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Globalization of Financial Markets: International Supervisory and Regulatory Issues

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I was delighted to accept your invitation to come to Jackson Hole. To economists and specialists in financial markets, Jackson Hole is, of course, firmly on the map of conference centers for the excellence of its seminars; but Wyoming is not a territory with which I can claim great familiarity. When I looked at the map to get my bearings, the schoolboy in me was intrigued to observe our proximity to such famous names from the Wild West as the Big Horn River and Fort Custer. General Custer might not have cared much about instability of the financial variety, but he would surely have made a forceful contribution as a discussant for a seminar devoted to policy responses to disorder and instability of a different kind.

My subject today is international supervisory issues and I propose to divide my remarks into two parts. First, I should like to use (or abuse) the privilege of a luncheon speaker to make some very general observations on the rationale for official supervision of financial institutions, and for international cooperation in this field, in today's world; and second, I shall look at some current issues facing supervisors. A good deal of what I shall have to say will be about the supervision of banks, but I shall also refer to supervision of securities markets.

To begin, then, with the question as to the rationale for supervision in today's world. The traditional goal assigned to the supervi-

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sion of the financial industry in general, and of banking in particular, is to ensure the stability of the system as a whole by promoting sound management of individual institutions. The reason for caring more about stability in the financial, and especially the banking, sector than about that in any other industry appears to be twofold: first, the failure of individual institutions can lead to chain reactions within the system because of the strong links tying institutions to each other, because of the speed at which funds can be shifted and because of the overwhelming role of expectations; and, second, as a result of its central place in the mechanism of credit allocation and in the payments and settlements system, whatever happens within the banking world can have far-reaching consequences for the real economy. It is for these reasons that central banks have been entrusted with the lender-of-last-resort function, of which bank supervision—so runs the argument—would seem to be the natural corollary.

I have not noticed anyone seriously challenging the view that the pursuit of stability in banking is a worthwhile objective, nor, indeed, that the achievement of this objective presupposes that central banks should be able and willing to perform (at least in a global sense) their lender-of-last-resort function. What has been questioned, however, by a number of observers and analysts in recent years is whether supervision has become largely unnecessary to the achievement of systemic stability and also whether it may not actually be counter-productive. I propose to look briefly at both these views.

Those who argue that supervision has become largely unnecessary are, in effect, saying that nowadays bank failures are no more harmful economically than failures of firms in other sectors of the economy. This assertion is based on the existence of retail deposit insurance schemes, which mean that most bank depositors now run no risk of losing their money if a bank fails. From this it is argued that the threat of systemic runs on banks leading to a multiple contraction of bank money and credit is now a thing of the past. This view would seem to be supported by the observation of what has, or rather has not, happened in recent years. In contrast to events in the 1930s, the numerous and, in some instances, very severe shocks that have affected individual banks or even the whole industry in the 1980s have not produced large-scale disturbances that could be called a genuine banking crisis.

The second of the two views I mentioned, namely that bank super-

vision may actually be counterproductive, is based on the argument that supervision has costs in weakening the efficiency with which banking functions. This is not a new view and it has several interconnected facets. Regulatory prescriptions governing, say, minimum capital or liquidity ratios are accused of inviting bank managements to suspend their own judgment on the risk involved in certain bank activities and/or to try to evade the cost they imply. At the same time, supervision, especially if carried out by the central bank, may induce the latter to bail out individual institutions more or less systematically. The argument that supervision is the natural corollary of the lender-of-last-resort function is therefore turned upside down: supervision carries with it the temptation to be lender of last resort to individual institutions in a fashion and with a predictability that would tend to distort management behavior. The result would be a weakening of market discipline, reinforcing the supposedly perverse influence of deposit insurance. Banks may take greater risks than they otherwise would with their depositors' money and, at the same time, depositors may be less attentive to the quality of bank management. The efficiency of market discipline would be impaired. Note that the logical implication of this view is that individual banks should be allowed to fail, or at least that no single institution should be able to operate on the assumption of a bailout—a principle I would find hard to contradict.

I would not want to deny that banking supervision, or retail deposit insurance, may *in general* involve some costs. These costs may be characterized as interference with the workings of the market. They include some loss of efficiency in banking and, of course, costs to the taxpayer to the extent that the bailout is financed by the state. I would not dispute either that some specific aspects of individual countries' supervisory regimes may be unnecessary, or even perhaps, counterproductive. Nor do I wish to hide my mixed feelings on observing the frequency of bailouts. But I believe that both the supervisory and the rescue techniques are improvable, so that these costs can be reduced, although not completely eliminated. More important, however, to my mind is the question about the balance between the costs and benefits of official supervision.

