Mr. Ferguson discusses the role of banking in the global market-place

Remarks by Mr. Roger W. Ferguson, Jr., a member of the Board of Governors of the US Federal Reserve System, before the Urban Bankers Coalition, Inc., in New York on 4/16/98.

Are Banks Safe for the World and Is the World Safe for Banks?

Thank you for your kind invitation to speak to you this evening. Your topic, banking in the global market-place, is obviously timely. Given the role of international capital flows, I expect that this is a topic that will continue to be the focus of a great deal of attention. The current crisis in Asia, which is both a banking crisis and a macroeconomic crisis, is the starting point of my talk this evening. As I considered the Asian crisis, I became curious to know whether it is a unique problem due to a unique set of circumstances, or an accident that happened in a few Asian countries this time, but could occur in other countries at almost any time. I would like to share with you the results of my inquiries.

Banks Continue To Be Important in a Global Context

The starting point of my research was to confirm the critical role banks continue to play in global finance, particularly for countries with relatively underdeveloped capital markets. For example, the Bank for International Settlements estimates that the stock of international bank loans had grown to $8.5 trillion at the end of September 1997 - almost 30 times the level 25 years earlier. Importantly, loans to developing countries now total about $1 trillion. While it is true that international bond and equity flows have grown during the period, new issues of bonds only exceeded bank lending 10 years ago, and the stock of outstanding loans is still considerably greater.

This flow of capital has been critical in increasing the standard of living around the globe. Funds have flowed internationally from savers to borrowers, who generally tend to be entrepreneurs and others in business who need capital to build businesses and serve customers, both in their home countries and overseas. This international flow moves capital toward its most productive use, in principle, from the higher saving industrialized world to the high return, capital-short developing nations.

Are there issues that should give us concern in this benign picture? Unfortunately, there are many. I would like to turn now to the question of whether banks are safe for the world economy and if the world economy is safe for banking.

Are Banks Safe for the Global Economy?

The current crisis in Asia led me to ask how many other countries have experienced banking crises, either domestic or cross-border? The answer I found may surprise you. Research done by economists of the International Monetary Fund indicates that 133 of the 181 countries who are members of the Fund, more than two-thirds, have experienced significant banking problems at some time since 1980[1]. Thirty-six of those instances would be described as banking "crises" in that there were runs or other portfolio shifts, collapses of financial firms, or massive government intervention. Several countries experienced multiple banking crises. Banking crises have affected developed countries, such as the United States, Sweden, France,

[1] See "Bank Soundness and Macroeconomic Policy", C. J. Lindgren, G. Garcia, and M.I. Saal, International Monetary Fund, 1996.

and Norway, as well as rapidly developing or “transitional” countries, including now Korea, Indonesia and Malaysia, but earlier Mexico, Argentina, and Chile.

Banks fail for a number of reasons, including poor management, excessive risk taking, fraud and a poor operating environment. Individual bankers too often forget the fundamental tenets of banking, which are universal and apply to internationally active banks in Amsterdam as well as to community banks here in New Amsterdam. These tenets include: Know your customer; understand the legal framework in which you are working; thoroughly understand the sources of repayment and the risk of nonperformance; and price your services accordingly. We know that in Asia banks violated some of these rules. Banks often engaged in directed lending, either directed by government bureaucrats or commercial enterprises under shared ownership with the bank. Because of government intervention in the lending process, Asian banks had not developed the necessary credit risk skills, and bank supervisors were incapable of enforcing reasonable standards of behavior on the part of local banks.

In the international context, the interbank lending problem that emerged in Asia arose in part because of a lack of transparency in the financial system, making it difficult for foreign bank lenders to know the quality of the ultimate credit. More importantly, however, foreign banks that funded Asian banks may have assumed an implicit government guarantee of inter-bank counter-parties because a history of supporting troubled institutions may have left that impression.

What is the impact of a banking crisis? First, the financial cost of fixing an insolvent banking system is high, and that cost is ultimately borne by the taxpayer. For example, in Australia’s banking crisis of 1989-1992, the IMF estimates the cost of rescuing state-owned banks to be nearly 2% of GDP. In Mexico, the overall cost of several programs to support the banking system is estimated (in present value) at 6.5% of GDP. Currently in Japan, the government has announced an intention to spend as much as 30 trillion yen, 6% of GDP, to support its banking system. For Finland, Chile, and Argentina, the IMF estimated the fiscal impact of banking crises to have been between 4% and 8% of GDP. Finally, in the United States, resolution of the S&L crisis is estimated to have cost $150 billion, approximately 3% of GDP in 1990.

