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Financial Globalization and International Financial Institutions: Principles and Parallels

by

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I'm very pleased and honored to be part of this session. The distinguished panelists with me today are, of course, experts on post-Communist economies. And I'm looking forward very much to hearing their views on the role international financial institutions can play in these countries as goods and financial markets become increasingly globalized.

My experience as a policymaker is more in the area of the U.S. financial system and developments in financial globalization. From this experience, I'd like to draw some principles and parallels that are relevant to the discussion today. I believe they can be useful to post-communist countries as they make the transition to a greater market orientation, and they can provide guideposts for the role of international financial institutions.

My remarks will be organized around three main principles. First—the more open financial markets are, the more effective they can be in meeting the demand for financial services. Specifically, more openness increases the flow of credit and the flow of technology, including financial technology. Second—cross-border entry by financial institutions remains central to the transfers of goods, capital, and technologies. Third—financial regulation and supervision should reflect the changes stemming from financial globalization, including cross-border banking.

Let me turn now to my first point. The scope of financial globalization is a testament to the market's ability to respond to new opportunities. Some of these opportunities come from the increasing openness in trade and in capital flows, such as we've seen in Europe during the past decade. Other opportunities come from new technologies. By "new technologies" I mean both advances in computers and telecommunications and advances in the theory and practice of finance.

Of course, there have been some bumps along the road of financial globalization—most recently, the troubles in Mexico, East Asia, and Russia. But, overall, financial globalization has been beneficial—both for developed *and* emerging economies. It has stimulated competition and innovation in financial services. It has helped ensure that funding flows more readily to projects offering the highest returns. And it has improved risk management.

Now to the importance of cross-border entry by large financial institutions. Let me begin by noting that foreign banking institutions have a sizable presence in *many* countries. In the U.S., they account for around twenty percent of banking assets. And in some countries in the European Community—Belgium, for example—foreign institutions are *far* more prominent.

In the post-communist countries, the process of privatization has resulted in foreign banks having a substantial—and growing—stake in their banking and financial systems. And these institutions are playing several important roles. One is the traditional role of providing support for trade and direct investment. But, perhaps more important, they have two other roles. They serve as a source of capital to the financial sector. And they provide what amounts to technology transfers in terms of financial services. Technology, of course, includes knowledge and expertise.

These latter two roles—a source of capital and technology transfers—also were important in the U.S. banking market's move to interstate banking. This process evolved over a number of years. Before the early 1980s, few states allowed entry by an out-of-state bank. By the early 1990s, though, those restrictions had crumbled under the pressure of market realities. From this process, I'll draw three parallels with post-communist countries.

The first parallel involves one of the main *reasons* for permitting interstate banking. As with many countries needing capital infusions, state borders in the U.S. were first opened as a way to let out-of-state institutions acquire troubled banks in-state.

The second parallel is with the role of technology transfers. With interstate banking, states that are too small to support a large in-state bank have access to the broad array of services offered by larger out-of-state institutions. For example, in several smaller states—such as Arizona and Nevada—around 90 percent of their banking assets are held by out-of-state banks.

The third parallel is with the emerging structure of the banking sector. Large interstate banks tend to approach customer needs differently from small local banks. For example, the larger institutions tend to be less effective in serving some customers—such as small businesses—than smaller local banks. Such differences between large and small banks leave room for smaller and medium-size institutions to remain viable. Indeed, even with consolidation, the banking landscape in the U.S. is marked not only by a few large national firms, but also by regional banks and by thousands of independent local banking organizations. This parallels the structure that appears to be arising in the EC.

And I wouldn't be surprised to see regional and local banks competing effectively in Central Europe as well. For example, the level of banking activity currently is low compared to economic activity, so there is plenty of room for the supply of financial services to expand. And this will only expand further as the economies in the region gain momentum.

Now let me turn to financial regulation and supervision. Because financial globalization is a *private sector* development, financial supervision and regulation needs to work *with* the market, not against it. To do this, regulators need to be flexible and to accommodate market innovations. At the same time, regulators need to ensure against systemic risk without creating undue moral hazard.

Globalization and other dimensions of modernization complicate this task in several ways. For example, institutions are larger and more complex. In addition, there are more inter-institutional exposures—and therefore links—for transmitting adverse shocks. Finally, there is more potential for jurisdictional and legal conflicts. Over the past year and a half, the Federal Reserve has established several task forces to address these issues. I'll focus on three points from this work that are especially important and relevant to banking globally.

First is capital regulation. Over the last decade, the U.S. banking system went from very bad times to great times and to what now looks like a bright future. An important component of this transition has been the buildup in bank capital. But current capital regulations built on international agreements are flawed, since they can create incentives for capital arbitrage. The recent Basel efforts to restructure risk-based guidelines promise to be constructive in this regard. But it's important to note that problems can arise from focusing too much on the *guidelines* for capital ratios and not enough on the *goals*. The guidelines could be viewed not as a *means* to the goal, but as the goal *itself*. Specifically, it's not enough for regulators to ensure that institutions meet capital ratios. Instead, they also must demonstrate that the regulatory process has achieved its goal regarding the overall risk exposure of institutions, especially large, internationally active financial organizations.

Second is taking steps to enhance the effectiveness of market discipline. One step is to put more market participants at risk. For example, a recent Federal Reserve Staff Study looks at the idea of requiring banks in the U.S. to issue subordinated debt, because it is sensitive to firm-specific risk. Such a requirement could provide some check on risk-taking as well as ongoing market assessment of a bank's risk. Another step is to improve transparency. Various Basel Committee reports and a recent Federal Reserve study strongly support this idea. An important conclusion of the Fed study is that the market should have a major role in shaping disclosure policies. At the same time, regulatory agencies can improve the process in several ways—for example, by releasing nonconfidential data in a timely manner and by using the supervisory process to encourage best practices in bank disclosures.

The third point on regulation is to develop procedures for dealing with *failures* of institutions. Improving the effectiveness of market discipline is consistent with the goal of fostering competitive and efficient financial markets. It also can be compatible with reducing the effects of moral hazard on risk-taking. But for all this to work, supervisory agencies *must* have mechanisms in place to deal promptly with problem institutions, especially larger and more complex banking organizations. And for institutions that operate across national boundaries, it is especially critical that both the host *and* home regulators coordinate the development and implementation of these procedures.

To sum up, let me emphasize that the procedures and rules that make up financial supervision and regulation are as much a part of the technology of financial services as are underwriting or risk management practices. And this transfer of supervisory technology, or expertise, has to be effected by official agencies. That is one reason why the Federal Reserve has joined international institutions in consulting with post-communist countries on supervision and regulation as well as on payments systems issues.

But there's an even more compelling reason for this involvement. The U.S., like other countries, has a clear interest in the sound functioning of financial systems around the world.

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