GLOBALIZATION

Globalization in the financial services industry

Is Europe ready for 1992?

Foreign competition in U.S. banking markets

The supervisory implications of financial globalization: Three views
GLOBALIZATION

It's a small world, shrinking fast, and the global village is awash with clichés and buzz words; this special issue begins with a hard look at the numbers and trends now apparent in the globalization of financial services, and ends with forthright—and sometimes controversial—opinions on the role of regulation in the new world of financial services

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For some financial market participants, globalization is already a reality. Other, more sheltered, participants are only beginning to awaken to its implications. On November 2 and 3, 1989, thirty-four experts from eight countries gathered at the Harrison Conference Center in Lake Bluff, Illinois, to assess the current status of and future prospects for the integration of the world’s financial markets. The conference, “Financial Globalization: Public and Private Strategies,” was sponsored jointly by the Federal Reserve Bank of Chicago and the Mid America Institute for Public Policy Research. This issue of Economic Perspectives draws on a number of presentations made at the Conference, particularly those focusing on the banking industry. Our goal in putting this issue together is to provide our readers with both hard facts and informed opinion on the many issues that globalization is now forcing bankers and policymakers to confront. We are sure that you will find the contents of this issue informative and expect that you will find some of the ideas controversial.
Globalization can be defined as the act or state of becoming worldwide in scope or application. Apart from this geographical application, globalization can also be defined as becoming universal. For the financial services industry, this second meaning implies both a harmonization of rules and a reduction of barriers that will allow for the free flow of capital and permit all firms to compete in all markets.

This article looks at how global the financial services industry already is, and will likely become, by examining the nature and trends of globalization in the industry. It will also draw lessons from global nonfinancial industries and from recent geographic expansion of banking firms within the United States.

Financial globalization is being driven by advances in data processing and telecommunications, liberalization of restrictions on cross-border capital flows, deregulation of domestic capital markets, and greater competition among these markets for a share of the world's trading volume. It is growing rapidly, but primarily at the intermediary, rather than the customer, level. Its effects are felt at the customer level mainly because prices and interest rates are influenced by worldwide economic and financial conditions, rather than because direct customer access to suppliers has increased. However, globalization at the customer level will soon become apparent, at least in Europe after 1992, when European Community banking firms will be allowed to cross national borders.

Trends in other industries and lessons from interstate banking in the United States suggest that as financial globalization progresses, financial services will become more integrated, more competitive, and more concentrated. Also, firms that survive will become more efficient, and consumers of financial services will benefit considerably. Reciprocity is likely to be an important factor for those countries not already part of a regional compact, as it has been for interstate banking to proceed in the United States.

**International commercial banking**

The international banking market consists of the foreign sector of domestic banking markets and the unregulated offshore markets. It has undergone important structural changes over the last decade.

Like domestic banking, international banking involves lending and deposit taking. The primary distinction between the two types of banking lies in their customer bases. Since 1982, international lending and deposit taking have both been growing at roughly 15 percent annually. At year-end 1988, foreign loans and foreign liabilities at the world's banks each totalled more than $5 trillion. The extent, nature, and growth of international banking, however, are not the same in all countries.
Figures 1 and 2 show the ten countries whose banks have the largest shares of foreign banking assets and liabilities. Combined, these ten countries account for nearly three-quarters of all foreign assets and liabilities. Nearly half of all foreign banking assets and liabilities are held by banks in the United Kingdom, Japan, the United States, and Switzerland, up from 47 percent in 1982. This increase is almost entirely due to the meteoric rise in foreign lending by Japanese banks.

Perhaps the most notable event in international banking has been the rapid growth of Japanese banks. This extraordinary growth can be traced to deregulation in Japan, as well as to its banks' high market capitalization, the country's high savings rate, and its large current account surplus. Japanese foreign exchange controls and restrictions on capital outflows were removed in 1980. This allowed the banks' industrial customers to go directly to the capital markets for financing. The loss of some of their best customers, along with deposit rate deregulation and stiffer competition from other types of institutions, reduced profits. To improve their profitability and to service Japanese nonfinancial firms that had expanded overseas, Japanese banks moved into new markets abroad. While a large part of the business of Japanese banks abroad is with Japanese firms, Japanese banks have been very successful lending to foreign industrial firms because of a competitive advantage conferred by a more favorable regulatory environment. Japan's capital requirements have been relatively easy, allowing banks to hold assets at 25 to 30 times book capital. Japan's share of all foreign assets and liabilities rose from 4 percent in 1982 to more than 14 percent in 1988, surpassing the U.S. and second only to the U.K.

While many banks have significant international operations, only a few are truly international in scope. More than one-half of the total banking assets and liabilities in Switzerland, nearly one-half of total banking assets and liabilities in the United Kingdom, and over one-quarter of total banking assets and liabilities in France are foreign. In contrast, less than 25 percent of the balance sheets of German, Japanese, and U.S. banks consist of foreign assets and liabilities.

