

BANK REGULATION IN A GLOBAL ECONOMY
Remarks by Cathy E. Minehan
First Vice President and Chief Operating Officer
Federal Reserve Bank of Boston
April 7, 1994

Our economy is becoming more and more integrated with the rest of the world, and this influences virtually every aspect of our economic activity. Increasingly, flows of goods and services, flows of direct investments, and flows of financial transactions cross international borders.

The banking system serves as the financial infrastructure for much of this global activity. Banks facilitate international transactions in a variety of ways: exporters and importers use letters of credit and bankers' acceptances to finance the inventories of sellers and those of suppliers of foreign goods; they use currency and interest rate derivatives to hedge their currency positions; and they use the international payments system to transfer funds. A well-functioning international banking system is critical to the successful conduct of business across national borders, whether it is an exporter financing goods, a firm considering foreign direct investment, or a financial services firm conducting international transactions.

Bank regulation has had to adapt to the increasing globalization of the banking system. This has occurred in two ways in the United States. First, as foreign owned banks began operations in the United States after the passage in 1978 of the International Banking Act, domestic banking authorities have had to consider charter and supervisory issues. Until the passage of

FDICIA in 1991, foreign branches were supervised either by the individual states or by the federal government, depending on their charter. This created a patchwork of supervision, at times hampered by varying degrees of sophistication in and knowledge of foreign banking issues. Now all foreign branches are supervised by the Federal Reserve, and we expect that over time this will mean more consistent treatment, at a minimum.

To me, the more interesting international trend in bank regulation, however, has been the desire to deal with the "unseen" aspects of banking--unseen on the balance sheet, that is. I would group two related regulatory areas here: risk-based measurement of capital and control of payment system risk. In both cases, central banks and other regulators worldwide have acted to develop rules that place individual bank financial structures, and the structures of national and international payment systems, on bases that reflect risks not immediately apparent from balance sheet totals, risks that can operate to threaten the health of both individual institutions and the system overall.

I'd like to touch briefly on this last aspect of global bank regulation and discuss both risk-based capital and payment system risk issues. On the capital side, I conclude much remains to be done to ensure that banks are treated consistently, worldwide. I will draw on New England experience and the recent Japanese downturn to illustrate this point. On the payment side, international rules exist both for participation in U.S. dollar

payment systems and for private sector netting systems around the world. However, this work also is far from done. Both these areas of global bank regulation illustrate, I think, the necessity for Federal Reserve involvement in bank regulation, at least for the large, internationally active depository institutions. Central banks' understanding of international financial conditions, and its involvement in payment system issues and in many cases service provision, make it uniquely qualified to be the regulatory body for this group.

As you all are aware, in 1988 the G-10 industrial countries adopted risk-based capital requirements for banks, under the Basle Accord. Adoption of the Basle Accord has resulted in two significant improvements in the way we regulate banks in a global environment. First, by requiring risk-weighted capital ratios, the Accord assures that bank capital is standardized for the credit risks inherent in bank assets. Second, the Accord assures a more level playing field for banks. This is important for two reasons. First to ensure that regulatory laxity in some countries does not encourage banks to compete by choosing to locate in areas where they can operate with the lowest amount of required capital. Second, to allow banks of different countries in the same market to compete more fairly. This last aspect of the level playing field is of most concern here in the United States.

Foreign banks have significantly increased their presence in the United States over the past decade. This slide shows that

foreign subsidiaries, agencies, and branches located in the United States have steadily increased their share of all commercial and industrial loans issued to U.S. companies, and they now account for roughly 33 percent of the total. This number actually underestimates the total foreign presence in the U.S. commercial lending market, since many loans to U.S. businesses are booked offshore, that is, by banks or branches located in other countries. A recent survey indicated that foreign banks with an onshore presence in the United States booked \$144 billion of commercial and industrial loans onshore, while an additional \$79 billion were booked offshore, as of the first quarter of 1993. Thus, when offshore branches of non-U.S. banks are included, non-U.S. banks account for 49 percent of all commercial and industrial loans to U.S. companies.

