as insurance companies and investment management firms.*

TIE *sat down with the Institute of International Finance's Charles Dallara to discuss the future of the global financial system.*

IIF *at* 25

TIE: Congratulations on the twenty-fifth anniversary of the Institute of International Finance. Under your tutelage the membership has increased dramatically and there appears to be a new vibrancy to the Institute.

Dallara: Thank you. It's obviously been a team effort. We have a small but strong staff here. People are shocked when we tell them that the total number of employees remains under one hundred, but we achieve a great deal and we are rather proud about our efficiency.

Importantly, we've been fortunate in having a very strong and supportive Board that has seen the value of growing and building the organization. Our number of bank members has tripled over the last 12–13 years. Our total number of members has more than doubled. Part of this is due to the willingness of our own Board to reach out, along with the growing membership from emerging market financial institutions, asset managers, and hedge funds that has more than offset the decline of members through the consolidation process, especially in the United States.

TIE: The Institute appears to have taken on an important role, particularly in the last decade. Financial regulators—really once a side show to the broader market issues—have become the main event. After the subprime crisis, banking regulation has become the tail that wags the financial market dog. How can the Institute fit into this

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new environment? Clearly there's going to be a lot of discussion about where this system goes from here.

Dallara: It's very important for the Institute to sustain its role as an effective bridge between the public and the private sectors. It also serves as a forum to advance best practices in risk management and in overall operations of the capital markets, where there have clearly been some shortcomings.

Obviously, it's a bit early to have a clear view of the lessons learned. Yet one can't help but realize that there were some serious risk management deficiencies in terms of default estimates right at the ground level, which is subprime lending. Deficiencies of risk management are clearly emerging in the LBO credit market, which now has a substantial volume of hung deals that will need to be resolved among the private equities sponsors, by the corporations, and by the banks themselves.

Several other issues merit considerable scrutiny. One is the role of rating agencies and the process by which they evaluate structured products. The second is the issue of just how risks are transferred or not transferred when banks create these so-called conduits which become vehicles backed up by securitized assets. We are going to have to rethink what we thought we knew in terms of the linkages between credit risks, markets risks, and reputational or operational risks here when it comes to the creation of these new conduits and all of the complex products associated with them.

At the Institute, we see our role here as framing a very thoughtful industry response on critical issues along with some articulation of best practices going forward. We're open and honest in discussion with the regulators. The final point is that we have been able to develop a very vigorous, a very productive, mutually respectful dialogue with the regulatory community over the past decade, and we would hope that dialogue will continue and deepen as we grapple together with the issues which will inevitably arise out of the latest set of serious market events. We look forward as well to a dialogue with the International Monetary Fund and World Bank in terms of their response to these strains.

TIE: **As we understand it, former Federal Reserve Chairman Alan Greenspan called all the U.S. regulatory agencies together several years ago to discuss the subprime mortgage issue. He warned them that they needed to pay careful attention to the potential for problems. Obviously his and a lot of other warnings went unheeded. Why was that the case and what changes need to be made to the regulatory structure at least from the U.S. standpoint to avoid this kind of problem in the future?**

Dallara: Before we talk about changes in regulatory structure, I would stress that the community of banks itself needs to be brutally honest in terms of looking at where industry participants made misjudgments in risk management and what needs to be done to clean this up. There needs to be action on that front in the subprime mortgage market. Going forward, one could expect close regulatory scrutiny of the terms, conditions, pricing, and given default estimates that banks used. But the losses in earnings and in valuations of stock prices for major financial institutions will also be part of the corrective medicine for dealing with the subprime issue. Other aspects of what has gone wrong provide equally important lessons. We need to rethink how LBO financing has been structured and priced. We need to rethink the way in which banks created these conduits to transfer risk off balance sheets and yet may not have transferred the risk as cleanly or as completely as many would have believed.

TIE: **As a former U.S. government official, do you worry about the European bank regulatory system? Both the European Central Bank and the Bundesbank now have little bank regulatory supervision responsibility. Trichet and his colleagues are in an awkward position—they're relying on the information coming from government regulatory agencies which are run by politicians to a certain extent.**

Dallara: I see it a little differently. Yes, the degree of separation of some central banks from the regulatory community presents a challenge to central bankers, but I think the challenge can be overcome by intense and close dialogue between central bankers and regulators. The key issue is not so much regulation driven by governments, but banking structures that are still imbedded in the political systems. We have seen lately the rather anachronistic and non-market nature of the municipal- and state-owned banks in Germany who have once again demonstrated that their risk manage-

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Political Banking

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One of the biggest priorities must be to move banking systems globally onto a more healthy market-based footing. We have learned time and again whether it is state-owned banks in Germany or France or Italy or China, the same kind of tendencies toward vulnerability and mismanagement exist in banking systems that are too interwoven with political structures.

—C. Dallara

ment skills and their methods of operating are not sufficient to enable them to operate in the markets and with the assets and products in which they are currently engaged.

For the first time since there was serious separation between central bankers and bank regulation, we need to consider how to ensure that the lines of communication and cooperation between central bankers and regulators are strong and robust. But equally we need to encourage central bankers themselves and regulators to realize the global nature of this problem. One has the impression that early on there was a lot of market specific reaction that was not fully discussed at the international level or as fully coordinated as might have been the case.