The United Kingdom and Switzerland have long been international financial centers. For more than 100 years Swiss bankers have been raising loans for foreigners. The largest Swiss banks, in fact, try to maintain a 50-50 split between their foreign and domestic assets for strategic and marketing reasons. Deregulation, or the lack of regulation in some cases,
and the restructuring of the British financial system have made London a powerful international financial center. More than half of all banking institutions in the U.K. are foreign-owned, and 59 percent of all assets of banks in the U.K. are denominated in foreign currency.4

At the aggregate level, the proportion of bank assets that are claims on foreigners is roughly equivalent to the proportion of liabilities that are claims of foreigners. This is not true of individual countries. Some countries’ banks lend more to foreigners than they borrow from them. Foreign assets of German banks are almost twice the size of foreign liabilities, and Swiss banks hold about 34 percent more foreign assets than liabilities. For banks in these countries, the combination of international orientation and their country’s high domestic saving rates makes them strong net lenders. Banks in the United States, Japan, and France, however, have more foreign liabilities than foreign assets, although in each case the difference is less than 5 percent.

U.S. banks have not always been net foreign borrowers. In 1982, foreign deposits at U.S. banks accounted for less than 13 percent of total liabilities, while foreign assets accounted for over 20 percent of total assets. Foreign deposits at U.S. banks have more than doubled over the 1982–87 period, growing far more rapidly than domestic deposits. Foreign assets increased only 37 percent over that time and more slowly than domestic assets. This is due largely to the reduction in LDC lending and to the writing down of LDC loans by U.S. banks.

Foreign deposit growth also outpaced domestic deposit growth at Japanese banks. In 1982, foreign deposits accounted for 9 percent of total liabilities, and by 1987, they accounted for 18 percent. Similarly Japanese banks booked foreign assets about twice as fast as domestic assets over the 1982–87 period.

**Offshore banking centers**

A considerable portion of international banking activity occurs in unregulated offshore banking centers commonly known as the Euromarkets.5 The Euromarkets, unlike the domestic markets, are virtually free of regulation. Euromarkets consist of Eurocurrency deposits, Eurobonds, and Euro-commercial paper. Eurocurrency deposits are bank deposits denominated in a foreign currency, and account for 86 percent of banks’ foreign-owned deposits.

The development of Eurocurrency deposits marked the inauguration of the Euromarket in the mid-1950s. Eurocurrency deposits grew at a moderate rate until the mid-1960s when they began to grow more rapidly.6 At that

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**FIGURE 2**

**Foreign liabilities held at domestic banks**

![Graph showing foreign liabilities held at domestic banks](http://fraser.stlouisfed.org/)

time, the U.S. government imposed severe controls on the movement of capital, which "deflected a substantial amount of borrowing demand to the young Eurodollar market." These U.S. capital controls were dismantled in 1974, but the oil crisis of the 1970s helped to fuel the continued growth of the Eurocurrency market. The U.S. oil embargo made oil-exporting countries fearful of placing their funds in domestic branches of U.S. banks. In the late 1970s and early 1980s, high interest rates bolstered the growth of Eurocurrency deposits, which are free of interest-rate ceilings and not subject to reserve requirements or deposit insurance premiums. From 1975 to 1980, Eurocurrency deposits grew over threefold. Since 1980, Eurocurrency deposits have continued to grow quite rapidly, reaching a gross value of $4.5 trillion outstanding in 1987 and a net value of nearly $2.6 trillion (net of interbank claims). Eurodollar deposits, however, have not grown as rapidly. During the early 1980s, Eurodollars represented over 80 percent of all Eurocurrency deposits outstanding, but by 1987, they represented only 66 percent (see Figure 3). The declining importance of Eurodollar deposits can be explained, at least partially, by the decline in the cost of holding noninterest-bearing reserves against domestic deposits in the United States.

Many Eurocenters have developed throughout the world. They have developed where local governments allow them to thrive, i.e., where regulation is favorable to offshore markets. Consequently, some countries with relatively small domestic financial markets, such as the Bahamas, have become important Eurocenters. Similarly, some countries with major domestic financial markets have no or very small offshore markets. In the United States, for example, the offshore market was prohibited until 1981 when International Banking Facilities (IBFs) were authorized.

Japan did not permit an offshore market to develop until late in 1986. Until then the "Asian dollar" market consisted primarily of the Eurocenters of Singapore, Bahrain, and Hong Kong. Now Japan's offshore market is about $400 billion in size, over twice as large as the U.S. offshore market, but still smaller than that in the United Kingdom.

The interbank market

The international lending activities of most banks, aside from the money centers, are concentrated heavily in the area of providing a variety of credit facilities to banks in other countries. Consequently, a large proportion of banks' foreign assets and liabilities are claims on or claims of foreign banks. Eighty percent of all foreign assets are claims on other banks. This ratio varies somewhat by country; however, since 1982, it has been increasing for all the major industrialized countries.

Similarly, nearly 80 percent of all banks' foreign liabilities are claims of other banks. In Japan, 99 percent of all foreign liabilities at banks are deposits of foreign banks. Swiss banks are the exception, where only 28 percent of foreign liabilities are claims of banks.