Table 1 shows the relative shares of loan activity of foreign banks in the United States, as of the first quarter of 1993. By far the largest onshore presence is that of Japanese banks, which account for 54 percent of all loans held by foreign banks in the United States. When the offshore presence is included, the Japanese share shrinks to 36 percent, since Japanese banks lend primarily from units in the United States while many European banks are more active lenders to U.S. business from the Cayman Islands or the Bahamas.

The primary focus of global bank regulation has been the standardization of bank capital requirements. Because bank capital is the ultimate insurance that depositors or

counterparties will obtain repayment - an all-purpose risk cushion - it was a natural starting point for regulators. Adoption of the Basle standards was a major innovation, enabling comparisons of the adequacy of bank capital across national borders. It is now much easier to compare banks' financial statements than previously. Nonetheless, implementation of the capital regulations still provides sufficient leeway that we should be careful not to assume that similar standards imply similar enforcement.

Capital regulation becomes most relevant for banks that are experiencing problems, and it is instructive to compare what has happened to banks in two areas that have experienced significant increases in problem loans, New England and Japan. Figure 2 shows the capital-to-asset ratio for all banks in the United States and New England. Several trends are apparent. First, capital ratios at banks had been declining steadily, from 1960 to the mid 1980s, before increasing rather dramatically over the past five years. Second, bank capital ratios have not shown any significant movement during most recessions. Third, while the recent recession did little to alter bank capital ratios nationwide, New England banks showed significant decreases. What so devastated New England banks was not just the recession, but also the decrease in collateral values caused by the sharp decline here in real estate prices.

Bank regulators in New England soon applied significant pressure on banks to restore their capital ratios. Because most

banks in the early 1990s were experiencing negative earnings and were unable to raise new capital, their capital ratios could be restored only by shrinking their assets. And because the real estate problems were so widespread, the shrinkage in bank portfolios was also widespread. Research at the Federal Reserve Bank of Boston has documented that attempts to restore bank capital reduced bank lending, particularly to bank-dependent borrowers such as small businesses. Between the first quarter of 1989 and the first quarter of 1993, commercial and industrial loans held by banks in New England declined by 27 percent. While much of this decline was caused by reduced demand for loans as a result of the recession, the problems were exacerbated by attempts to restore bank capital. And at least initially, much of the improvement to bank capital was achieved by shrinking lending. Fortunately, New England banks are now better capitalized and once again in a position to resume lending. However, some of the improvement in capital ratios was at the expense of credit availability to New England borrowers.

This does not appear to have occurred in Japan. Japanese banks segment their loan loss reserves into a general reserve, special reserve accounts, and a foreign reserve. The special loan loss reserves are used to charge off specific loans with a high expectation or certainty of being written off. The level of general loan loss reserves is set at 0.3 percent of total loans. This ceiling was imposed by the government to limit the tax deductions available to banks. However, the implication of this

limit is that taxes, rather than expected losses, drive the loan loss reserve. Despite the decline in the Nikkei (Figure 3), and the dramatic decline in real estate prices in Japan, neither banks' general reserves nor their charge-offs of loans have increased significantly, so that risk-based capital for Japanese banks has not shown the dramatic decline experienced by New England banks. Without required charge-offs and reserving as loans deteriorate, Japanese banks are insulated from declines in capital like those that occurred in New England as a result of falling real estate prices.

By not reducing bank capital during a recession accompanied by falling real estate prices, the Japanese have mitigated the macroeconomic impact of their banking problems. However, the Japanese regulators' implementation of this policy breaks the link between bank capital and loan losses, and it is virtually impossible to get a clear picture of the financial health of a Japanese bank. This may have been an appropriate macroeconomic policy, but it also places Japanese banks at a competitive advantage relative to banks in those countries where reserves and charge-offs reflect expected losses.

The increasing global presence of banks also has been a factor in concerns about domestic and international payment systems. Growth in the value transferred over such systems during the 1980s has been dramatic (Figure 4), with the transfers over Fedwire and the New York Clearing House's CHIPS system alone now totaling \$2 trillion each day. Foreign banks in the United

States are major participants in both Fedwire and CHIPS, while U.S. banks abroad are major players in foreign payment systems. All these systems have experienced rapid volume growth. Technological change has both accommodated such growth, and provided technical alternatives in the form of payments netting, to stem transaction costs.