To that question I would give the traditional answer that the benefits of supervision clearly outweigh the costs, for two reasons. First, I think it is an exaggeration to say that retail deposit insurance schemes

have largely extinguished the risks of systemic runs on banks. Quite apart from the fact that not all countries provide deposit insurance, the main thing wrong with this argument is that insurance does not cover wholesale deposits, nor deposits placed in foreign branches. In saying this, I am well aware that in the United States there is an active brokerage trade engaged in cutting up wholesale deposits into retail slices. But insurance is not, indeed should not be, complete, and I would add that it is in the field of wholesale banking in the Euromarkets that competition has been keenest in recent years, and that banking has become more integrated worldwide.

I am familiar with the argument that wholesale (i.e., corporate) depositors are supposed to be able to judge the quality of bank managements, and therefore, to look to the safety of their deposits, better than the man in the street. Recent experience does not suggest that this is always the case. For instance, it was not true of the wholesale depositors at Continental Illinois Bank, particularly those in the Euromarkets from which Continental drew a large part of its funding.

My second reason, or set of reasons, for holding the traditional view has to do with the structural changes that have taken place in banking over the past decade and with some of their consequences. The main features of these changes have been international financial integration, the wave of financial innovations and the deregulation of banking. Their most important consequence has been a very marked increase in competition between financial intermediaries, both in their home markets and, even more so, internationally.

There are three points to which I would draw your attention to this connection. First, greater competition in banking is supposed to improve the allocation of resources through banks. I am ready to accept this as a general proposition, but I have some difficulty in forgetting the lessons of the debt crisis. The present external over-indebtedness of many sovereign borrowers—one of the largest contemporary macroeconomic imbalances, and one that continues to give a lot of headache to the banks themselves—emerged at a time when bank credit was provided by banks which were not only competing freely with each other but were doing so with very little regulatory impediment. The Euromarket of the 1970s and early 1980s came as close as possible to the model of a free, unregulated market. It is, of course, true that "overlending" could not have happened without

"overborrowing", and that it was not easy to foresee a combination of world slump with very high interest rates. Nevertheless, anyone who had the experience of seeing bankers queuing up in front of the offices of lesser developed country (LDC) finance ministers at that time cannot help feeling that the highly competitive environment had something to do with the emergence of the problem.

Second, in recent years, there has been a very large increase in corporate and household debt ratios, particularly here in the United States but also in some other industrial countries, carrying obvious risks in the event of a cyclical downturn. One cannot rule out, in my view, the influence of financial innovations, notably leveraged buyouts, on the increase in corporate debt ratios.

Third, and more generally, competition works partly through the elimination of weaker units from the system—the process that Schumpeter described as "creative destruction". If, like me, you cannot accept the view that the risk of systemic runs on banks is now a thing of the past, you feel that such destruction can be more dangerous in banking than in any other sector of the economy. Moreover, the worldwide integration of banking has given this risk a dimension that it never had before.

My purpose in making these points is not to argue that the costs of increased competition in banking outweigh the benefits. I do not believe that they do; nor do I wish to underestimate those benefits. My argument is simply this. The rapid evolution toward a more and more competitive environment in banking exerts tremendous pressure on bank management to outperform rival banks or simply to fight for survival. This means not only cost cutting but also finer pricing for deposits, a search for higher-yielding investment, new ventures, the use of innovative techniques and new products. In other words, it is likely to imply an incentive to greater risk-taking. Add to this a very uncertain and basically imbalanced global macroeconomic environment leading to wildly fluctuating exchange rates, interest rates, stock prices, real estate values and commodity prices, and it is hard to avoid the impression that the risks in banking have been set on a rising trend. I do think that in order to preserve the stability of the banking system, which is a valuable aim in its own right, bank management needs the support of the restraining influence of supervision even at the cost of some loss of efficiency, whatever the definition of efficiency may be. And it is obvious that in today's globalized

banking market, supervision has to be as far as possible globalized, both in the geographical and in the inter-industry sense of the term.

I now turn to some current supervisory issues. Capital adequacy lies at the heart of sound banking. For some years, therefore, the efforts of supervisors to help banks meet the challenges of the more competitive environment in which they now operate have been concentrated on strengthening banks' capital positions. The accord reached last month by the G-10 central banks on capital adequacy represents the culmination of those efforts. I know that the agreement has not been universally acclaimed by all sections of the banking community in the United States, but it has also been criticized, from different angles, in other countries. This is, perhaps, the sign that it is a good agreement, well-balanced and distributing the strategic adjustment efforts evenly across the world. I would like to spend a few minutes considering the importance of this landmark in supervisory cooperation.