The Swiss have a long history of providing banking services directly to foreign corporate and individual customers, which explains their relatively low proportion of interbank claims. A favorable legal and regulatory climate aided the development of a system that caters to foreigners, especially those wishing to shelter income from taxes. Confidentiality is recognized as a right of the bank customer, and stiff penalties can be imposed on bank officials who violate that right. In effect, no information about a client can be given to any third party.

Since a very large portion of foreign deposits are Eurocurrency deposits, it is no surprise that about half of all Eurocurrency deposits are interbank claims. Eurocurrency...

**FIGURE 3**

<table>
<thead>
<tr>
<th>Eurocurrency deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross</td>
</tr>
<tr>
<td>1982</td>
</tr>
<tr>
<td>1983</td>
</tr>
<tr>
<td>1984</td>
</tr>
<tr>
<td>1985</td>
</tr>
<tr>
<td>1986</td>
</tr>
<tr>
<td>1987</td>
</tr>
</tbody>
</table>

**source:** J.P. Morgan and Co.
deposits are frequently re-lent to other, often smaller, banks in the interbank market.13 The Japanese have become very large borrowers in the interbank market in response to domestic restrictions on prices and volumes of certain activities. Japanese banks operating overseas have been funding their activities by borrowing domestically (from nonresidents) in one market (e.g., the U.K.), and lending the funds through the interbank market to affiliates in other countries (e.g., the U.S.).14

Foreign exchange trading

Foreign exchange (forex) trading is another important international banking activity. Informal estimates place daily foreign exchange trading at $400 billion.15 Like the loan markets, forex markets are primarily interbank markets. The primary players involved in the United States are the large money center and regional commercial banks, Edge Act corporations, and U.S. branches and agencies of foreign banks. Forex trading also involves some large nonbank financial firms, primarily large investment banks and foreign exchange brokers. However, according to the Federal Reserve Bank of New York's U.S. Foreign Exchange Market Survey for April 1989, 82 percent of the forex trading volume of banks was with other banks. Foreign exchange trading in New York grew at about 40 percent annually since 1986 to reach more than $130 billion by April 1989. In contrast, foreign trade (imports plus exports) has been growing at only about 6 percent annually since 1982 (3 percent on an inflation-adjusted basis).

The German mark is the most actively traded currency, followed by the Japanese yen, British pound, Swiss franc, and Canadian dollar. Since 1986, however, the German mark has lost some ground to the Japanese yen and the Swiss franc.16

The explosion of forex trading can, at least partly, be explained by the high rate of growth in cross-border financial transactions. Capital and foreign exchange controls were reduced or eliminated in a number of countries during the 1980s.

An international banking presence

There are several ways that commercial banks engage in international banking activities—through representative offices, agencies, foreign branches, and foreign subsidiary banks and affiliates. In addition, in the United States, commercial banks may operate International Banking Facilities (IBFs) and Edge Act corporations, which unlike the other means, do not involve a physical presence abroad. The primary difference among these types of foreign offices centers on how customer needs are met (often because of regulation). For example, agencies of foreign banks are essentially branches that cannot accept deposits from the general public, while branches, as well as subsidiary banks, can offer a full range of banking services.

U.S. branches and agencies of foreign banks devote well over half of their assets to loans, about the same proportion as the domestic offices of U.S. commercial banks. U.S. commercial banks, however, hold a much larger proportion of their assets in securities and a much smaller proportion in customer's liability on acceptances.17 This latter situation reflects the international trade financings of U.S. foreign offices.

U.S. offices of foreign banks compete with domestic banks primarily in commercial lending and, to a lesser extent, in real estate lending.18 However, a significant portion of the commercial loans held at U.S. offices of foreign banks were purchased from U.S. banks, rather than originated by the foreign offices themselves.19

Both U.S. offices of foreign banks and domestic offices of U.S. commercial banks primarily fund their operations with deposits of individuals, partnerships and corporations (IPC).20 Offices of foreign banks currently gather 23 percent of these deposits from foreigners, and nearly all of these deposits are of the nontransaction type.

The presence of foreign banks in the United States has been increasing. The ratio of foreign offices to domestic offices in the United States has increased from 2.8 percent in 1981 to 4.4 percent in 1987. Similarly, the ratio of assets of foreign banking offices in the United States to assets of U.S. domestic banks has increased over 5 percentage points since 1981 to nearly 21 percent in 1987.21

The presence of U.S. banks abroad, however, has been falling since 1985. At that time, U.S. banks operated nearly 1,000 foreign branches.22 Similarly, the number of U.S. banks with foreign branches peaked at 163 in 1982 and began to fall in 1986. By 1988, the
number of banks with foreign branches had fallen to 147. On an inflation-adjusted basis, total assets of foreign branches of U.S. banks fell 12 percent since 1983 to $506 billion in 1988. The number of IBFs and Edge Act Corporations has also been waning. Edge Acts numbered 146 in 1984 and were down to 112 by 1988.23 This retrenchment reflects the lessening attractiveness of foreign operations as losses on LDC loans have mounted.

