

THE FEDERAL RESERVE'S PERSPECTIVE ON FOREIGN BANK REGULATION
Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
Federal Reserve Bank of Atlanta Conference on
Latin America and the Caribbean: Opportunities for Trade and Investment
Miami, Florida
October 28, 1994

It is a pleasure to be here in Miami on the occasion of this international conference on Latin America and the Caribbean. I am delighted that the Atlanta Fed is cosponsoring this timely conference with the Beacon Council and the Florida International Bankers Association. I hope that each of you in the audience is finding it to be well worth your time.

My topic today is the Federal Reserve's perspective on foreign bank regulation, but before I delve into this topic, I would like to reflect a bit on how far Latin America has come in recent years. Not very long ago most countries in the region were beset by huge external debt burdens, rampant inflation, crushing budget deficits, and a general economic and financial malaise. Now, in the wake of significant macroeconomic reforms, we are beginning to see rapid economic growth, a significant return of flight capital, and an increase in foreign investment.

Of equal interest to me are numbers from the Fed's most recent data on foreign lending by U.S. banks. As of March of this year, U.S. bank exposure among developing countries, including Latin America, was up more than 25 percent since 1993. The largest increases in lending have been to Peru and Argentina, which have received nearly 25 percent more than in 1993, while Mexico has received more than 10 percent than the year before. U.S. money center banks and the large regionals are responsible for this lending. I see this increase in foreign bank

lending as a definite sign that the reforms undertaken by many Latin American countries are beginning to yield fruit.

Reforms Necessary for Continued Growth

Transforming previously protected economies into market economies that are integrated into global trade is certainly a significant first step in the process of ensuring long-term, sustainable growth. Yet there is much work to be done by some countries to become full members in the community of advanced economies, particularly in the area of banking reform. Countries that do not have sound banking systems in place have never been able to sit at the same table with those who do. It is my intention today to discuss the necessary underpinnings for a well-regulated banking system from the perspective of the Fed. Later in my remarks, I will also touch on the Foreign Bank Supervision Enhancement Act (FBSEA), which I am sure weighs on the minds of many here. But at the outset, I think it is most useful to think about supervision and regulation as if the Foreign Bank Supervision Enhancement Act did not exist. What would still be necessary to ensure safety and soundness in the global banking system?

From my point of view as a central banker, the key to continued long-term, stable growth in Latin America and the Caribbean--in addition to the macroeconomic policies that have already been put in place--depends on having a strong financial system in place in each country. In turn, a strong financial system requires an independent central bank to ensure that the making of monetary policy is separate from fiscal decision making. Moreover, a strong financial system requires an independent regulatory authority. Personally, I believe that the central bank should

perform both roles. However, the main point is that the entity responsible for bank supervision must not be vulnerable to politicization.

Why are such structures so critical to the future of Latin America and the Caribbean? History has taught us that financial intermediation is a keystone in the structure of any advanced economy. And, as we have seen recently in Eastern Europe, true and lasting market reform is difficult to achieve when restructuring the banking system lags behind other reforms. But even more to the point for those many countries in Latin America and the Caribbean that have suffered bouts with hyperinflation, a strong and independent central bank would take steps to reduce and contain inflation. The most immediate benefit of an independent monetary authority would be that the fiscal authority could no longer print money to pay its debts. In turn, the danger of hyperinflation would be greatly reduced.

I would also like to emphasize the importance of supervision and regulation in the broader scope of a financial structure. Because the world is driven increasingly by technology linking countries more closely, unsound banking practices pose threats to more than the home country. The failure of Banco Latino in Venezuela and its affiliates in the United States and Curaçao did not affect the U.S. system. Yet it did raise serious concerns about possible problems that may arise when proper supervisory and regulatory controls are not in place. The collapse of BCCI is another obvious example of unsafe banking practices that have the potential to disrupt global banking. Generally speaking, the kinds of controls necessary to prevent such situations are enforced by strong, independent central banks. In order to ensure the security of the international

banking system, it is important that all countries have an independent supervisory authority and that all financial institutions be subject to comprehensive and consolidated supervision.

I realize that this is a costly proposition, especially for economies and financial systems that have to start from a very modest base in terms of their present supervisory framework. However, let me repeat a favorite saying of the late Bill Taylor, former head of bank supervision at the Board of Governors and chairman of the Federal Deposit Insurance Corporation: A system of supervision and regulation is expensive, but the costs of no supervision and regulation are far greater.