Regulators first began to be concerned, however, when in 1974 the failure of a small German bank--Bankhaus Herstatt--threatened the settlement of the CHIPS system in New York, which settles for the vast majority of all the dollar legs of foreign exchange contracts and most Eurodollar transactions. Since that time, the twin specters of Herstatt risk and systemic risk have animated the bank regulatory world. Herstatt risk is the risk that, owing to time zone differences, one side of a linked foreign exchange transaction would settle but the other would not. Systemic risk is the risk that the failure of one participant in a net settlement system would bring about a domino-like failure of other banks in the system.

In a fashion not unlike the way capital regulation was undertaken, two improvements have been made in payment system regulation. First, the ability of banks to create exposures on large-value dollar payment systems was restricted, based on the risk they presented to the payment system, and existing net settlement systems adopted extensive risk reduction measures. Second, a more level playing field was created among existing and proposed payment netting schemes worldwide. As a result, CHIPS

moved to same-day settlement, taking billions in float off balance sheets; controls over intraday payment system exposures have been implemented here and abroad; and global standards for netting system regulation have been developed by the G-10 countries.

How useful have these steps been? Well, in some ways it may be too soon to tell. They certainly have not restrained the growth of intraday payment system exposures in the United States (Figure 5) though such exposures are more controlled now and will soon be priced. In the United States payment system risk has evolved from an unknown concept to a major operational and credit issue. Enormous changes have occurred in CHIPS rules, Fedwire operations, and foreign and domestic commercial bank processes.

In other countries, however, measurement of implicit intraday exposures has lagged, and recognition of this risk by significant payment system participants has been even slower. Herstatt risk still exists and given the enormous volumes of foreign exchange transactions (\$880 billion per day), it probably is a bigger issue now than ever. However, the recent announcement of expanded Fedwire hours beginning in 1997 is being greeted as a platform on which private or public sector solutions to this issue could be built.

More positively, the adoption of the netting system standards has probably restrained the further development of ill-considered systems, and it has prompted a much closer liaison between central banks and groups looking at multilateral, multi-

currency netting. Thus, while actions taken so far have been necessary and useful, global payment system risk control, like risk-based capital regulation, may be a goal we have some way to go in meeting.

In conclusion, I would like to point out that the Federal Reserve traditionally has had a significant role in international banking. It has chartering and supervisory authority over international banks, oversees bank holding companies, which frequently have significant foreign operations, and regulates and operates aspects of the domestic payment system. For the international activities of banks to have significant central bank oversight is natural, because of the importance of banks to the macroeconomy, the potential for problems with international payments, and the potential for transmission of international banking problems to domestic lending markets.

As long as the central bank carries the responsibility for ensuring financial stability, implementing monetary policy, and operating the payments system, it will be critical that it also maintain regulatory authority over internationally active banks. This leads me to the current stalemate over bank regulation in this country. I am in sympathy with the idea that fewer regulatory bodies may be desirable. However, I do fear that much could be sacrificed on the altar of efficiency, if reformers are not careful.

In my view, not only does the Federal Reserve need to regulate internationally active banks in order to adequately