But I think one of the biggest priorities must be to move banking systems globally onto a more healthy market-based footing. We have learned time and again whether it is state-owned banks in Germany or France or Italy or China, the same kind of tendencies toward vulnerability and mismanagement exist in banking systems that are too interwoven with political structures.

TIE: **There are linkages here to global imbalances. What are the prospects for an orderly reduction of global imbalances?**

Dallara: For many years now we've been asking whether these imbalances are sustainable. If they're unsustainable, will they be resolved in an orderly growth-oriented fashion or in a disorderly fashion involving much weaker growth? For the past two months we've seen what happens when the markets themselves are at the helm of resolving strains—it can be a pretty bumpy ride. We need to look at how to reduce the bumps in the road so that we don't allow this financial strain to translate into economic setbacks.

TIE: **This is the twentieth anniversary of *The International Economy* magazine. We came into existence during a great period of G7 policy coordination. You were at the center of things as a U.S. Treasury official in the 1980s and early 1990s. Has the sheer size of financial markets made policy coordination obsolete, or is close policy cooperation and coordination even more important?**

Dallara: Several thoughts. Yes, the globalization and complexity of markets has certainly greatly increased the challenge of effective policy coordination. I remain firmly of the view that there is considerable scope for enhanced policy coordination today, especially in dealing with global macroeconomic and financial issues. But in order for that to happen, there needs to be two central ingredients. One is to have the right players around the table. We at the Institute called for the G7 to be expanded to the G11 three and one-half years ago. And still today we do not have a clear distinct shift from the G7 to a G11. Now a G11 isn't meant to be nirvana. We had suggested that the G7 be expanded explicitly and formally to include India, China, Brazil, and Russia. We got a little bit of pushback from Mexico and South Korea. But the issue isn't really whether it's a G11 or a G13. You absolutely have to have the right players around the table to solve today's global economic problems. Until the G7 recognizes that and explicitly incorporates other key players such as China, India, Brazil, and Russia into the global decision-making process, it is going to be very difficult for policy coordination really to find the right solutions.

The second key ingredient that remains essential for effective policy coordination is to have an objective arbiter who can help frame the problem and frame the solutions. I continue to believe that there is considerable scope for the IMF to play that role. I recognize that they have tried to step up their involvement, and they have created a con-

sultative group to look at global imbalances, but not enough has been done for the IMF to assert itself here in this arena.

Can organizations like ours play a supportive role? Absolutely, particularly in the areas of global coordination of financial market policy issues. But when it comes to issues of global coordination of efforts to sustain growth while reducing imbalances, we need the right players around the table and we need effective objective multilateral leadership. Neither has been clearly and strongly in place as they should have been these last few years.

TIE: **People have been impressed, particularly in the policy community, by the depth of the Institute's discussions. What do you see as the Institute's major accomplishments under your tenure and what areas do you feel need further development?**

Dallara: One accomplishment is having created a truly global association of financial institutions. In the early years the Institute was largely a G10 bankers' forum. There were always a few emerging market banks mingled in but they were clearly in the distinct minority. We have been successful in broadening the membership base to include more than one hundred banks headquartered in emerging markets, fifteen from China, more than a dozen from Turkey, more than seventy from the Middle East, and a strong number of Latin American banks. This really adds robustness, depth, and legitimacy as a truly global organization.

A second and related accomplishment is our diversification of the nature of financial institutions that are part of the organization. We have a significant number of mutual funds, asset management firms, insurance companies, and hedge funds as part of our network.

On the substantive front, the most important accomplishments include the dialogue on regulatory issues. Focusing on both Basel II and more recently on global consistency and effectiveness in regulation has really been a gradual step-by-step process that has now begun to bear fruit by providing a forum wherein bankers can feel comfortable talking across borders to regulators. A British banker recently told me, "I never thought I would have the chance to speak frankly to a French regulator about what I see as some of the regulatory problems we have operating in that country unless it was a face-to-face contact about my own specific institution." He said the marvel of this process is that we can talk openly, across borders, about the importance of global consistency because that is where the future of effective regulation lies.

Another major accomplishment on the substantive front has been the contribution to the emerging markets architecture through the creation of a voluntary code of conduct—the so-called Principles for Stable Capital Flows to Emerging Markets. Time and the support we have now from the global community have demonstrated convincingly the validity of a market-based approach to preventing crises and managing crises in emerging markets. Our trustees now include ECB President Jean-Claude Trichet, China's central bank governor Zhou Xiaochuan, Brazil's central bank governor Henrique de Campos Meirelles, foreign minister Ali Babacan of Turkey, South African finance minister Trevor A. Manuel, and a wide array of leading individuals. Equally important, these trustees on the official side are joined by trustees on the private market side. This experiment in cohesion and consensus building between the emerging market official leaders and the private sector official leaders is a far cry from the confrontational world we bankers and emerging market authorities lived in twenty-five years ago.

Finally, we have continually adapted our analysis to keep up with the changing times. Understanding emerging markets is one thing. Being able to communicate to your membership in a way that is meaningful during a period of capital market turmoil is another. We remain determined to help our members face the challenges continually arising in today's global markets.

TIE: **Thank you very much.** ◆

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