Besides the gains that accrue from appropriate supervisory and monetary policy, another benefit of an independent central bank is that it greatly enhances the credibility of a financial system. In turn, private capital is more readily attracted to banks and other financial intermediaries. As a result, the financial system itself becomes an engine of privatization and growth.

From Bâsle to FBSEA

Aside from purely domestic considerations, safe and sound banking practices are a prerequisite for full participation in the global financial system. That is why the Federal Reserve has strongly supported the original Bâsle Accord and, more recently, the work being done in Bâsle on capital standards for all banks. The Foreign Bank Supervision Enhancement Act, which came in response to the problems revealed by the collapse of BCCI, has been a watershed in

terms of foreign bank regulation in the United States. However, in a larger sense, it also represents a continuation of earlier moves toward international bank supervision as set out in the Bâsle Accord and the International Banking Act of 1978. From the mid-1970s, we have seen a slow movement from the view that bank supervision is unilateral to the current view that it must be multilateral in order to protect the international banking system. This movement began with the formation of the *Bâsle Committee in Switzerland in the mid-1970s, which was established* in reaction to the failure of Herstatt Bank.

We often think of Bâsle mainly as the source of international capital adequacy standards. However, the committee actually originally addressed itself to two propositions: that no foreign bank should be able to escape supervision and that supervision should be appropriate and consistent throughout the world. Currently, many other countries besides the G-10 countries have adopted the Bâsle capital requirements. I expect market forces will ultimately require banks of all countries, including those in Latin America, to meet the internationally agreed-upon capital rules. At the Atlanta Fed, the impression we get from on-site discussions with those concerned with banking reform in Latin America is that all fully appreciate the Bâsle Accord and recognize that it is fundamental. The question is how soon can the countries in Latin America and the Caribbean get to comprehensive supervision?

No doubt, this issue has become more intense for us in the United States since Congress passed the Foreign Bank Supervision Enhancement Act in 1991. This law basically governs whether an international bank can establish offices and do business in the United States, based

its home country. Now as we at the Atlanta Fed are considering more bank applications from Latin America, we find that there are problems in meeting comprehensive supervision. The obvious example of what can happen when such a situation occurs is Banco Latino in Venezuela.

Challenges of Foreign Banking Regulation

Let me now turn to a few specific challenges facing those who are involved in foreign bank regulation--both in other countries and in the United States. For instance, many Latin American and Caribbean bankers have been unhappy with the long time it is taking to review bank applications. The numbers speak for themselves. The Federal Reserve has approved only two foreign bank applications from Latin American countries since the passage of the Foreign Bank Supervision Enhancement Act two years ago. One was from Banco de Chile and the other from Banco de Galicia in Argentina. As of today, these two approvals compare with 17 other approvals in that same period for banks based in Asia and Europe.

I would be the first to agree that the application process has not been as smooth as we would like. However, in all fairness I must point out that the Fed has not been lax in handling these situations. To view this situation in proper perspective, it must be understood that legal requirements call for detailed information, and we cannot process applications unless the institutions provide this information. We must also be certain that home countries have in place the comprehensive and consolidated supervision that the law requires. Thus, the challenges for expediting this process rest not only with the Fed but also with the applicant institutions themselves and with their governments.

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For our part at the Fed, we have already made some changes both at the Board of Governors and at our own Bank, which now has primary responsibility for most Latin American and Caribbean banks in the United States. To expedite review, the Fed has started to keep country files on bank regulation in various foreign countries, so that applicant banks will not have to reinvent the wheel and provide this information. In our Bank, we are working toward a partnership with the supervisors in each country as the best method toward ensuring comprehensive supervision. This work includes visits to many countries in Latin America and the Caribbean as a basis for creating partnerships. Also, as a clear sign of our intent, we are adding staff. We intend to spend the money and to get the resources to do the job right. Obviously, it cannot be done overnight, but I hope that the actions we are taking show how seriously we view this responsibility.

As I see it, a second major challenge pertains to policymakers in Latin American and Caribbean countries who should consider many legal reforms. Among the evolving economic and political reforms taking place in many countries, one area that has not yet become firmly implanted is private property and contract law. In many countries, such laws are taken for granted. However, in countries where nationalization has been a recurring theme, the concept of private property exists on shaky grounds. Setting up an enduring legal system as a foundation for newly privatized companies and property is a daunting challenge, but one that should, in my

opinion, be met. Otherwise, private and corporate citizens will continue to operate as though the government could take their property at a moment's notice. It is in fact this very real fear of enforced nationalization that caused the extremely complex pattern of offshore holdings that developed in many Latin American countries.