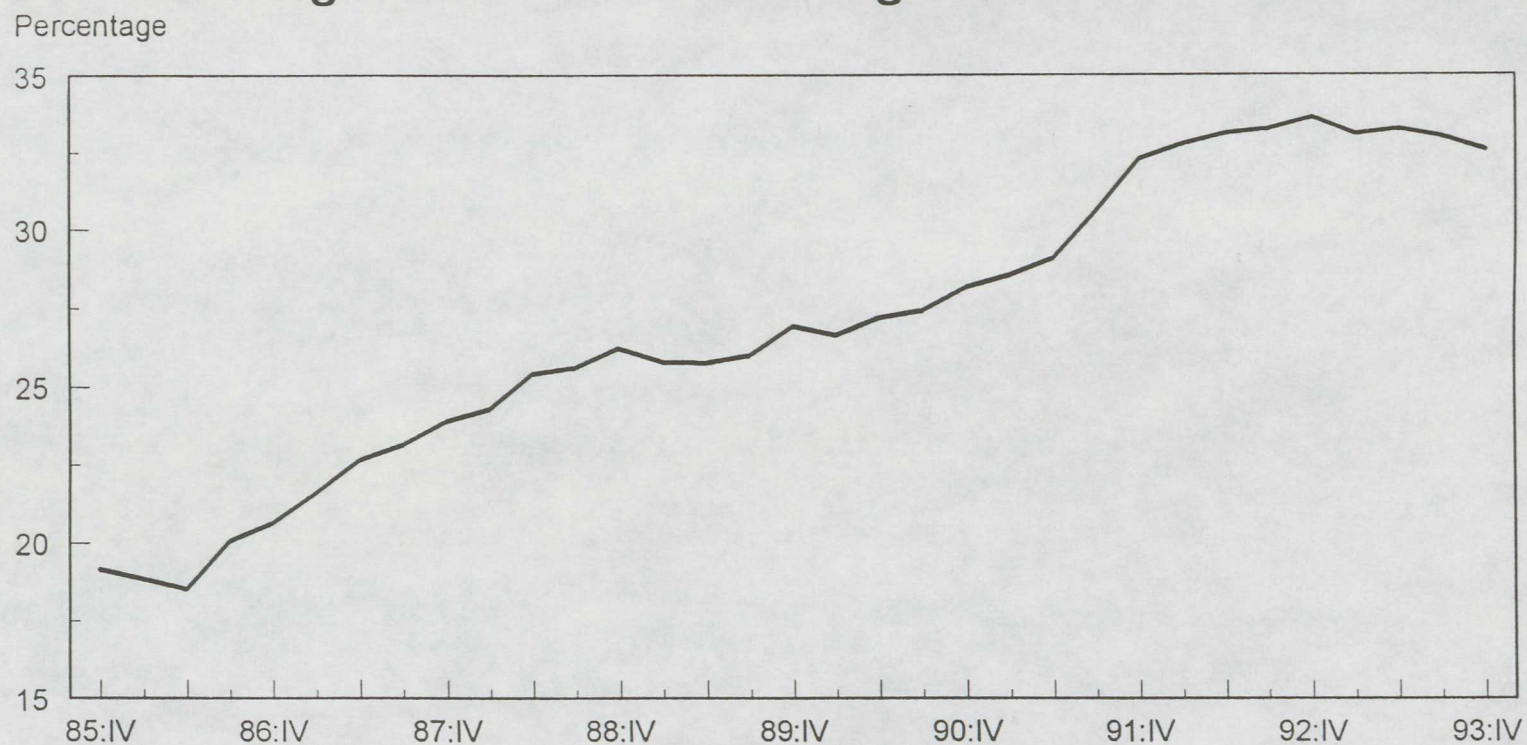
discharge its other duties, it also brings a broader perspective to its role as a regulator because of its central bank role. I would worry whether issues like risk-based capital, or payment system risk, would be addressed with the same priority and concern by a regulator not directly involved with the economic effects of regulation or the need to ensure financial stability in the face of systemic risk. I trust this worry will only be academic.

**Graphics to accompany remarks by
Cathy E. Minehan,
First Vice President and Chief
Operating Officer
Federal Reserve Bank of Boston**