In addition to the cost imposed upon society, an unsound banking system cannot carry out its credit-creation function and can distort macroeconomic performance. Unsound banks, ones with sufficient liquidity but a high percentage of nonperforming loans and a deteriorating capital base, act on a different set of incentives than do sound banks. First, unable to declare loans in default unless they admit their own insolvency, such banks may continue to lend to nonperforming borrowers or, alternatively, capitalize unpaid - and uncollectible - interest. That is, they may act to defer recognition of their problems. At the same time, they might seek riskier investments to try to offset their problems with higher earnings. In addition, such banks may attempt to attract depositors by paying higher interest rates than their solvent competitors. A high percentage of nonperforming loans may also lead to a contraction of credit, a “credit crunch,” as banks turn away sound borrowers in order to continue to support unsound ones or unduly raise underwriting standards in fear of making more weak loans. Finally, a banking system that is unsound cannot perform its role as a transmitter of monetary policy. Particularly in emerging economies, in which other financial markets are not well developed, banks transmit monetary policy by expanding or contracting their balance sheets, i.e., engaging in more or less lending. An economy which is relatively stagnant cannot easily recover using monetary policy if it is saddled with an unsound banking system, because efforts to stimulate growth by lowering interest rates may not lead to a sufficient expansion of lending.

In an international context with cross-border lending, the same issues may apply. Banks that are saddled with a large number of nonperforming loans from another country, either private or public debt, will have a need to work out those loans, and continue to support those borrowers rather than engage in new lending, either domestic or cross-border. Similarly, such banks are unlikely to be as efficient as they otherwise would be in transmitting the monetary policy of their home country central bank into their home country macroeconomy.

So it is clear that an insolvent banking system is bad for a local, and indeed, the global economy. The costs to fix such as system can be substantial, the credit function cannot be carried out properly by such a system, and monetary policy may be hampered.

Is the Global Economy Safe for Banking?

Obviously, however, the record of banking crises around the globe does not prove that banking is the source of all problems. Macroeconomic policy and the performance of policymakers also have the potential to create systemic problems. Macroeconomic conditions or policies that undergo sufficiently significant and unexpected changes impact all banks, well managed and poorly managed alike. Unfortunately, the current Asian crisis and previous bank crises, including our own, indicate that a range of macroeconomic mistakes can lead to an unsound banking system. Put another way, there are many macroeconomic roads to ruin.

First, let’s start with Asia. The countries currently in crisis followed traditional macroeconomic policies that in the main were sound. They avoided fiscal deficits, and in some cases ran surpluses. In addition, they avoided a general inflation in the prices of goods and services. However, notwithstanding responsible macroeconomic policies, strong increases in private spending, much of it financed by bank credit and capital inflows, turned out ex post to have been unwarranted. Much of the increased investment spending was concentrated in stocks and real estate, and asset price bubbles emerged. Moreover, exchange rates were in some cases allowed to get out of line with fundamental forces in the economy, leading to sharp increases in imports and a widening of trade deficits. To some extent this effect was a result of pegging exchange rates to the U.S. dollar, or to a basket of currencies in which the dollar had a large weight, at a time when the value of the dollar was rising against the yen.

Exchange rate and capital flow problems could similarly be assigned blame in several earlier banking crises, as well. For example, in the late 1970s, the Chilean government followed a policy of rapid exchange rate appreciation, culminating in a fixed exchange rate in 1979. Credit to the private sector rose sharply as massive capital inflows followed. An international slowdown in the early 1980s resulted in a collapse in the price of copper, Chile’s major export, an increase in the country’s trade deficit, and a sudden reversal of its capital flows. Recession followed and banks were left with unserviceable, foreign-currency-denominated debts.

However, exchange rate problems are only one type of macroeconomic concern. Other countries, such as Finland, Sweden and Norway, experienced banking crises following explosions in central bank credit and bubbles in asset prices or in credit creation by banks. Fiscal and monetary policy, and the need to reverse policy unexpectedly, can also lead to banking crises if bubbles arise in asset markets and banks are heavily exposed to assets with inflated values through their lending practices or balance sheets.

Other countries, particularly those that rely heavily on a single international commodity export, such as oil, have experienced banking crises following rapid adjustment in the prices for those commodities. Often in these cases, the government attempts to use fiscal or monetary stimulus to offset the loss of standard of living that results from a decline in commodity prices. This policy generally only succeeds in inducing a cycle of strong inflation, perhaps accompanied by pressures on exchange rates, followed by a steep correction.

Finally, here in the United States, the S&L crisis was due in part to deregulation of interest rates on deposits, that left S&Ls with low returns on assets but a high cost of funds. In a scramble for new sources of revenues and an effort to generate earnings, S&Ls took on greater and greater risk.

Potential Solutions

Given this history of banking crises throughout the world - some the result of poor banking practices, some tied to the rapid ebb and flow of cross-border capital, and some due to internal macroeconomic policies - what should one recommend? I would like to focus on three sets of solutions designed to minimize the risk of future cross-border banking crises: (1) improvements in supervision and basic banking skills; (2) international transparency, including sound accounting standards; and (3) ways to avoid potential problems in capital flows. This analysis also points to a responsible policy for countries faced with unsound banking systems.

First, with respect to banking supervision, the faster pace and increasing complexity of financial services mean that banking supervision has had to change its methods to rely more heavily on market forces as a means of regulating banks. For example, the Federal Reserve has become more focused on how individual institutions, including community banks, manage the risks of banking.

