

Mr. Ferguson remarks on themes in international bank supervision Remarks by Mr. Roger W. Ferguson, Jr., a member of the Board of the Governors of the US Federal Reserve System, before the International Banking Conference, Federal Financial Institutions Examination Council, in Arlington, Virginia on 20/7/98.

Themes in International Bank Supervision

The scope of my introductory remarks for your conference today is broad and touches on a number of topics, some of which will be more fully developed by other speakers later in this seminar.

Risks and Benefits of a Global Banking System

Let me start by addressing the question of what value and what risks might arise from having a more global banking system such as the one developing currently. Academic and popular literature is full of articles arguing both sides of the case. Conceptually, global banking, by which I mean both direct entry and cross-border inter-bank lending, may influence macro-stability in both positive and harmful ways. Those who see potential harm argue that trans-national banks stimulate capital flight, particularly in developing markets, and in stressful times may be a source of capital outflows and currency crises. Second, some analysts argue that foreign banks may lack commitment to their host country and will flee, or withdraw credit, when faced with problems in local markets or in their home market. A third concern is that the participation of foreign banks may be associated with broader efforts at deregulation and may overwhelm domestic banking supervisors, creating a riskier environment.

Those on the other side of the debate argue that participation in global banking is a source of stability and improved banking practice. Proponents of this view claim that foreign banks may directly bring new and better basic banking skills, more sophisticated management techniques, and products better suited to managing and spreading risk. Through the benefits of competition, these commentators argue, local banking skills and services will be improved. In addition, some observers see indirect benefits from the participation of foreign banks. They argue that global banks, as either direct entrants or as inter-bank lenders, may accelerate the development of ancillary institutions, such as rating agencies, accounting and auditing firms, and credit bureaus, which acquire and process information. Similarly, banks that participate in many national markets may improve information disclosure about the banks themselves as the foreign banks compete to gain market share by demonstrating their comparatively sound financial condition. Finally, the proponents of this view argue that participation by cross-border banks may stimulate improvements in the supervisory and regulatory framework.

I believe that those who argue for the benefits of having a country open to global banking may have the better of the argument. We know, however, that whether foreign banks are a source of stability or fragility depends very much on the market, banking and supervisory environments that they find in the host country. There are conditions that must accompany, or better still, precede a country's decision to participate in today's global banking market. If the participation of foreign banking competitors, either directly or through inter-bank lending, comes with improvements in the underlying bank credit underwriting culture, the capability of bank supervisors, and the degree of transparency, then the benefits of foreign bank participation will eventually emerge. On the other hand, if foreign banks participate in a country in which neither the market transparency, nor domestic banks, nor bank supervisors are prepared to change, I believe that the participation of foreign banks, by itself, will not necessarily be beneficial and could prove to be

negative. Therefore, entry of foreign banks, either directly or as participants in the inter-bank lending market, without movement to better information, better supervision and better banking, provides access to credit, but not necessarily an increase in macro-stability. To argue the benefits of global banking in the abstract, removed from these required conditions, therefore seems to miss the true focus.

Lessons from the Asian Crises

Let me now turn to the broad-based lessons that the Asian crisis teaches us. One of the most important contributing factors to the current financial crisis in many of the emerging Asian nations was the weakness of their banking systems, as well as weakness of bank supervision within those countries. It seems clear now that, Asian banks, as well as their government supervisors, violated some of the fundamental principles of banking and banking supervision. Banks' managers had not developed adequate processes for underwriting loans and monitoring their continued performance, or of establishing sufficient and timely reserves to buffer expected loan losses. Some of these problems stemmed from lending directed by governments, which led to expectations that the government would support such loans, if needed. But, the primary cause of these credit problems stemmed from banks' failure to deploy effective tools of credit risk analysis.

The absence of credit risk analysis led to financial structures that were inherently fragile. Banking supervisors in these countries proved ill-equipped to compensate for the fragility. Poor allocation of credit undermined the prospects for sustained economic growth. Some borrowers could not service their loans. As these domestic banks' loan portfolios deteriorated and their financial condition eroded, their creditors, domestic and foreign, looked at them more critically, and began to withdraw their funding. In short, the deteriorating condition of borrowers hurt the banking system, which increased economic harm to the rest of these countries' economies.