**BANKING IN THE NEW GLOBAL ORDER
Hosted by
Suffolk University and
Environmental Business Council
April 7, 1994**

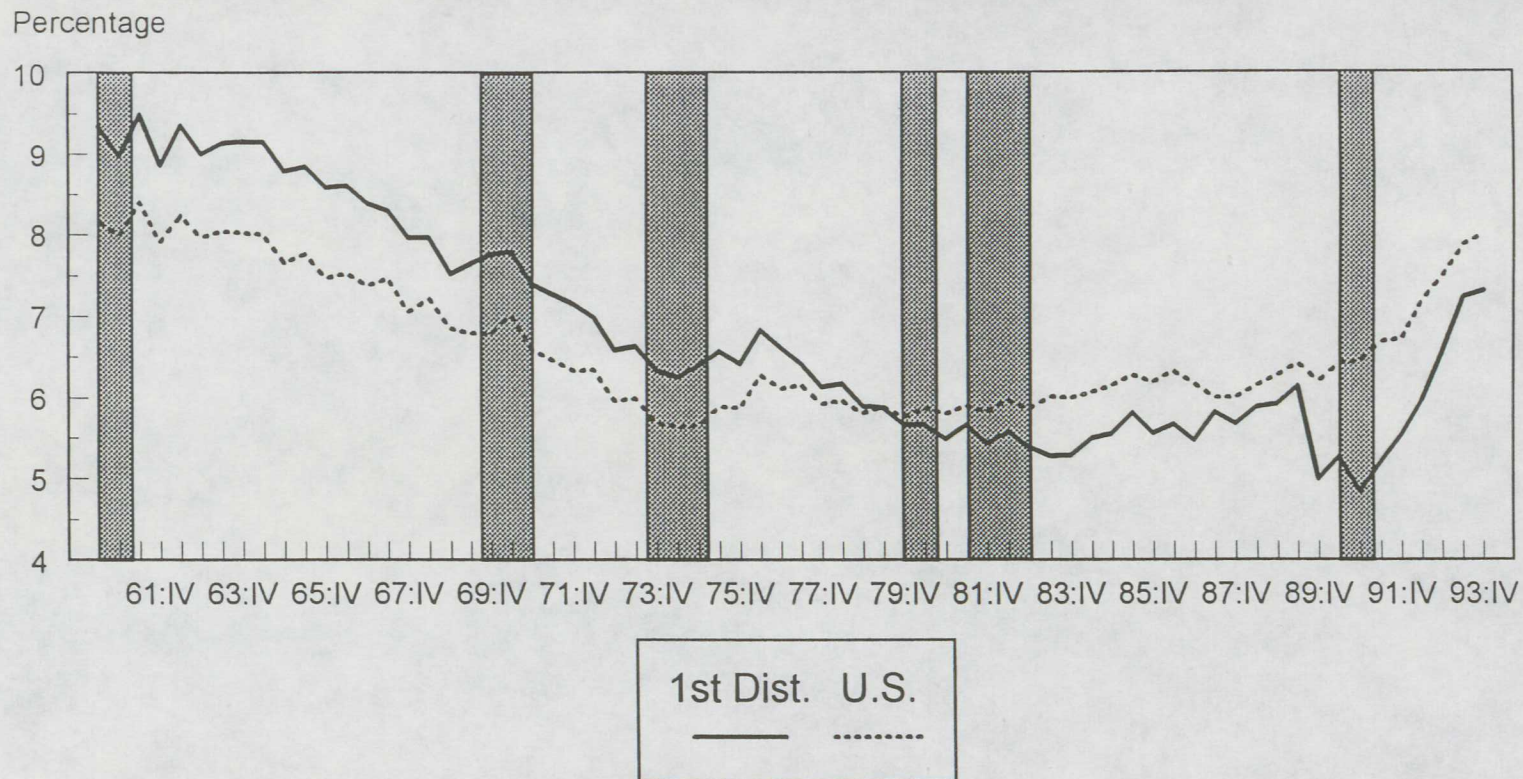
**Panel 3:
The Role of Government in the New Global Order
"Bank Regulation in a Global Economy"**

Figure 1
C&I Lending to U.S. Addresses
Foreign Banks as a Percentage of Total U.S. Banks