Implications of Europe after 1992

The presence of foreign banking firms in European domestic markets will likely increase over the next few years as the 12 European Community states become, at least economically, a “United States of Europe.” The EC plans to issue a single license that will allow banks to expand their networks throughout the Community, governed by their home country’s regulations.24

Since banking powers will be determined by the rules of the home country, banks from countries with more liberal banking laws operating in countries with more restrictive banking laws will have an advantage over their domestic competitors. Consequently, the most efficient form of banking will prevail. Countries with more fragmented banking systems will need to liberalize for their banks to compete with banks from countries with universal banking.

While reciprocity will not be important for nations within the EC, it will be an issue for banks from countries outside the EC, especially those from Japan and the U.S. As financial services companies in Europe begin to operate with fewer restrictions, there will be competitive pressure on the U.S. and Japan to remove the barriers between commercial and investment banking. To be most efficient, firms operating in various markets want similar powers in each market. The EC, as previously noted, solved this problem with a Community banking license. Thus, the EC’s efforts at regulatory harmonization may hasten the demise of Glass-Steagall in the U.S. and Article 65 in Japan.25

The implications for European banking will be similar to the experience in the United States following the introduction of interstate banking in the early to mid-1980s. Since that time, the U.S. commercial banking industry has been consolidating on nationwide, regional, and statewide bases through mergers and acquisitions. Acquiring firms tend to be large, profitable organizations with expertise in operating geographically dispersed networks, while targets tend to be smaller, although still relatively large firms, in attractive banking markets. Large, poorly-capitalized firms will also find themselves to be potential takeover targets.

What these lessons imply for Europe in 1992 is that the largest and strongest organizations with the managerial talent to operate a geographically dispersed organization will become Europe-wide firms, while smaller firms will have a more regional focus and others will survive as niche players. In addition, just as different state laws have slowed the process of nationwide banking in the United States, language and cultural barriers will slow the process in Europe as well. The overall result of a more globally integrated financial sector in Europe, and elsewhere, will be that the organizations that survive will be more efficient, and customers will be better served. Also, it is very likely that the 1992 experience will improve European banks’ ability to compete outside of Europe.

Size is not, and will not be, a sufficient ingredient for survival. In general, firms in protected industries, such as airlines, tend to be inefficient. Large banking organizations based in states with restrictive branching and multibank holding company laws tended to be less efficient than their peers in states that allow branches and, therefore, more competition. In addition, commercial banking organizations that operated in unit banking states had little expertise in operating a decentralized organization, and tended to focus primarily on large commercial customers. Consequently, these banking firms have not acquired banks far from home.

The process of consolidation has already begun within European countries and within Europe as firms prepare for a single European banking market. Unlike the United States’ experience of outright mergers and acquisitions, however, the European experience centers on forming “partnerships.” Partnerships have been formed Europe-wide, even though the most recent directive on commercial banking permits branching, because of the difficulties in managing an organization that spans
several cultures and languages. Apparently, financial services firms want to get their feet wet first, rather than plunge into European banking and risk drowning before 1992 arrives. But also, until regulations among countries become more uniform, partnerships and joint ventures allow financial firms to arbitrage regulations.

The formation of partnerships and joint ventures is not only a European phenomenon. Indeed, U.S. firms have entered into such agreements with European and Japanese companies. For example, Wells Fargo and Nikko Securities have formed a joint venture to operate a global investment management firm, and Merrill Lynch and Société Générale are discussing a partnership to develop a French asset-backed securities market.

The experience of nonfinancial firms suggests that this arrangement can be a good way to establish an international presence. For example, in 1984, Toyota and General Motors entered into a joint manufacturing venture in California. Through this venture, the Japanese were able to acquaint themselves with American workers and suppliers before opening their own plants in the U.S. Since then, Toyota has opened two more manufacturing plants on its own in North America, and there is speculation in the auto industry that they will buy GM’s share of the joint venture once the agreement ends in 1996.26

Another case of international expansion through joint ventures can be found in the petroleum industry. Oil companies from some oil-producing countries have been quite active in recent years buying stakes in refining and marketing operations in the United States and Europe. These acquisitions give producers an outlet for their crude in important retail markets, and refiners get a reliable source. Saudi Arabia purchased a 50 percent stake in Texaco’s eastern and Gulf Coast refining and marketing operations in November 1988. The state-owned oil companies from Kuwait and Venezuela have joint ventures with European oil companies as well.27 If joint ventures between financial services firms are as successful as nonfinancial ones have been, then global financial integration will benefit.

**International securities markets**

International securities include securities that are issued outside the issuer’s home country. Some of these securities trade on foreign exchanges. Issuance and trading of international securities have grown considerably since 1986, as has the amount of such securities outstanding.