Two other features of these countries' financial systems have compounded the problems caused by poor lending practices and inadequate supervision. First, standards for the transparency and disclosure of private financial information were extremely lax. It was difficult for creditors, foreign or domestic, to distinguish good risks from bad, and this caused them to both grant and, later, withdraw credit from borrowers within these countries without full knowledge of borrowers' creditworthiness. This latter reaction exacerbated the crisis for the businesses and citizens of these countries. Second, creditors to banks no doubt relied to some extent on a public safety net to back up their claims. This was true not only of small depositors, but also of foreign bank creditors. As it turned out, the presumption of public support was at least to some extent misplaced.

Therefore, participation in the global banking market did not work to save these countries from fundamental information, banking and supervisory weakness. The fact that the information, credit and supervisory cultures had not yet changed, even with the participation of foreign banks and the extension of inter-bank credit, meant that ultimately these financial systems were proved fundamentally flawed.

We have also learned, or relearned, other lessons because of the handling of these crises. First, prolonged delay in tackling systemic banking sector weakness invites further weakness, not strengthening. Delay in the hopes that the economy will grow banks out of their problems, is attractive, but is actually a trap. Because of the credit allocation role that banks play in many economies, delay allows problems to grow. Inefficient banks are allowed to allocate credit inefficiently, and open, insolvent banks, in effect distribute taxpayer money to bank shareholders, employees and borrowers. Second, extra attention is required to solve systemic bank weaknesses because of the inherent pitfalls associated with banks that are "too-big-to-fail". Because the threat of

closing very large banks may not be credible, it may be more difficult for supervisors to pressure very large banks to improve their operations. As a consequence, supervisors need to have clear legal authority, and political support, to order banks to take a variety of steps to improve their operations. This is a lesson that we in the United States learned only recently, and supervisors here are now required to order banks to take remedial actions as capital falls below 8 percent.

Reactions of the International Supervisory Community

The international supervisory community has heeded these lessons and reacted to them. International recognition of the need for strong, effectively-supervised banking systems is the reason that the Basle Supervisors Committee issued its 1997 paper, "Core Principles of Effective Banking Supervision." Bill Rutledge, Senior Vice President of the Federal Reserve Bank of New York, will discuss this paper with you after your break this morning. I cannot overstate the importance of adopting such core principles of sound banking and banking supervision in the international banking system, and also the need to develop a workable mechanism for enforcing the implementation of these standards.

The Asian crisis also underscores the importance of transparency. Adequate market discipline depends on investors having information that is sufficient in quantity, reliability, and timeliness. In recognition of this, the Basle Committee is now exploring the possibility of setting benchmarks for providing information about financial institutions that should be available to both supervisors and markets. International progress toward greater transparency is a vital initiative for the markets and sound supervision. More broadly, I believe that the time is appropriate to hasten the wide-spread adoption of international accounting and disclosure principles that raise the standard for accounting treatments in all countries. These standards should focus on three goals. 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.

Because of the increasing complexity of financial instruments and the speed of movement in financial markets, intrusive supervision has become less meaningful, if not virtually impossible. Thus the federal banking agencies have adopted a risk-focused approach to banking supervision that emphasizes the adequacy of banks' internal risk management systems. Events in the financial markets today occur too quickly to give anyone a comfortable learning curve in grappling with financial problems. I believe that our objective should be to make managers and institutions behave as if there were no safety net and align their natural market-driven decisions with supervisory objectives. Together with the traditional approaches of loan review and transaction monitoring, market-based supervision will best ensure the continued viability of the banking sector. We should, and are, actively searching for other methods to create incentive-compatible regulation and supervision.

The Asian situation highlights the value of a reliable system for US banking supervisors to assess banks' country risk, which I know has occupied some of you recently. As many of you are aware, the federal banking agencies, through the Interagency Country Risk Exposure Review Committee (ICERC), are developing an improved guide for examiners in evaluating the country-risk exposure in banks. This system will permit examiners to be more thoroughly informed on countries in which US banks have exposure and allow for a better cross check against banks' country risk management systems. New risk-focused examination procedures will also be a by-product of the current review of management practices.

Finally, the Asian crisis and the speed with which it occurred demonstrate the need for effective international communication and coordination. You confront this need in your daily work in supervising global financial conglomerates. These large diversified companies, which are becoming more prevalent in domestic and global markets, blend banking, securities, and other financial activities in a single diversified company operating across national borders and traditional industry lines. This presents a significant supervisory and examination challenge because most of the legal systems of the countries in which these firms operate are structured along national or smaller geographic regions. Many of these countries, including the United States, continue to employ different supervisory approaches, implemented by different regulators, for each traditional sector of the financial services industry. The crossing of national and industry lines can result in numerous financial services supervisors having responsibility for theoretically distinct pieces of these financial conglomerates, but no supervisor having clear authority to coordinate supervision of the entire jigsaw puzzle of each conglomerate. This is a critical deficiency because these conglomerates are working to coordinate and integrate their business operations and supporting systems to the greatest extent feasible.