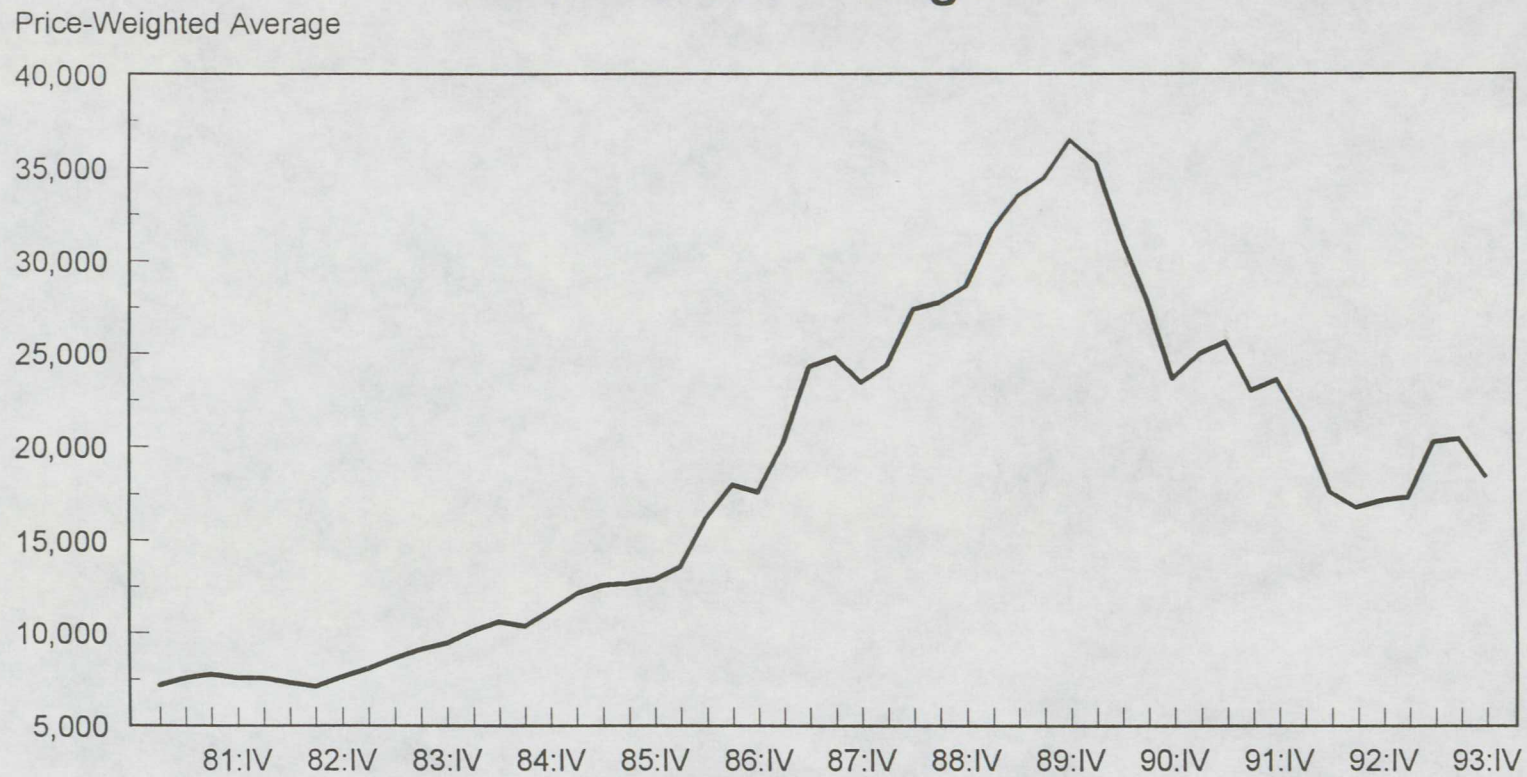
Source: Board of Governors of the Federal Reserve System.

Figure 2
Equity Capital to Total Assets
U.S. and First District Commercial Banks



Source: Board of Governors of the Federal Reserve System.