Greater demand for international financing is stimulating important changes in financial markets, especially in Europe. Regulations and procedures designed to shield domestic markets from foreign competition are gradually being dismantled. London’s position as an international market was strengthened by the lack of sophistication of many other European markets. Greater demand for equity financing in Europe has been encouraged by private companies, and by governments privatizing large public-sector corporations. These measures to deregulate and, therefore, improve the efficiency, regulatory organizations, and settlement procedures are a response to competition from other markets, and the explosion of securities trading in the 1980s.28

It is estimated that the world bond markets at the end of 1988 consisted of about $9.8 trillion of publicly issued bonds outstanding, a nearly $2 trillion increase since 1986.29 At year-end 1988, two-thirds of all bonds outstanding were obligations of central governments, their agencies, and state and local governments. This figure varies considerably across countries. Over two-thirds of bonds denominated in the U.S. dollar and the Japanese yen are government obligations, but less than one-third of bonds denominated in the German mark are government obligations, and only 10 percent of bonds denominated in the Swiss franc represent government debt.30

The international bond market includes foreign bonds, Eurobonds, and Euro-commercial paper. Foreign bonds are bonds issued in a foreign country and denominated in that country’s currency. Eurobonds are long-term bonds issued and sold outside the country of the currency in which they are denominated. Similarly, Euro-commercial paper is a short-term debt instrument that is issued and sold outside the country of the currency in which it is denominated. The Japanese are the biggest issuers of Eurobonds because it is easier and cheaper than issuing corporate bonds in Japan. Japanese companies issued 21 percent of all Eu-
robonds in 1988. Ministry of Finance (MOF) regulations and the underwriting oligopoly of the four largest Japanese securities firms keep the issuance cost in the domestic bond market higher than in the Euromarket. The ministry would like to bring this bond market activity back to Japan, so it has been slowly liberalizing the rules for issuing yen bonds and samurai bonds (yen bonds issued by foreigners in Japan). So far, the impact of these changes has been small.

International bonds accounted for almost 10 percent of bonds outstanding at the end of 1988 and over three-quarters are denominated in the U.S. dollar, Japanese yen, German mark and U.K. sterling (see Figure 4). These countries represent four of the largest economies and financial markets in the world.

The importance of international bond markets has increased considerably for many countries. As Table 1 shows, international bonds account for nearly half of all bonds denominated in the Swiss franc and over one-third of all bonds denominated in the Australian dollar. International bonds account for over 21 percent of bonds denominated in the British pound, up dramatically from less than 1 percent in 1980. The rise in importance of international bonds for these currencies can, at least in part, be explained by the budget surpluses in the countries in which these currencies are denominated and, therefore, the slower growth in the debt obligations of these countries’ governments.

The value of world equity markets, at $9.6 trillion in 1988, is about equal to the value of world bond markets. Three countries—the United States, Japan, and the United Kingdom—account for three quarters of the total capitalization on world equity markets, and they account for nearly half of the 15,000 equity issues listed on the world’s stock exchanges (see Figure 5).

American, Japanese, and British equity markets are the largest and most active. American and British markets are very open to foreign investors, but significant barriers to foreign competitors still exist in Japan.

Stocks have, historically, played a relatively minor role in corporate financing in many European countries. Various regulatory and traditional barriers to entry made these bourses financial backwaters. The stock exchanges in Switzerland, West Germany, France, and Italy have only recently taken steps to modernize in order to compete against exchanges in the U.S. and the U.K. It was estimated that about 20 percent of daily trad-
TABLE 1
International shares of the world’s major bond markets
(Percent based on outstanding)

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1985</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. dollar</td>
<td>4.4</td>
<td>8.8</td>
<td>10.5</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>1.6</td>
<td>3.2</td>
<td>5.0</td>
</tr>
<tr>
<td>German mark</td>
<td>12.6</td>
<td>11.2</td>
<td>14.2</td>
</tr>
<tr>
<td>U.K. sterling</td>
<td>0.9</td>
<td>9.4</td>
<td>21.3</td>
</tr>
<tr>
<td>Canadian dollar</td>
<td>3.1</td>
<td>5.5</td>
<td>13.7</td>
</tr>
<tr>
<td>Swiss franc</td>
<td>27.3</td>
<td>42.3</td>
<td>49.2</td>
</tr>
<tr>
<td>Australian dollar</td>
<td>n.a.</td>
<td>9.5</td>
<td>36.2</td>
</tr>
</tbody>
</table>

SOURCE: Salomon Brothers

...
exchanges, however, would likely aid a re-bound in the appetite for and in the issuance of international equities.

