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THE INTERNATIONALIZATION OF WORLD FINANCIAL MARKETS -- IT'S A SMALL WORLD

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By

H. Robert Heller

All of us here today will agree that the globalization of world financial markets is indeed a reality. I want to talk to you about what that reality means, for banks, for their regulators, and for you as financial analysts.

The concept of the internationalization of financial markets is increasingly taken into account by financial organizations in their strategic planning. Competition makes this a necessity for most major banks. And all banks will soon have to meet safety and soundness requirements that have been developed by the regulators to respond to the internationalization of banking markets.

In the context of these developments, anyone who looks at banks only in terms of national markets will be left behind.

What has happened to the foreign exchange market in the past decade is indicative of the overall trends. Turnover in the foreign exchange market has grown 10- to 12-fold in the past decade. At the same time, many new players have entered the market. The total value of global foreign exchange transactions is now in the neighborhood of $400 billion per day - which is almost twice as much as our annual export volume.

The currency range of the market has also expanded. The yen has assumed a key role in foreign exchange markets -- along with the dollar and the mark. And currencies such as the Australian dollar have become more widely traded as their use in capital market transactions has expanded.

Another very significant change that has occurred only recently is the arrival of the 24-hour foreign exchange market. With the development of new Asian trading centers that bridge the gap in business hours between Tokyo and London, around-the-clock trading is now a reality.

I want to focus my remarks today on two important questions: first, what are the implications of the globalization of financial markets for U.S. banks, and second, what kind of regulatory framework is

appropriate in a global banking environment.

For an American observer, some of the trends that have accompanied the internationalization of financial markets are worrisome. American banks once dominated world financial markets. Now, they concede significant parts of that turf to foreign competitors.

The 1970s brought rapid overseas expansion by the major U.S. banking organizations and tremendous growth in overseas lending, particularly to developing countries.

In contrast, it seems that in the 1980s American bankers are falling behind their foreign competitors. U.S. banks are no longer aggressively pursuing international lending business; however, foreign banks are increasing rapidly their role in the U.S. commercial lending market.

The U.S. banks that are active in the international arena tend to focus on international investment and foreign currency activities, rather than on traditional commercial banking activities.

Here are the facts: In 1972, the 3 largest banks in the world, ranked by deposits, were U.S. based. Now, the largest U.S. bank ranks only number 17 in the

world. The rise in the value of the dollar in the first half of the 1980s and the relative decline of the currencies of our key competitor countries temporarily masked the underlying trends. But, with the return of the dollar to a more realistic value, the decline of the relative position of American banks has become obvious.

American banks have not only declined in relative position against their foreign competitors, but also in the absolute size of their foreign presence. Foreign branch assets of American banks grew from about $10 billion in 1965 to a peak level of $391 billion in 1981, before declining to $331 billion by the end of last year.

The same trend is also apparent in the physical presence of American banks abroad. Foreign branches of U.S. banks quadrupled from 211 branches in 1965 to 917 branches by 1984. Since then, the number of foreign branches declined to 899 by the end of last year.

At the same time that we have seen this decline in the importance of international lending activities by U.S. banks, foreign banks have substantially increased their share of the U.S. commercial lending market. In 1978, foreign-controlled U.S. banking offices held $33

billion in loans to U.S. commercial and industrial borrowers, representing about 13 percent of the U.S. business loan market. By 1986, the volume of lending by the foreign bank offices to U.S. businesses had grown to $127 billion, representing 23 percent of the market. By this, foreign bank offices have roughly doubled their share of the U.S. business loan market during the last decade.

Should we be concerned about these trends and developments? I believe that the increasing presence of foreign banks in the United States not only benefits American consumers and business, but also reflects the ever increasing globalization of international financial markets. It benefits us if we become a marketplace for the world.

However, the declining presence of U.S. banks abroad represents a more worrisome trend. First, over the decades, U.S. banks have gained a vast amount of knowledge and experience in international banking. This investment in human resources should not be allowed to go to waste.

Second, banks with an international presence tend to have large investments in buildings, offices, computers and other facilities. Once these fixed costs have been

incurred, a cutback in the operating rate may actually increase per-unit costs.

Third, it takes many years to assemble a global network, which is much more valuable than the sum of its parts. Banking is a regulated industry in every country of the world. Entry is frequently restricted and banking licenses in many countries are not freely available. Once banking licenses have been obtained, they cannot be returned to the national authorities for cash. Furthermore, it is unlikely that a bank can dispose of its international network intact. Laws and regulations in the various countries may stand in the way of a transfer of the respective banking licenses to a single buyer. The buyer, in turn, may already have a significant foreign presence and purchasing the entire network may therefore not be attractive. Consequently, the going-concern value of an international banking network is likely to exceed its liquidation value.

Fourth, American exporters need international banking services. It has been argued many times that "finance follows trade". On the other hand, if trade-finance is unavailable because American banks disengage from the international arena, American businessmen will have to conquer new export markets without an important ally in

the form of their own banker. The loss of that extra competitive edge may be costly in terms of foregone sales.