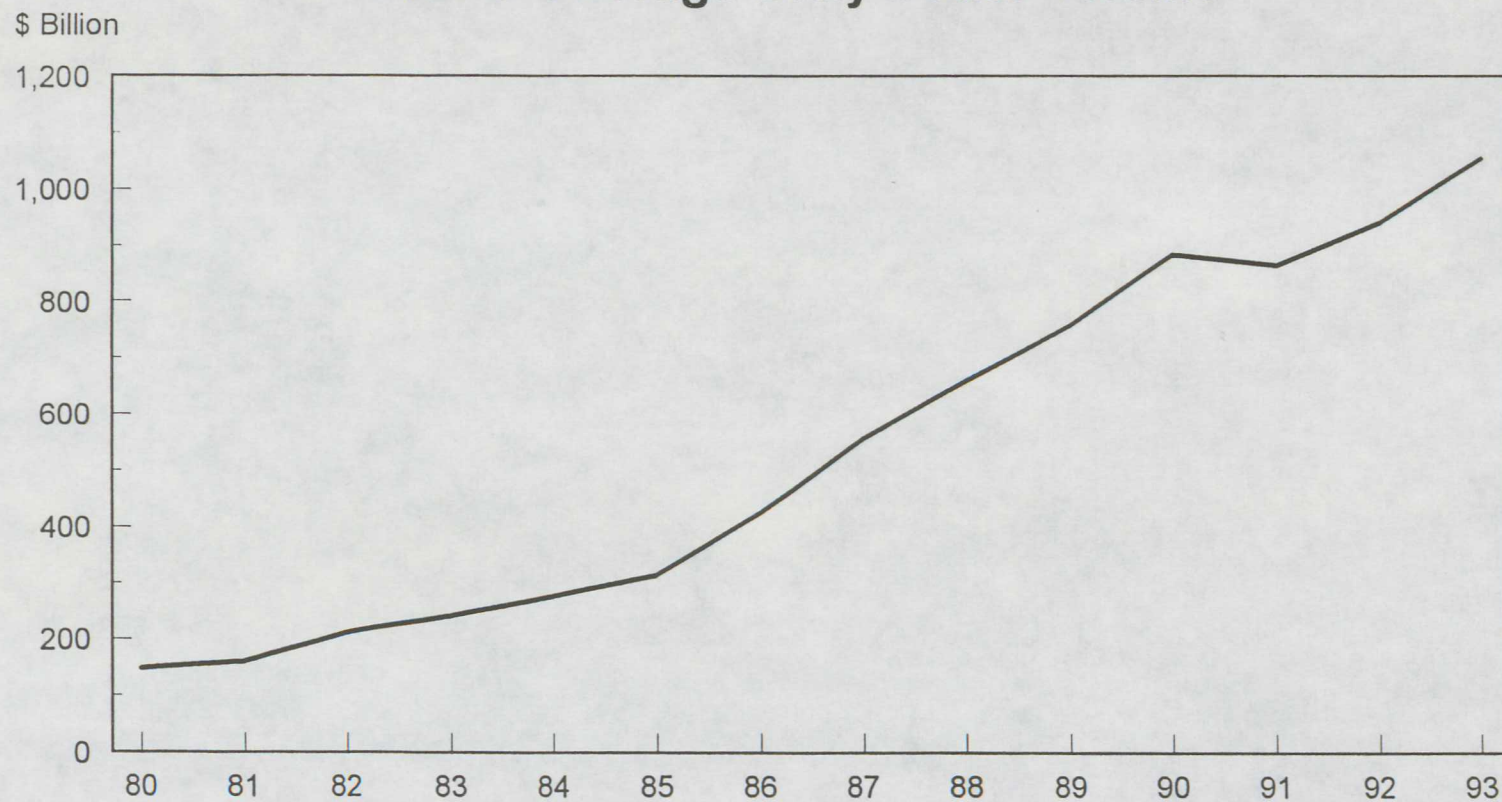
Figure 3
NIKKEI Stock Average Index



Note: Index is average of 225 stocks in the First Section of Tokyo exchange.