Some important structural changes took place in international financial markets between 1985 and 1987. A sharp increase in issuance for the U.K. translated into substantially greater market share of international equity issuance, from 3.7 percent in 1985 to 33.0 percent in 1987. This increased share of international activity reflects the deregulation and restructuring of the London markets that occurred in the fall of 1986, improving their place as an international marketplace for securities. Even with the retrenchment in 1988, London maintained its leading role, with twice the issuance of second-place U.S.39

Over this same three-year period, Switzerland’s international equity issuance translated into a substantially smaller market share, falling from 40.7 percent to 6.0 percent. This sharp decline in market share, from undisputed leader to fourth, reveals Switzerland’s failure to keep pace with deregulation in other countries. For years, a cartel system dominated by its three big banks has set prices and practices in the stock markets. It is only recently that competition from markets abroad has forced the cartel to liberalize its system.40

In contrast to the international equities markets, issuance of international bonds was very strong in 1988, following a sharp contraction in 1987 entirely due to a 25.5 percent decline in Eurobond issuance.41 Eurobonds account for about 80 percent of international bond issues, and nearly two-thirds of all international issues are denominated in three currencies—the U.S. dollar, Swiss franc, and the Deutschemark. Nearly 60 percent of international bonds are issued by borrowers in Japan, the United Kingdom, the United States, France, Canada, and Germany.

The long-time importance of the United States and the U.S. dollar in the international bond market has been dwindling. In 1985, 54 percent of all Eurobonds were denominated in U.S. dollars, but by 1988 only 42 percent were in U.S. dollars.

Similarly, U.S. borrowers issued 24 percent of all international bonds in 1985, but issued only 8 percent in 1988. The impetus behind this decline lies in part with the investors who prefer low-risk securities and are leery of U.S. bonds because of the perceived increase in “event risk” associated with restructurings and leveraged buyouts. Also, no doubt, developments such as the adoption of Rule 415 by the Securities and Exchange Commission (shelf registration) have encouraged U.S. firms to issue domestic securities by making it less costly to do so.

Trading in international securities

The United States is a major center of international securities trading. Foreign transactions in U.S. markets exceed U.S. transactions in foreign markets by a ratio of almost 7 to 1. This is a result of several factors. The United States has the largest and most developed securities markets in the world. U.S. equity markets are virtually free of controls on foreign involvement. SEC regulations on disclosure dissipate much uncertainty concerning the issuers of publicly listed securities in the United States while less, or inadequate, regulation in other countries makes investments more risky in those foreign markets. The market for U.S. Treasury securities has also been very attractive to foreign investors. In fact, large purchases of these securities by the Japanese have helped finance the U.S. government budget deficit.

Both foreign transactions in U.S. markets and U.S. transactions in foreign markets have been increasing at a very rapid pace. Foreign transactions in U.S. equity securities in U.S. markets plus such transactions in foreign equities in U.S. markets grew at almost 50 percent annually to exceed $670 billion in 1987.42 Foreign transactions in U.S. stocks on U.S. equity markets have been increasing faster than domestic transactions; in 1988, foreign transactions accounted for 13 percent of the value of transactions on U.S. markets, up from 10 percent in 1986 (see Table 2).

Foreign transactions have increased in securities markets abroad as well; however, they have not, in general, kept pace with domestic trading. Consequently, foreign transactions as a percentage of all transactions has declined over the 1986-88 period for Japan, Canada, Germany, and the United Kingdom. Nevertheless, transactions by U.S. residents in foreign equity markets were estimated at about $188 billion in 1987, nearly 12 times as much as in 1982.43
TABLE 2
Foreign transactions in domestic equity markets: Share of domestic trading (Percent of total volume)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>8.7</td>
<td>6.5</td>
</tr>
<tr>
<td>Canada</td>
<td>29.5</td>
<td>21.6</td>
</tr>
<tr>
<td>Germany</td>
<td>29.9</td>
<td>8.7</td>
</tr>
<tr>
<td>U.S.</td>
<td>9.7</td>
<td>13.1</td>
</tr>
<tr>
<td>U.K.</td>
<td>37.3</td>
<td>20.8</td>
</tr>
<tr>
<td>France</td>
<td>38.0</td>
<td>43.5</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.6</td>
<td>6.3</td>
</tr>
</tbody>
</table>

SOURCE: Salomon Brothers

Foreign transactions in U.S. bonds and foreign bonds in U.S. markets in 1988 increased to more than 13 times their 1982 level (see Figure 6). This trading boom was fueled mainly by growth in transactions for U.S. Treasury bonds, which accounted for about 84 percent of total foreign bond transactions in 1988, up from 63 percent in 1982. These transactions in U.S. Treasury bonds accounted for almost three-quarters of all foreign securities transactions in U.S. markets in 1988.

Bond transactions in other countries by nonresidents also increased dramatically. In Germany, for example, the value of such transactions increased by 300 percent over the 1985-88 period and now account for over half of the value of all transactions in German bond markets. Foreign bond transactions by U.S. residents reached an estimated $380 billion in 1987, six times greater than the 1982 figure.

Derivative products

Globalization has affected derivative financial products in two ways. First, it has spurred the creation and rapid growth of internationally-related financial products, such as Eurodollar futures and options and foreign currency futures and options as well as futures and options on domestic securities that trade globally, such as U.S. Treasury securities. Second, globalization has lead to the establishment of futures and options exchanges worldwide. Once the exclusive domain of U.S. markets, especially in Chicago, financial derivative products are now traded in significant volumes throughout Europe and Asia.