Still staying in the realm of reform, the need for more banking reforms remains imperative. One of the main problems we have found in Latin American countries that have had banking problems is insider abuse. Insider lending affected Chile and Colombia in the early 1980s, and we have seen a repeat of this pattern in Venezuela. It is clear to me that insider lending laws must be strengthened to prevent future problems in other Latin American and Caribbean nations. The encouraging news is that many Latin American countries have already begun to overhaul their banking laws to bring their banking systems more into line with international standards of regulation. I am much encouraged by developments in Chile, Colombia, and Argentina. Where supervisory systems have had to be rebuilt, the fruits of that labor are being seen in stronger banking laws and stronger banking systems.

A third area that presents serious challenges to foreign bank regulation comes back to the importance of consolidated and comprehensive supervision. In this regard, although many Latin American countries have reasonably good bank supervision within their borders, generally the same attention has not been paid to offshore operations. Needless to say, such a situation prevents consolidated, comprehensive supervision and regulation of banks. Revisiting my comments on private property laws, it is fair to say that the fear of nationalization has created these

complicated offshore business organizations in order to protect assets from being seized by the government. Another reason to be concerned about the quality of banking supervision comes from a new quarter now. We are encouraged that the large bond rating companies in the United States are beginning to follow the largest banks in the region. We are further encouraged that one of the first tests they apply in determining their ratings is whether the local supervision meets international standards.

Before leaving this subject, I would also like to make the case again that the best way to ensure comprehensive supervision is to give the central bank the responsibility for supervising and regulating commercial banks. The reason is that central banks take the larger view and tend to focus on the safety and soundness of the whole banking system.

As I evaluate the challenges I have enumerated, I think it is clear that, on one hand, people have not been enamored of new banking regulations such as the Foreign Bank Supervision Enhancement Act. However, on the other hand, with the near collapse of the Venezuelan banking system, I believe we can also see why such a law is important. My hope is that Latin American and Caribbean countries will be inspired to overhaul their banking laws, not because of the Foreign Bank Supervision Enhancement Act but rather because they recognize that creating a strong financial structure is a good idea in its own right.

Before I conclude my remarks today, let me also explain briefly how the Federal Reserve and other supervisory bodies have developed an enhanced framework to supervise the U.S.

operations of foreign banks. This new framework is scheduled to be announced in Miami to the foreign banking community on December 1, but I thought you might be interested in getting a preview today. The main points are that the Federal Reserve and the FDIC, along with the conference of state bank supervisors, plan to coordinate their efforts. We will also share key examination findings. We will prepare an overall assessment of the combined U.S. operations of the foreign banking organization, based on the findings of examinations of its U.S. entities.

In addition, the new framework recognizes the fact that branches and agencies, through which foreign banks transact most of their business in the United States, are integral parts of larger organizations. Thus, the U.S. supervisory agencies will exchange information on the financial condition of individual foreign banking organizations as well as information on their home country financial systems. This information will be maintained in a central information file, as I mentioned earlier, and made available to all relevant federal and state banking supervisory agencies. In this context, as the Federal Reserve responds to applications, we will come to some judgment as to the relative financial strength of the parent bank since this is the critical supervisory issue. I hope this gives you some idea about how we are trying to expedite the review of foreign bank applications.

Conclusion

In conclusion, many challenges remain before various countries in Latin America can enjoy the status of full-fledged financial players in the global arena. Latin America already has begun to benefit from its market-based reforms as reflected by increasing external financing and

stronger economic growth. Some observers might be tempted to say, though, that Latin America has always offered tremendous potential for growth, yet never translated this potential into full membership in the community of advanced economies.

As I have argued today, Latin America should finally be able to achieve its potential if its various countries incorporate into their reforms independent central banks, strong financial structures, and sound payments systems. I believe that many Latin American countries have made good progress toward these goals and that others will succeed in making the transition. Indeed, I look forward to more economic growth based on the successful implementation of additional economic, legal, and financial reforms. Such growth could catalyze true economic development that would transform the Latin economies into fully industrialized economies and increase prosperity for all members of society.