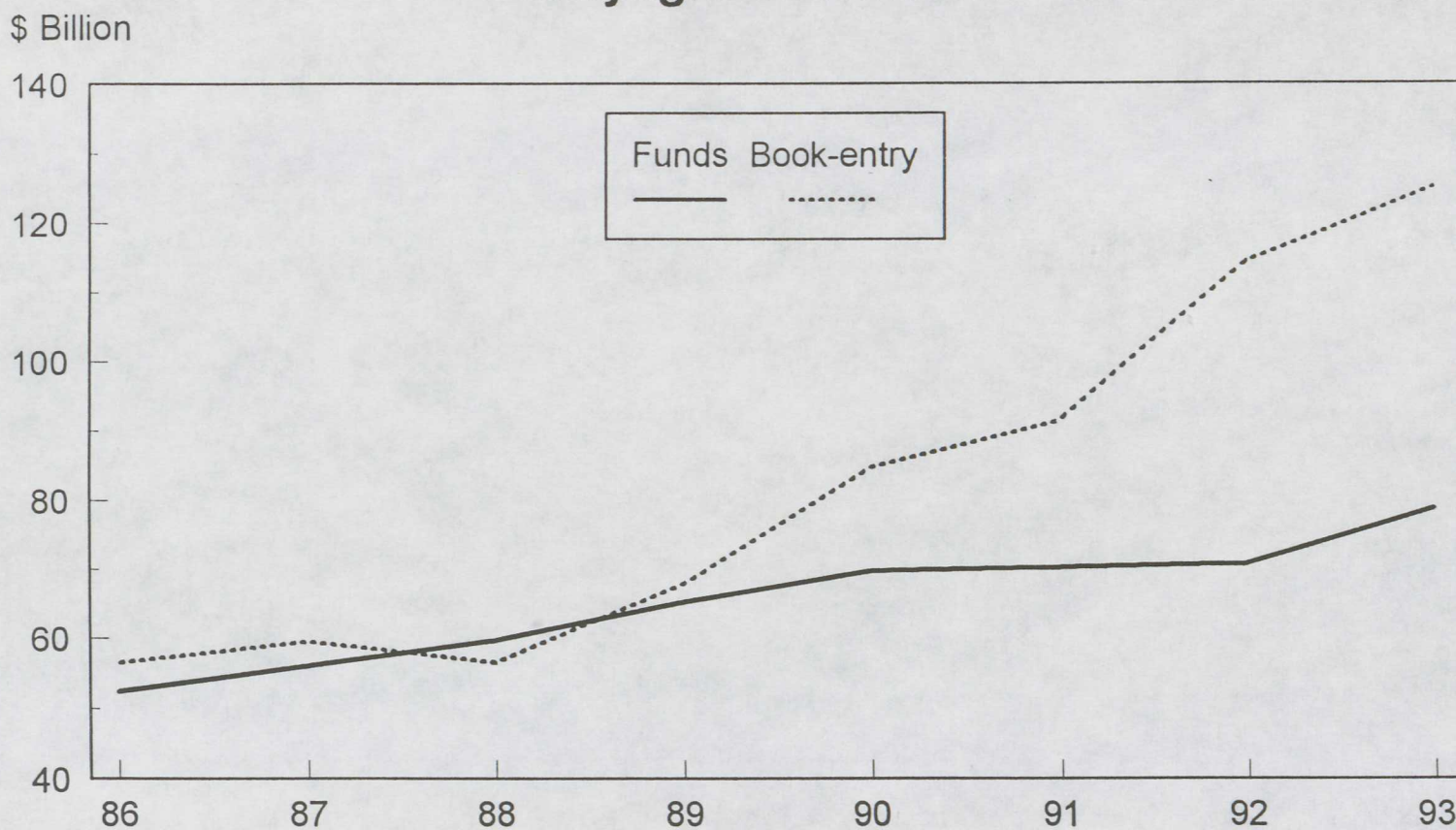
Source: Data Resources.

Figure 4
CHIPS' Average Daily Dollar Volume



Source: Board of Governors of the Federal Reserve System.

Figure 5
Daylight Overdrafts



Note: Average of the aggregated daily peak overdrafts. Book-entry overdrafts offset by funds credits after 1991.
Source: Board of Governors of the Federal Reserve System.

Table 1

National Share of Foreign Bank Activity in the United States and in Offshore Banking Centers, March 31, 1993
Percent

Country of parent bank	Lending to U.S. Businesses	
	By U.S. branches and agencies of foreign banks	By U.S. branches and agencies and offshore branches of foreign banks
Japan	54.1	36.3
France	7.7	11.6
Germany	2.1	6.9
Canada	9.4	10.5
Switzerland	7.4	8.5
United Kingdom	1.2	5.7
Subtotal	81.9	79.5
Australia	.6	2.2
Austria	1.1	1.1
Belgium	*	1.2
Italy	3.8	3.8
Netherlands	6.1	4.2
Subtotal	10.6	12.5
All others	7.5	8.0
Total	100.0	100.0

*Less than 0.05 percent.

Source: "U.S. Branches and Agencies of Foreign Banks: A New Look," Federal Reserve Bulletin, October 1993, p. 920.