In the international arena, the Federal Reserve is working with the Basle Committee on Banking Supervision, which was established by the central banks of the major industrial countries, to increase outreach to emerging-market countries. The Basle Committee has recently published a set of core principles for effective banking supervision. The implementation of these core principles should aid many countries in making their supervision more effective. I believe that adopting these principles, or something like them, is an important first step as countries move to participate more actively in global financial markets. The time is probably near when we have to determine how to encourage more countries to adopt and fully comply with these principles, or their equivalents. The world should not be subject to weak bank supervision in any country.

Having sound banking practices may also be a necessary condition for having fully open capital markets. In general, the skill building and training problem for banks in transitional countries is immense. I believe that governments should probably spend as much time determining how to transfer solid banking skills into domestic banks as they spend trying to determine whether to open capital markets. To date debate has probably centered a bit too much on the latter and not enough on the former.

Second, with respect to transparency, the Basle Committee is now exploring the possibility of setting benchmarks for information about individual financial institutions that should be available to both supervisors and markets.

More broadly, the time may be appropriate to hasten the adoption of widely accepted international accounting and disclosure principles that raise the standard for accounting treatments in all countries. These standards might focus on four key areas: (1) complete financial statements; (2) management disclosure about risk profiles, risk management practices and performance; (3) timeliness of disclosure and (4) control and audit environment. The goal would be three-fold. First, any international accounting principles should provide the basis for depicting a clear and fair picture of the condition of the bank and of corporate creditors. Second, any principles should provide a means by which firms identify and disclose their major risks, such as funding, foreign exchange or concentrations. Finally, compliance with these principles should be sufficient to support market confidence in the basic integrity of a firm's published financial statements and other disclosures.

Such transparency is important because, ultimately, the market is the best regulator. However, adequate market discipline can be brought to bear only if investors have information that is sufficient in quantity, reliability and timeliness. As my colleague Susan Phillips has said: "Well-managed firms can benefit if better disclosure enables them to obtain funds at risk premiums that accurately reflect lower risk profiles. Inadequate financial disclosures, on the other hand, could penalize well-managed firms, or even countries, if market participants do not trust their ability to assess firms' or countries' fundamental financial strength."

I indicated that historical experience teaches that volatile short-term capital flows, particularly those involving banks, are often at the heart of banking crises. A third policy challenge, therefore, is how to minimize the impact of these flows without attempting to limit them altogether, which is neither beneficial nor feasible. One approach advocated by many is the so-called Chilean model. This includes a system in which firms and banks that borrow funds from abroad maintain a non-interest-bearing cash reserve at the central bank for one year. The one-year term of the reserve deposit makes the requirement most onerous for short-term positions, which is of course the intent. Proponents argue that these controls encourage longer-term, more stable investments. However, there are downsides. Over time, controls can, and almost certainly will, be circumvented, which might encourage even more controls. Also controls, if successful, tend to perpetuate or create distortions and inefficiencies - including the protection of weak and poorly managed domestic financial institutions. On balance, even recognizing these potential problems, I believe that short-term capital controls may be appropriate, if they are a temporary part of an orderly entry by a small country into the global capital market.

All of the above initiatives and approaches are aimed at avoiding an insolvent banking system. Nevertheless, since we know that banking accidents will happen in the global market place, what is the best solution for countries that face an insolvent banking system? The best solution to emerge from these crises and significant banking problems appears to be to remove the nonperforming loans from the bank system, even if only through government (or quasi-governmental) purchases, and then resell them to private market participants at the best prices available. To the extent that the government is involved, a number of questions arise. First, should nonperforming loans be purchased at par to help recapitalize banks? This approach has been followed in some countries, but providing such a subsidy to banks does not deal with the issue of removing excess banking capacity nor does it discourage the repetition of similar mistakes. Second, what process should be used to determine which banks need to be closed, or merged, and which can continue to operate on a recapitalized basis, probably with new owners and managers? Third, how much support should the government provide, through guarantees for example, to purchasers of nonperforming loans? Our experience in the United States indicates

that the scale of such support, however structured, must be commensurate to the problem. Finally, and by no means least important, we must consider how official assistance can be structured, if at all, to minimize moral hazard. Do we understand how to achieve burden sharing with the private sector? A critical point, though, is to act decisively to restore market mechanisms and place nonperforming assets in the hands of those capable of putting them to greatest use. Allowing a serious problem to languish can be a great and costly mistake.

Conclusion

In conclusion, we know that the banking industry plays and will continue to play an important role in the global market place. Unfortunately, a combination of poor banking practice, weak supervision and a number of macroeconomic shocks can destabilize a banking system. The solutions might include bank supervision at the best international levels, greater transparency, and, perhaps, some interference with capital flows. When a banking system becomes insolvent, however, there is no substitute for stripping away the bad assets in order to allow banks to once again perform their special role in society. Who bears the costs and how to ensure market discipline may be the most important issues to be addressed in that solution.

Unfortunately, given changes in technology and global economic forces, I am sure that we will not stop discussing the issue of banking crises. I appreciate the chance to share these thoughts with you this evening.