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INTERNATIONAL BANKING AND BANK REGULATION

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It is a great pleasure to be here with you at your annual convention. I can not think of a group more interested in international economic and financial matters -- and it is greatly to your credit that you are a consistent defender of free and open markets on a global basis.

You asked me to speak on the Future of International Banking -- and this is certainly an appropriate time to consider this important topic. Significant trends are emerging now that will shape the future of the international banking industry for years -- if not decades -- to come.

I will begin by identifying some of the key trends in the environment within which we all will have to work. As a central banker, I can not resist the temptation to focus largely on international regulatory issues, because more so than many other factors regulation influences the shape of international banking and will do so in the years ahead. In particular, I will talk about international regulatory cooperation on capital standards, the future of securities powers and firewalls, as well as reciprocity and national treatment.

Global Market Liberalization

We are now in an important period of market liberalization throughout the world that will result in greater economic integration and constitute a powerful force for growth in international banking. I do not believe that it is an exaggeration to say that the United States government has been at the forefront of this reemphasis on market forces that is now in evidence world-wide. Deregulation brought increasing flexibility to entrepreneurs and lower tax rates restored incentives to individuals. Together, that resulted in the creation of 18 million new jobs in the continuing record expansion.

Europe is now engaged in an historic endeavor to dismantle economic and financial barriers among nations and thus to broaden the horizons of the marketplace and foster competition.

Even the Soviet Union and the countries of Eastern Europe have at last come to recognize the importance of market forces, and have begun their own restructuring under the banner of Perestroika.

Developing countries, too, now see that subsidized state enterprises merely sap their economic and financial strength. These countries are turning toward freer, more open markets as they adopt market-oriented growth strategies.

Environmental Trends

While the world economy continues to grow in a complex alternating cause and effect relationship, the effective size of the globe continues to shrink. Lower costs of information, transportation, and communication have made the vision of an integrated world economy a reality. Thus, the world is changing from one of many local and regional marketplaces to a closely woven web of global economic and financial relationships. At the extreme, the world's foreign exchange market is now effectively one unified global marketplace, where quotes from all parts of the world are displayed on the same computer screen and where new currency quotes immediately and automatically extinguish existing quotes.

One consequence of this deepening integration of the world economy is that more and more transactions transcend national borders. In the last quarter century, world GNP increased about two-and-a-half-fold, while world trade expanded five-fold. Consequently, the propensity to import -- or to export, for that matter -- also increased sharply. That is, the world's economies are becoming ever more open. And by this, they also become more interrelated.

Because all these international transactions have to be financed and paid for, international banking has also grown very rapidly. Total cross-border bank lending to non-banks increased about ten-fold during the last 25 years.

Another key trend is the changing distribution of wealth in the world, which has fostered corresponding changes in the roles of countries in the world economy. For example, the share of the United States in world GNP has fallen from 30 percent in 1960 to about 25 percent at present, and the European Community's share has declined from 25 percent to 22 percent. On the other hand, the share of Japan in world GNP has doubled, from less than 5 percent to almost 10 percent over the same time period.

Trends in Banking Markets

These developments have, of course, had tremendous effect on the development of the financial services industry over the last decade and the pace of change is quickening. What are these trends, and what are their dimensions?

For one, we are seeing a change in the top players in the banking market. Banks from Japan and Western Europe continue to enlarge their share in the world banking market, while the United States is retrenching. To cite a few figures: cross-border lending by American banks to non-banks reached its peak in 1983 with $121 billion. Since then, American banks have reduced their exposure by almost 15 percent to about $100 billion. During the same period, Japanese banks have increased their international lending from $28 billion to $129 billion. German and Swiss banks have more than doubled their lending volume, and British banks have expanded by 44 percent.

This growing dominance of Japan in international banking extends to the domestic markets. At year-end 1987, 111 Japanese banks held over 40 percent of the deposits in the 500 largest banks in the world. Ninety U.S. banks were in the top 500, but they accounted for only 11 percent of total deposits. No U.S. bank is among the largest 25 banks in the world, and Japanese banks occupy the top 10 positions.