This is why the Joint Forum on Financial Conglomerates in February issued its consultative documents, "Supervision of Financial Conglomerates". This international coordinating group is a joint initiative of the Basle Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS). The Joint Forum's consultative documents make concrete recommendations for steps that supervisors in each of the securities, insurance, and banking sectors can take to enhance supervision of the group-wide risk exposures of these global and inter-industry conglomerates. One key recommendation is for the international supervisory community to agree on one or more coordinators to facilitate international and inter-industry cooperation. The specifics need to be clarified, but you should all be aware of this international initiative, while also recognizing that more work remains to be done in this country to deal with the complex issues that arise from the international and inter-industry activities of these firms.

Domestic Supervision of Foreign Banking Organizations

Moving now from Asia to domestic issues, the International Banking Act (IBA) is perhaps the most notable of the laws governing the activities of foreign banking organizations (FBOs) here in the United States. The IBA requires, among other things, that, in order to approve a branch application, the Board must determine that a foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. This requirement, as you are undoubtedly aware, is commonly known by the initials CCS. I believe that the Federal Reserve should continue to be rigorous in applying the CCS standard. The Board should also take great care in allowing entry into the United States by foreign banks from a country where CCS is not yet in place. In these countries, appropriate conditions could be imposed on the operations of the US branch to help compensate for the lack of full CCS.

Finally, let me raise an issue that symbolizes our global interdependence: the major challenge of being ready to turn the calendar page on December 31, 1999. As you are all well aware, the Federal Reserve, as well as the other banking agencies, have a keen interest in the Year 2000 readiness of all banks in the United States and overseas. While all banks must address Year 2000 readiness issues within their organizations, the issue appears to pose special problems for foreign banks operating branches and agencies in the United States. To address the Year 2000 problem for these banks, and international banking generally, the Federal Reserve is taking an active role in a number of international initiatives, most notably including the Joint Year 2000 Council, which is jointly sponsored by the major international bodies for cooperation between financial market regulators. The Joint Year 2000 Council has made a good start at its task. I am sure that it will

continue to raise the visibility of this issue, help all countries recognize the magnitude of the Year 2000 challenge, and provide guidance to and assistance for supervisors and financial market participants in understanding the steps they need to take to meet the challenge. I refer you in particular to the Council's current paper on guidance to supervisors, which gives concrete steps on assessing preparations by financial institutions. Going forward I know that the Council intends to provide guidance on developing testing programs and contingency plans.

One focus of our concern with protecting the banking system in the United States is that many US offices of foreign banks may be particularly exposed if their parents are not ready for the Year 2000. Therefore, we have asked the US branches and agencies to confirm that they will be able to continue to conduct business using the usual standards for readiness that we apply to domestic banks. We are also examining foreign banking branches and agencies, as we have with domestic banks under our supervisory authority. The initial round of examination of US branches and agencies has been completed, and individual foreign banks are being made aware of the results.

There are, of course, a number of competing initiatives that further stretch the limited information systems resources available to achieve preparedness. In Europe and other parts of the world, the introduction of the Euro, and the coordination of systems within the Euro-countries, is requiring extensive planning and programming. In Japan, the "Big Bang" will likely take top management focus from Year 2000 systems issues. Particularly in light of these competing demands for system resources internationally, foreign and US banks need to recognize the magnitude and importance of the Year 2000 conversion effort. Banks need to take action now to devote sufficient resources to this critical mission. Senior management of banks and FBOs is responsible for dealing with Year 2000 issues. It is not a technical issue alone; it is also a strategic business issue.

Conclusion

I believe that the emergence of modern international banking is probably likely to be beneficial. While international banking holds the potential for macro-stability, the history of financial crises, including the current ones in Asia, also shows how weakness in banking systems and banking supervision may contribute to macro-instability. The prescription to avoid, or at least minimize the impact of, future crises includes a combination of solid banking skills, well-conceived banking oversight at the national level, greater transparency, risk-focused and incentive-compatible banking supervision, and coordination among international banking supervisors.

While creating this long-term environment, we must also respond to the more immediate challenge of protecting our domestic financial system from poorly supervised foreign entities and from the risks inherent in technology as we go into the new millenium.