The number of futures contracts on Eurodollar CDs and on foreign currencies as well as the number of open positions has increased rapidly (see Figure 7). The number of futures contracts on Eurodollar CDs traded worldwide increased almost 70 percent annually since 1983 to reach over 25 million in 1988. This compares with a 20 to 25 percent annual growth rate for Eurodollars. Similarly, nearly 40 million futures and options contracts on various foreign currencies were traded worldwide in 1988, up from 14 million in 1983. This growth rate is roughly equivalent to that of forex trading.

The rapid increase in the volume of trading of internationally-linked futures and options contracts has largely benefited U.S. exchanges, which are the largest and sometimes the only exchanges where such products are traded. Nevertheless, the share of exchange traded futures and options volume commanded by the U.S. exchanges has dropped from 98 percent in 1983 to about 80 percent in 1988.
These 18 percentage points were primarily lost to European and Japanese exchanges.

In the past four years, 20 new exchanges have been established, bringing the total to 72. Many of these new exchanges are in Europe. In addition, foreign membership at many exchanges is considerable. For example, over two-thirds of LIFFE’s (London International Financial Futures Exchange) membership is based outside of the United Kingdom.

Two notable additions to futures and options trading are Switzerland and West Germany. The Swiss Options and Financial Futures Exchange (SOFFEX) was established in March 1988, and is the world’s first fully-automated, computer-based exchange. SOFFEX trades index options on the Swiss Market Index, which consists of 24 stocks traded on the three main stock exchanges in Geneva, Zurich, and Basle. Critics of the system contend that there is a lack of liquidity on the underlying stocks, thus limiting its effectiveness. Swiss banks control brokerage and can match trades internally with their own clients. This leaves a small amount for open trading on the exchange.

The Germans will begin trading futures and options in 1990. The exchange will trade bond and stock-index futures, and options on 14 high-turnover German stocks. Trading will be executed entirely by computer, as on its Swiss counterpart. The main reason the government approved the new exchange was competition from London for business that the Germans felt should be in Frankfurt. LIFFE began trading futures on West German government bonds in September 1988, and, as of year-end 1989, it was the second most active contract on the exchange, trading about 20,000 contracts daily. It has been estimated that anywhere from 30 to 70 percent of this London-based trading is accounted for by the German business community.

When an exchange is established, its product line usually includes a domestic government bond contract, a stock index futures contract, and, sometimes, a domestic/foreign currency futures or option contract. Therefore, the number of contracts listed on foreign exchanges that compete with contracts on U.S. exchanges is small relative to the number of contracts traded throughout the world.

The U.S. exchanges’ most formidable competitors are LIFFE and SIMEX (Singapore International Monetary Exchange). LIFFE competes with U.S. exchanges for trading volume in U.S. Treasury bond futures and options and in Eurodollar futures and options. SIMEX also competes for trading volume in Eurodollar futures as well as in Deutschemark and Japanese yen futures. But the SIMEX contracts are also complements to U.S. contracts in that a contract opened on the U.S. (Singapore) exchange can be closed on the Singapore (U.S.) exchange.

As shown in Figure 8, LIFFE commands less than 3 percent of trading volume in T-bond futures and options and Eurodollar options. Similarly, less than 3 percent of all Deutschemark futures trading occurs on SIMEX. LIFFE and SIMEX, however, are much more significant competitors for Eurodollar futures volume. SIMEX accounts for 7.5 percent of trading volume and LIFFE accounts for 6.5 percent.

Furthermore, in only three years, SIMEX managed to capture over 50 percent of the annual trading volume in the yen futures contract. The relatively greater success of SIMEX with the yen contract reflects the importance...
of trading in the same time zone as one side of a foreign exchange transaction. In June 1989, a yen/dollar futures contract was launched in Tokyo, along with a Eurodollar contract. The experience of SIMEX suggests that the yen contract will attract market share away from SIMEX rather than from the CME because Singapore and Tokyo are in the same time zone. The above experiences suggest that once deutschmark futures begin trading on the German exchange, some proportion now traded in London will move to Germany.

24-hour trading

True 24-hour trading exists in only a few markets, and is most valuable for assets whose investors span several time zones. Major currencies are traded around the clock in at least seven major money centers. Precious metals, especially gold bullion, and oil, which trade in New York, London and Singapore, are traded 24 hours a day. U.S. Treasury bonds are traded around the clock as well, but overseas markets are thin. Twenty percent of the business at the French futures exchange in Paris (Matif) is conducted outside of normal trading hours, indicating how important the extended hours can be.51

To a lesser extent, stocks of about 200 major multinational firms are traded in foreign markets as well as in their domestic markets, but foreign trading volume does not compare with that in domestic markets. One reason is that most information about a firm is revealed while domestic markets are open.

