**Mr. McDonough discusses the importance of sound financial systems** Remarks by the President of the Federal Reserve Bank of New York, Mr. William J. McDonough, at a presentation in Mexico City, Mexico on 22/7/98.

Introduction

I am delighted to be here today in my second-favorite country in the world to address you on the very timely subject of the importance of sound financial systems. Having worked closely with my friends in the public and private sectors here over the years, I know the importance of these issues to them. Judging by the attendance here today, this interest appears very broad indeed, a positive sign for the continued revitalization and strengthening of Mexico's banking sector.

My remarks today, necessarily, reflect my perspective as president of the Federal Reserve Bank of New York, which supervises the majority of domestic and foreign bank assets in the United States, and as Chairman of the Basle Committee on Banking Supervision, a position I accepted last month. These positions allow me a front-row seat on the wide range of developments taking place in international banking and banking supervision, a perspective which I hope to share with you today.

To understand the importance of sound financial systems, one need only look at the impact of financial system breakdowns, of which, unfortunately, there are many recent examples. Indeed, prior to the onset of the Asian crisis, the IMF had estimated that fully three-quarters of its member countries had experienced significant banking sector problems since 1980. Banking problems have afflicted both industrial and emerging market countries, including the US, which weathered the savings and loans and banking problems of the 1980s and early 1990s.

Crises around the world have exacted a high price, with direct fiscal costs of associated resolutions typically starting at roughly 5 percent of GDP (in the US case, such costs ran more than $100 billion). To these substantial sums, one must add the less quantifiable, but no less real, consequences for the economy and financial system. A weakened financial sector cannot serve its role as intermediary - as banks seek to repair their balance sheets, restrict new lending, and shore up capital - leading to diminished growth prospects. In a number of Asian countries today, exporters have difficulty obtaining trade financing from domestic banks, delaying the process of economic recovery and raising fears of a credit crunch in which even sound companies are driven into bankruptcy. Banking sector problems reduce depositor confidence in the banking system and can trigger capital flight. Banking system problems, significant in their own right, can cause distortions in monetary policy, render monetary policy tools less effective, and put at risk the integrity of the payments system. In an integrated international financial system, it is increasingly difficult to contain a banking crisis within a country's borders. Finally, we must not forget the human consequences of a financial and broader economic crisis, which disproportionately fall on those least able to weather the storm.

Clearly we need to learn what we can from recent history and take steps now to make domestic and international financial systems more resilient. Crises are opportunities for implementing change, and in the US and internationally, significant reforms traditionally have been born of crisis. To effect meaningful and appropriate reform, however, we must fully understand cause and effect and the broader trends of international financial intermediation. Today, I would like to share with you my perspective on these issues based on US and international experience, with special emphasis on the need for additional preventive measures.

Importance of sound banking systems

Over the long run, a nation must be able to mobilize domestic savings and other sources of funds needed to finance investment and other productive expenditures. This requires the development of an effective banking system that transfers surplus funds of households and businesses to borrowers and investors. Fair and impartial allocation of credit accommodates the economic development that results in improved national living standards. Notwithstanding broad changes in the intermediation process which have reduced the role of banks in favor of the capital markets, banks retain a critical role in direct intermediation and as managers of financial risk. Sound financial institutions, and banks particularly, remain integral to a sound economy.

Effective financial intermediation is particularly important in the context of most emerging market countries given the relative scarcity of savings, a relatively underbanked population, and large-scale investment needs. The banking sector in emerging market countries also tends to be more concentrated and represents a larger share of the domestic financial system, suggesting that problems there will have an amplified effect on the economy and on the fiscal costs associated with bank rescues.

Causes of banking system problems

Banking system crises have many and complex causes, both macro and microeconomic. Macroeconomic causes include exogenous shocks, sustained or sharp declines in real growth, accelerating inflation, deterioration in the terms of trade, and changes in the policy regime. Macroeconomic shocks also typically expose underlying microeconomic deficiencies in risk management practices and internal controls at financial institutions such as weak underwriting standards, insider lending, excessive credit growth and credit concentrations, interest rate and exchange rate mismatches, and fraud. They also tend to reveal weaknesses in financial system supervision and regulation. The threats to financial system stability are many and interact in complex ways.

Policy responses

Reflecting the many causes of financial system distress and differences in country conditions and institutional settings, responses to financial system crises typically have been varied and hybrid. Banking sector restructurings are art as well as science, and can be influenced by a host of factors, such as the depth and breadth of problems in the banking, corporate and household sectors. Other critical factors include the existence of adequate enforcement mechanisms to achieve corrective action and of financial markets that are deep enough to permit the orderly disposal of problem bank assets. Indeed, there is no “one size fits all” solution, and individual countries must tailor their approach to their own conditions. Moreover, crises typically evolve in unpredictable ways, and policy must be sufficiently fluid to adjust to changing conditions. Nonetheless, past crises have taught us important lessons applicable to the current situation worldwide.