It has two aims: to strengthen bank capital standards in the G-10 countries where the core of the international banking system is located; and to do so in a way that tends to equalize the impact of supervision on the competitive positions of banks in different G-10 countries.

Disparities between national regulations with respect to the measurement of capital and the assessment of capital adequacy can have a number of harmful consequences. First, banks in countries with high capital standards are less able than their opposite numbers in countries with lower standards to compete for new business. Second, as a consequence, banks with lower capital and larger balance sheets will be able to lend on substantially lower margins with the result of diminishing returns for all. Third, some banks may, therefore, take on riskier, higher-margin lending in an effort to boost their earnings. And, fourth, the combination of these factors can make it harder for banks, and for supervisors, in a given country to raise their capital standards in isolation from what is happening elsewhere.

It may be argued that over the long run the market might do the job that the new accord on capital adequacy is designed to do. The market would, without any help from supervisors, pass its verdict on weak and inadequately capitalized banks and would reward strong banks for their prudence. But the history of banking does not suggest that the market can do this sort of thing and, *at the same time,* preserve the system's stability. This is a practical illustration of the

general point I made earlier, namely that whatever costs supervision may imply, they are likely to be offset, especially in today's world, by the advantages such supervision produces in terms of the preservation of financial stability.

Turning now to the securities markets, last October's stock market crash and the events that followed it were remarkable for two features, the first having been the speed at which other markets reacted to the fall in prices on Wall Street. That was the most dramatic illustration we have yet had of the degree to which financial markets are now integrated worldwide. Moreover, this reaction occurred despite quite marked contrasts between different countries, both in economic conditions and in price/earnings ratios for equities.

The second feature was the resilience that the markets displayed after the crash. There was no cumulative decline of share prices which, in fact, stabilized rather quickly (except in Japan) at lower levels.

This resilience of markets was no doubt partly the result of the rapid and efficient way in which the Federal Reserve and other central banks supplied extra liquidity to their markets. Given that the authorities took those actions, we shall never know to what extent there were also market forces at work that prevented a tailspin of prices which would certainly have had deflationary effects on the real economy. Probably there were such forces at work. But, in my view, it was a good thing that the central banks did not wait to see how effective they would have been, on their own, in stabilizing the situation.

One consequence of the post-crash resilience of markets was that no really large-scale problems emerged in the financial markets, either for individual institutions or, still less, for the system itself. This means, in my view, that there is no reason in the light of last year's events to consider drastic changes in the ways that markets work and, in particular, to try and put into reverse the structural changes of the past decade. At the same time, however, the crash certainly pointed up issues for market participants and for supervisors in both the banking and securities markets.

Those who supervise securities markets have had brought home to them, more clearly than before, the extent to which the cash securities markets and the markets in derivative instruments are linked to one another. Effective supervision of the securities markets must cover all their different parts.

Those responsible for supervising banks have realized more clearly than before the implications of the banks' increased involvement in the securities business. In fact, the losses sustained by banks on equity holdings were, in most instances, substantially offset by gains on their bond portfolios. The full implications of the banks' participation in the securitization phenomenon of the 1980s will only become apparent when we next experience a period of rising interest rates and falling bond prices—when there might well be no offset from rising equity prices to banks' losses on their bond portfolios.

Last year's events have also alerted bank supervisors and securities market supervisors to the necessity of cooperating with one another, both nationally and internationally. Action is now being taken to organize such cooperation. Even at the national level this may not always be easy, for institutional and other reasons. Internationally, it is likely to prove even more difficult, since the greater the number of countries that attempt cooperation the harder it becomes to reach an agreement that is both worthwhile and workable. But the worldwide character of financial markets and the geographical mobility of both financial transactions and financial institutions mean that cooperation between supervisors in different parts of the financial system needs to be put on the widest practicable basis.

Let me conclude by expressing my conviction that one of the great challenges policymakers are facing today is to encourage market participants to behave in a way that maximizes the advantages of free global competition without exposing the system to greater instability. They can do this by creating an appropriate regulatory framework and by implementing stability-oriented macroeconomic policies. I have tried to make the point several times that the adjustment of supervisory practices and their coordination internationally have an essential part to play. It was not within my remit today to insist on the role that must be assumed by macroeconomic policies—and their coordination—but it is clear to me that the high capital mobility implied by free competition will not be tolerant vis-a-vis policies that lead to, or appear to be unable to correct, large financial imbalances, be they domestic or international. And this intolerance would express itself in continued exchange rate and financial asset price volatility—the very topic of this symposium.