Of course, American banks enter these international comparisons with a significant handicap, because no bank is permitted to have a nationwide presence in the United States. Thus, it is perhaps more accurate to argue that California and New York banks compete against Japanese and German banks. In a straight economic comparison, California and New York would be about equal to Canada or Brazil -- and showing by U.S. based banking institutions may be considered more respectable according to that yardstick.

This all goes to show that we are handicapping ourselves unnecessarily in the national and international marketplace, and that a repeal of the barriers to interstate banking could do much to level the global playing field. A removal of the interstate barriers would also result in more diversified and safer institutions -- a highly desirable result in these difficult times. But I am getting ahead of myself and should stick to the trends in international banking markets.

The retrenchment by American banks is reflected in foreign markets. Let me just cite a few data pertaining to the London market -- probably the most important international banking center. In 1982, 77 American banks were represented in the City; that number has dwindled to 59. Although some of this trend is due to consolidation of U.S. banks, the rest reflects the departure of our banks from this important international banking center, while Japanese banks keep increasing their presence there.

In contrast to the decline in the role of American banks abroad, the presence of foreign banking organizations in the United States has expanded tremendously during the last decade. Now, 259 foreign banks operate in the United States through subsidiaries, branches, and agencies. Their combined assets in the United States amount to more than $600 billion, or roughly 20 percent of total U.S. banking assets. Those numbers vividly demonstrate the attractiveness of the U.S. market and of the opportunities deregulation and national treatment have afforded. In short, as the boundaries among financial markets around the world gradually erode, we move toward one global marketplace, where the strongest competitors will succeed.

International Regulatory Cooperation

As financial markets around the globe have become increasingly intertwined, regulators around the world have found it increasingly necessary to coordinate international regulation.

Part of the impetus toward this coordination stems from the concern that differences in supervisory regimes might place banks from countries with tighter international regulations at a competitive disadvantage. For instance, after the U.S. banking supervisors imposed tight primary-capital standards in the early 1980s, some internationally active American banks had to curtail their interbank credit lines because they were required to hold more capital against such lines than their foreign competitors.

The new Basle Accord on a risk-based capital framework, which 12 major industrial nations developed jointly, should go a long way toward redressing inequities among banks incorporated in different countries. This framework not only establishes uniform capital standards for internationally active banks in the countries that are direct parties to the agreement, but will force banks domiciled in other countries to adhere to the new international standards if they want to have an international banking presence.

By converting off-balance-sheet exposures into on-balance-sheet equivalents, the Basle Accord also reflects the concern among bank regulators that banks have an appropriate level of capital as they enter new activities that are not reflected in the traditional way on the balance sheet.

Liberalization of Securities Powers

As you are all aware, the United States is almost unique in restricting the combination of banking and securities activities in the same or affiliated institutions. The Federal Reserve believes that the Glass-Steagall Act, which provides for this separation, should be repealed. We believe that it is possible to do so without jeopardizing the safety and soundness of banks and without tearing the federal safety net.

Within the narrow regulatory discretion available, the Federal Reserve recently took carefully measured steps to grant limited securities powers to bank holding companies. We have now authorized bank holding companies to have subsidiaries that underwrite and deal in debt securities, while ensuring that proper safeguards and "firewalls" are in place. These institutional "firewalls" will help to insulate the depository institution from the risk of its securities affiliate. In a way, the American firewalls are similar to the informal Chinese Walls that separate banking and securities activities in universal banks. Overall, the repeal of Glass-Steagall restrictions would benefit both investors and borrowers, and afford better access to the securities markets for the customers.

Furthermore, within a year, we will review the situation with an eye toward allowing bank holding companies to engage in underwriting and trading equity securities, provided the companies have established proper controls and systems and have appropriate management in place.