First, it is imperative that bankers and authorities be realistic about the size of the problems they face. While it is often difficult to accurately gauge the scale of problems at the outset of the crisis, history shows that problems usually are much larger than they first appear, and estimates often are subject to frequent and significant upward revision. While pressures to muddle through may, at times, be almost irresistible, policymakers and bankers must realize that the costs of inaction and denial are substantial and that problems left unaddressed grow rapidly over time.

Second, it is important to recognize that financial system distress typically encompasses weaknesses in many individual areas, and effective solutions need to be comprehensive and multidimensional. Solutions usually involve complex tensions and trade-offs: improving the condition of the banking sector, for example, may have the effect of worsening the condition of the corporate and household sectors, which may, in turn, negatively affect the banks. Similarly, liquidating problem banking assets may put additional downward pressure on a broader range of asset markets and further exacerbate banking sector problems. However, asset retention more often than not erodes values and freezes market liquidity. Policymakers face difficult choices in managing problem bank restructurings, and there is a great need for creativity in devising solutions.

Third, crisis situations cry out for solutions to be adopted quickly to stem further deterioration. At the same time, however, solutions adopted in the short term need to account for the long-term consequences for market efficiency, particularly with respect to moral hazard. The highest priority at the outset of a crisis is usually to restore confidence in the banking system. To this end, authorities in a number of countries have implemented guarantees of bank deposits or broader bank liabilities, in some cases both domestic and foreign, followed by concrete actions to make deposit insurance schemes more explicit and bolster the insurance fund. To minimize the moral hazard implications of such arrangements, however, it is critical that guarantees be established for a defined transitional period, and that supervision of financial institutions simultaneously be stepped up.

Issues of moral hazard also need to be considered in authorities' actions in cases of financial institution insolvency. Supervisors have adopted varying approaches to insolvent institutions, including mergers, purchases and assumptions, nationalization, and liquidation. While the authorities should have a general bias toward writing-off existing shareholders and removing management and directors of troubled institutions, such actions may need to be balanced against arguments that current owners and management may be best positioned to achieve an effective work-out.

Fourth, I think we should bear in mind that banking sector crises often are not just short-term aberrations, but usually are manifestations of longer-term structural problems. Therefore, it is crucial that policymakers address not only the immediate stock of problem assets through "bad bank/good bank" vehicles, but also structural problems, or weaknesses in core profitability stemming from high overhead, low margins, and excessive regulatory costs. To the extent that underlying problems are not addressed, the banking sector will remain vulnerable to future instability.

Thus, at the same time as authorities seek to battle a crisis, they also may be compelled to undertake a range of longer-term reforms to banking sector infrastructure, most notably in areas of accounting, disclosure, capital, and supervision and regulation. These changes often involve bringing domestic standards in line with international standards, and can involve difficult trade-offs, in that, for example, fuller disclosure of problem loans may undermine depositor confidence.

Finally, the scale of banking sector problems in a number of countries has necessitated opening up the sector to significant foreign investment. Clearly, such a course brings political tensions and possible domestic backlash. Notwithstanding these concerns, foreign ownership is both inevitable and positive as foreign capital brings not only additional financial strength to a domestic banking sector, but also frequently needed technology and skills transfer.

Overall summary of initiatives

What has been the success of responses to recent banking crises? While it is still premature to draw firm conclusions, based on the experience in Latin America and early indications from Asia, I believe that, on the whole, policy responses have been meaningful and have strengthened domestic safety and soundness considerably. Let me briefly review the new, post-crisis, financial landscape in Latin America.

Crises have left perhaps their greatest imprint on domestic financial system structure. Financial systems have generally experienced significant consolidation - leading to a less fragmented banking market - as weaker and more marginal players have been forced to exit. Foreign capital now accounts for a noteworthy share of banking assets across a number of countries, bringing additional financial strength and know-how. Many governments have sought to reduce their direct role in the financial system through the privatization of state banks, although this will likely remain a longer-term policy objective for many countries.

Authorities also have made tremendous strides in improving system infrastructure. Disclosure standards have been greatly improved, and in some Latin American countries, disclosure standards are now comparable to that of G-10 countries. Recognizing the greater historical volatility in emerging market economies, minimum capital requirements have also been raised to levels above Basle minima, and now incorporate additional sources of risk, such as market risk. Financial supervision and regulation has been improved, with additional resources dedicated to the hiring and training of examinations staff and to investments by regulators in information technology. Authorities have been tested and have established more effective mechanisms for addressing problem bank situations.