Fifth, foreign trade is now the fastest growing sector in the American economy, and American banks stand to lose important profit opportunities if they choose not to finance that sector. Also, as a long-term proposition it stands to reason that foreign trade will expand more rapidly than national economic activity in general. Thus, international banking should be a strategically important sector.

Finally, international banking offers important opportunities for portfolio and earnings diversification that cannot be achieved within the national borders. Indeed, due to the interstate banking restrictions that prevent American banks from achieving the full benefits from portfolio diversification at home, the possibility of international diversification may be all the more important.

What caused the decline in international banking activity by American banks? The answer to this question lies both in certain competitive inequalities based in existing law and regulation as well as in the impact of the LDC debt crisis.

We will therefore have to ask ourselves what can be done to improve the competitiveness of U.S. banks in the international arena? The banks, the regulators and Congress can cooperate to reduce and, hopefully, eliminate any remaining international competitive inequities. While there are many complex and diverse issues to be faced, a few problems stand out.

American bankers have complained for a long time about geographical and product-line restrictions in the United States that limit the formation of a broad home base upon which to build their international activities. If we are to improve the international competitiveness of U.S. banks, we need to reduce these product-line and geographical barriers to banking in the United States.

Congress is well along in its considerations of the Financial Modernization Act, which would grant banks the right to offer a broader product range; a range that more closely approximates the types of services that foreign banks are able to offer their customers.

Interstate banking restrictions constitute another barrier toward building a strong base upon which to build an international banking presence. The states have taken the lead in reducing the barriers to

interstate banking. Some 40 states have adopted some form of legislation pertaining to the issue, but the remaining patchwork quilt of regional and reciprocal interstate banking privileges constitutes a cumbersome and irrational arrangement that needs Congressional attention. The interstate commerce clause of the Constitution brought national markets and prosperity to commerce and industry. Let's apply the same principle to banking!

Another problem that may have handicapped American banks in their international activities is that American capital requirements are more stringent than those of some other countries.

It should be pointed out that banks domiciled in still other countries where capital requirements are even stiffer seem to have suffered few ill effects from these capital requirements. Indeed, their strong capital bases may have enabled them to attract those foreign deposits looking for a very high degree of safety and they may have been able to raise funds at advantageous rates due to their high credit ratings.

Nevertheless, high capital requirements that apply to all asset categories may discourage banks from engaging in certain types of business. For instance, some

internationally active American banks reduced their interbank credit lines in the early 1980s, after the current regulations regarding primary capital were put into place. Given the very thin margins prevailing in the interbank business, these exposures simply could not generate enough of a profit margin to justify the capital requirements.

As banking markets become increasingly globalized, a primary task for the bank regulators is to bring about the harmonization of the competitive environment. This is the goal of the new risk-based capital framework proposed by the Basle group of 12 regulators. This international framework for evaluating capital adequacy will provide the same definition of capital, the same risk classes and the same leverage ratios for all internationally active banks.

The risk-based standards tentatively agreed to in Basle identify specific capital ratio targets for year-end 1990 and for year-end 1992. In the meantime, banking organizations should be expected as a minimum either to meet the Board's current primary capital guidelines or to have risk-based capital ratios that are consistent with attaining the 1990 standards. In keeping with the Board's policy of national treatment this applies to domestic as well as foreign banking institutions.

It is also true that many internationally active banks were hit hard by the LDC debt crisis, which impacted a major part of their portfolio. Consequently, the appetite for international lending was sharply reduced. Due to the lingering of the debt service problem, new lending continues to be sharply curtailed.

The regulators have tried to be helpful in the resolution of the international debt service difficulties by working with both lenders and borrowers in bringing about a constructive dialogue and resolution to the problem. Where there were regulations that impeded progress, we have taken the necessary actions to modify or remove such regulatory barriers -- all within the framework of safe-and-sound banking practices. The liberalization of Regulation K to make debt-to-equity swaps easier is a prime example of such pro-active regulatory action to ease the LDC debt service burdens.

I cannot let this opportunity pass without mentioning some points that the Federal Reserve considers important at the present time. We consider the capital adequacy of banking organizations highly important in these troubled times. In particular, we look to the bank holding company to be a source of strength for the bank. Also, along the same lines, in bank merger cases

there should be no weakening of the combined organization's capital base. That is, any cash paid out in the transactions would need to be supported by new issues of capital, not mere accounting adjustments. This is particularly important when mergers of large institutions are being considered. Finally, the Federal Reserve is concerned that dividend payouts by banking organizations not be excessive, and be based on the banks' actual earnings. For many institutions, retained earnings represent an advantageous way to build capital and may obviate the necessity to go to the market in situations where this is not desirable.

I would conclude that American banks face many new challenges and opportunities in what has become a global financial marketplace. The world has changed rapidly with the result that there are many competitive inequities to be resolved.

The regulators have taken action to level the international playing field and to equate competitive conditions among nations. Within the framework of sound banking practices, we have also removed, or reduced, barriers and obstacles to international business.

For you as financial analysts, it is important to be mindful of both the risks and opportunities present in the international marketplace. My parting thought for you is that you should not only be conscious of the risks inherent in international banking, but also consider the diversification and profit opportunities foregone by a bank that decides not to be a player in the global arena.