Many issues that pertain to the foreign operations of U.S. banks and the U.S. operations of foreign banks have not been resolved. Some of them have significant international implications. For one, many foreign banks have traditionally conducted both banking and securities activities in their home countries and abroad. In fact, even U.S. banking organizations have been active in securities markets overseas because the Glass-Steagall restrictions do not apply to their activities outside the United States.

These issues arise because the banking structures in the various countries differ, and so does the manner in which banking organizations conduct securities activities overseas. Most significantly, foreign countries typically do not have bank holding companies, while U.S. banking organizations often engage in securities activities overseas through subsidiaries of the bank. This difference presents difficult issues to the Federal Reserve in considering the appropriate rules for the securities activities of U.S. banking organizations overseas and for foreign bank operations in the United States.

For example, one of the purposes of the firewalls is to insulate the securities company from its affiliated bank so that the company will not be funded by the deposit-taking capability of the bank or benefit implicitly from the federal safety net. These restrictions are important not only for safety and soundness reasons, but also because, without them, bank-affiliated securities companies might have competitive advantages vis-a-vis securities companies with no such affiliation.

Overseas, our safety and soundness concerns are the same, but our competitive concerns are quite different. While U.S. banking organizations compete against U.S. investment banks in these markets, their main competitors are the foreign banks, which often operate as "universal banks" or with securities subsidiaries of the bank itself. In some countries, the chief competitors of U.S. banking organizations operate without firewalls and with the implicit safety net of their home country. The absolute insistence that U.S. banking organizations utilize a structure overseas consistent with that required at home could therefore place them at a significant competitive disadvantage.

Conversely, foreign banks that seek to engage in securities activities in the U.S. through securities affiliates contend that the safety and soundness for which firewalls are erected are the concern of the home country, not the host country, thus, they should not be required to have them. But, giving foreign banks that right would also bestow upon them a significant competitive advantage over U.S. banks in the U.S. market.

I cannot tell you today how these issues will be resolved, since they will have to be addressed by the Federal Reserve Board as a whole in the context of particular cases and regulatory amendments. However, I can safely state that there is a recognition of, and sensitivity to, the fact that the internationalization of these activities requires that they be reviewed with a broad perspective. While the Federal Reserve has a clear preference for the bank holding company as the vehicle for engaging in these activities, an integrated world necessitates some flexibility in applying these preferences where they might have an extraterritorial effect. Thus, we will have to balance carefully the desirability of the various firewalls against other policy imperatives. These are not easy issues to resolve.

Most of these complex issues would not arise at all if banking organizations were to conduct all their foreign activities through subsidiaries. In such a framework all banking and securities activities could be carried on under the rules and regulations of the host country and no competitive concerns could arise, provided full national treatment were granted to all organizations. While I am not advocating such a significant change in banking structure, this may well be a model to keep in mind when the complexity of the situation becomes overwhelming.

Reciprocity versus National Treatment

Another aspect of the internationalization of financial markets is the overall legal position toward foreigners active in other banking markets. In Europe, much progress is now being made in the creation of a unified banking market and a uniform regulatory environment. If the various initiatives that are now being considered are adopted, nation states will, in many instances, subjugate their interests to a greater

European interest. This is of true grandeur; its fulfillment could mean the creation of the largest unified banking market in the world.

Obviously, Americans are more than interested bystanders: the European policy toward banks from outside countries is of great importance to us.
As you know, the policy underlying entry of foreign banks into the United States has consistently been one of national treatment. That is, foreign banks operating in the United States are subject to the same restrictions, and are entitled to the same powers, as similarly situated domestic banks. This policy was embodied in the International Banking Act of 1978, in which Congress eschewed a policy of reciprocity and implemented a number of measures to further the concept of national treatment. These measures have no element of "reciprocal national treatment": a foreign bank is entitled to national treatment regardless of how U.S. banks are treated in the bank's home country.

The primary-dealer provisions of the 1988 trade bill are the only recent U.S. statutory provisions regarding banking services that incorporate a reciprocal national-treatment principle. They pertain only to a very few companies doing direct business with the government of the United States. And even these provisions were vigorously opposed by the Federal Reserve and the U.S. Treasury.