Financial institutions have undertaken a range of measures themselves to improve risk management practices, operational controls, and core profitability. Some institutions have attempted to comply with international standards, notwithstanding lower domestic requirements. These reforms are especially important in light of the fact that the obligation to promote financial soundness rests mainly with financial institutions themselves.

Taken together, these reforms indicate progress toward reduced systemic risk, heightened competition, increased banking services provided to the domestic population, and higher standards of conduct better approximating international standards.

## Work Ahead

Notwithstanding this progress, much work remains ahead. While crises have motivated a great deal of reform in individual countries, and standards are approaching international norms, the international financial system remains a patchwork of varying standards and guidelines. While international disclosure standards have improved markedly in recent years, greater disclosure still is required, particularly with respect to bank asset quality, both in emerging and industrial countries alike. In seeking to make these improvements, however, we should avoid a “checklist” approach which may not address the risks of a given country and may soon become outdated.

Improved disclosure will require more than a comprehensive framework. Accounting standards also need to be upgraded to reflect innovations in financial products and risk management techniques. The process of upgrading accounting standards, in turn, would benefit from greater harmonization of accounting standards that would facilitate comparison of global financial institutions and result in more uniform capital standards across countries.

At a fundamental level, I wonder whether the crisis has engendered the most important reform of all – the development of a true credit “culture”. While necessarily a longer-term process, the existence of a sound credit culture is the *sine qua non* of long-term financial stability. Improved disclosure requirements for nonperforming loans, for example, will be meaningless to the extent that credit standards are weak to begin with, or that there is widespread tolerance regarding the restructuring of past-due loans, motivated by an unwillingness to admit that the loans are troubled. Further enhancements to the bankruptcy and legal codes to increase the efficiency and transparency of collateral recovery are equally necessary.

While supervisors have made tremendous strides to effect comprehensive, consolidated supervision globally, significant work remains to be done (and perhaps always will). The rapidly evolving international financial system, in which institutions operate to a greater degree across national borders through a variety of entities and, increasingly, in combination with securities underwriting and insurance businesses, poses continued challenges to supervisory frameworks organized primarily on a national, legal-entity, and business-specific framework. The existence of parallel, offshore, and other unregulated structures also will continue to present obstacles to the full implementation of comprehensive, consolidated supervision on a global basis. Managing these issues will require intensified coordination and information-sharing among international supervisors.

Authorities need to ensure that capital adequacy guidelines keep pace with developments in internal risk measurement techniques and changes in the business of banking. To that end, the Basle Capital Accord's market risk amendment, which went into effect at year-end 1997, represents a significant shift in capital supervision, moving away for the first time from the prevailing approach of a mandated and rigid regulatory formula or ratio. The amendment also represents a major step toward a more market-based approach to supervision that draws on banks' internal methodologies for risk measurement, places greater emphasis on promoting sound risk management and control processes, and encourages further innovation and improvement in the banks' internal models.

While the market risk amendment is a major step in the right direction, we need to begin thinking now about a conceptual framework for the next generation of capital rules, particularly given the long lead times involved. The original Basle Capital Accord took about five years to develop, and almost seven more years were required to reach agreement on the market risk amendment. I intend to do whatever I can as chairman of the Banking Supervision Committee to raise the relevant issues and promote the development of new approaches to capital adequacy as early as possible.

In discussing the challenges ahead, I should also note some recent accomplishments, particularly the work of the BIS Committee on Payments and Settlements Systems, of which I was the former chair, on reducing Herstatt risk in foreign exchange settlements. Previous work by the Committee, embodied in a March 1996 report, recognized that settlement risk depends not only on the payments system infrastructure, but also on the way market participants use this infrastructure and manage their internal processes. A follow-up report was issued one week ago that applauded the progress made, while noting that there were further opportunities for private sector initiatives in reducing settlement risk. The central banks, of course, are ready to work closely with the private sector in achieving this goal.

## Closing

Preventing future banking crises poses difficult issues for policymakers. Given the indispensable role that banks play in a nation's economic well-being, all governments have found it important that financial institutions be subject to regulation or oversight. It is important to understand from the start, however, that there are limits to the supervisory process. Supervisors have limited ability, for example, to detect fraud. Most important, in a market-oriented banking system, bank directors and management must have the ability to set the bank's overall course, to seek a reasonable profit, and to innovate and experiment with new banking activities and products. In other words, supervision can not be so heavy-handed as to stifle competition and innovation. As such, the supervisory process has an inherent tension between the freedom banks need in order to earn reasonable profits and the latitude to take such large risks that their future could be endangered. In seeking reforms to supervision and regulation in response to financial system crisis, we need to ensure a proper balancing of these trade-offs.

While I am broadly encouraged by the international policy responses to recent financial crises, I recognize fully that more work remains to be done. I look forward to taking up these challenges in my new position on the Banking Supervision Committee, and to our continued cooperation as we work together toward building a sounder international financial system.