We are much heartened by recent indications that the European Community is moving toward adopting a policy of national treatment, rather than the reciprocal approach favored by some. Reciprocity would result in different rules for banks from various countries that compete in the same market. Not only would such a situation be inequitable and difficult to administer, but it could lead to competitive regulatory leniency because regulators from various countries might attempt to grant their banks the best possible franchise.

Furthermore, reciprocity implies the creation of a multitude of complex bilateral relationships that will benefit no one except banking lawyers. If 100 countries are active in banking, one can conceive of 100 times 99 or 9,900 bilateral, reciprocal treaties!

A policy of reciprocity also could engender further protectionist pressures that would be harmful to all. I therefore hope that the final EC banking directive will embrace the international standard of national treatment, rather than reciprocity.

Key Trends in World Banking

What then are the main forces that will shape the future of the world banking industry?

I have identified three key trends: First, international trade will continue to grow faster than the domestic economies, and international banking will continue to grow faster than trade. Bankers who ignore these trends will turn their backs on one of the most rapidly growing segments of the business.

Second, important barriers in the banking area will fall in the years to come. Europe endeavors to integrate its banking industry and, with a policy of national treatment, will be open to international banking. In the United States, we will see the gradual dismantling of interstate barriers to banking and the lowering of product barriers that still separate the banking business from the securities business. Japan has made serious efforts to open up its banking markets, but more progress needs to be made in granting foreigners full banking licenses.

Third, increasing regulatory cooperation will result in closer similarity in the rules for all international bankers. A more level international playing field will provide equality of opportunity for all participants.

In summary, the world of international banking will be increasingly open and offer new market opportunities for all. As protective barriers fall, competition will intensify and safe havens will disappear.

All this means that we will see banks adopting a variety of strategies to survive and prosper. At one extreme, banks may attempt to become competitive, low-cost producers of standardized products and services. Integrated backrooms and volume-driven efficiencies will mark these institutions. In the foreign exchange area, for instance, they may have one consolidated dealing room with phone lines girdling the globe. Discount brokerage services and loan-by-phone services offer other examples of standardized products that can be delivered in a low-cost fashion through electronic media.

At the other extreme, we can see the banker who is essentially in the financial consulting and advisory business, designing products for the specific needs of his customer. High-quality, on-the-spot service, and a capacity to offer the latest innovations in financial engineering, will mark these organizations. Many employees of these banks will be constantly on the road or in a plane to maintain customer contact and to deliver services.

But attractive opportunities also beckon the bank that offers convenience and basic service to the small businessman and to the retail customer whose needs go beyond access to an automated teller machine. These needs will continue to be met by banks that offer a broad branch network with a range of standardized services. Increasingly, these banks will span the globe through subsidiaries and branches.

Clearly, not all banks will be active internationally. Instead, some will choose to concentrate on local and regional markets and on convenience and friendly service. They may be highly profitable enterprises within a limited service area. While they will not compete directly in the international banking arena that has been the focus of our attention today, they may nevertheless be important competitors in the provision of many banking services.

Conclusion

I have touched on several topics today, and I want to leave you with this thought: flexible adaptation is the key to the challenges that await the international banking community in the 1990s. We all are part of a rapidly changing world, in which our activities as we know them today, are certain to change. Thus, the coming decade will be extremely challenging to the world banking community.

At the same time, new doors are opening. Bankers must find ways and means to capitalize on those opportunities that will strengthen their market position, while remaining flexible to respond to new challenges. Such a posture will enable the successful banks to increase their role in the expanding world financial markets.

Bank regulators will be equally challenged to provide banks the opportunity to compete fairly in an increasingly international marketplace, and at the same time to ensure that banks remain sound institutions whose depositors are protected from excessive risk.

All members of the banking community -- central bankers and commercial bankers alike -- must work together to achieve these goals. Much is at stake. Failure would have incalculable consequences for the world economy. Success will offer a brighter future for all.

Thank you very much.