In preparation for the increase in round-the-clock trading and due to perceived competition from foreign exchanges, the National Association of Securities Dealers, the Chicago Mercantile Exchange, and the Chicago Board of Trade have made plans to extend their normal trading hours through computerized systems. The New York Stock Exchange is considering trading stocks electronically outside of normal trading hours, and the Cincinnati Stock Exchange and the CBOE are planning 24-hour electronic trading systems. The trading hours for foreign currency options on the Philadelphia Stock Exchange begin at 7:45 a.m. (Eastern Standard Time) to encompass more of the London business day.

International investment banking

As financial markets become more globally integrated, foreign investment banks are attempting to play larger roles in domestic markets. Overall, they are meeting with mixed results.

Foreign investment banks in the United States

Foreign-based investment banks have made some inroads into U.S. domestic capital markets. For the first time, two foreign firms ranked among the top ten advisers for U.S. mergers and acquisitions in the first quarter of 1989. Kleinwort Benson and S.G. Warburg, ranked sixth and seventh, respectively, according to the value of deals.52 They placed ahead of Merrill Lynch and Kidder Peabody. No Japanese firms ranked among the top M&A advisers, although Fuji Bank of Japan has an ownership interest in Kleinwort Benson.

The Japanese are making a concerted effort to penetrate the U.S. investment banking market, but they have met with little success. The Big Four—Nomura Securities, Daiwa Securities, Nikko Securities, and Yamaichi

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**Figure 8: World competition for futures contracts (Market share of world volume)**

- **1985**
  - T-bond futures: 1.5%
  - Eurodollar futures: 3.0%
  - Deutschemark futures: 1.0%
  - Yen futures: 3.0%

- **1986**
  - T-bond futures: 3.0%
  - Eurodollar futures: 1.0%
  - Deutschemark futures: 1.0%
  - Yen futures: 3.0%

**Source:** Intermarkets
Securities Company—expanded in the United States in the mid-1980s, but have scaled back personnel due to unprofitable U.S. operations. Two of the Big Four—Nomura and Yamachi—have been trying to model their U.S. operations as identifiable Wall Street companies, and not just subsidiaries of Tokyo firms, by their appointment of Americans to head their U.S. operations. Nomura’s strengths have been its primary dealership in U.S. government securities and U.S. stock trading unit, primarily for Japanese purchase. Nomura’s weaknesses, however, are its lack of financial product development and its trading skills.

The Japanese have been more successful in U.S. derivative markets. In April 1988, Nikko Securities became the first Japanese securities firm to acquire a clearing membership at the Chicago Board of Trade (CBOT). Since then, fifteen others have joined the CBOT. The Chicago Mercantile Exchange (CME) has seventeen Japanese companies as members. Nikko, Daiwa, and Yamaichi are members of both the CBOT and CME. Recently, Nomura announced a cooperative agreement with Refco, one of the world’s largest futures merchants. Consummation of the deal will assist Nomura in learning futures trading.

U.S. investment banks’ activities abroad

Merger and acquisition activity has been slowing in the United States, prompting Wall Street firms to look to foreign markets. According to a 1988 survey, U.S. firms accounted for slightly more than half of all cross-border merger and acquisition activity. The most active U.S. investment banks were Shearson Lehman Hutton (57 deals), Goldman Sachs (46), and First Boston (34).53

U.S. investment banks represented about 12 percent of all mergers and acquisitions for European clients in 1988. The most active U.S. firms in this category were Security Pacific Group (37 deals), Shearson Lehman Hutton (26), and Goldman Sachs (22). Security Pacific has acquired two foreign investment banks, one Canadian and one British.54

U.S. firms expect to find some business in Asia as well. The newly formed investment bank, Wasserstein Perella, for example, recently dispatched merger and acquisition teams to Japan to set up the Tokyo joint venture, Nomura Wasserstein Perella.

In the area of securities underwriting, U.S. firms are quite strong. Seven of the top ten underwriters of debt and equity securities worldwide are U.S. firms; however, only three U.S. firms rank among the top underwriters of non-U.S. securities. Merrill Lynch was the top underwriter of all debt and equity offerings worldwide during the first half of 1989.55

The strength of U.S. firms abroad lies primarily in Europe. Foreign securities firms in Tokyo have found it difficult to establish themselves. Thirty-six of the 51 Tokyo branches of foreign securities houses lost a total of $164 million for the six months ending March 1989.56 As a result of these losses, many foreign firms have cut back their Tokyo operations, concentrating on a particular product or service. Twenty-two out of the 115 Tokyo stock exchange members are foreign firms. Another 29 foreign securities houses have opened branch offices in Tokyo. Nevertheless, the Big Four dominate the Tokyo exchange, accounting for almost 50 percent of daily business. The foreign firms account for only 4.5 percent of this daily business.57

Three American investment banks, Salomon Brothers, Merrill Lynch, and First Boston, have been able to develop profitable operations in the Tokyo market. All three American firms attribute their success in part to a well-trained staff, and to hiring Japanese college graduates to fill positions. Salomon posted a $53.6 million pretax profit as of March 31, 1989. It also made a $300 million capital infusion, which has helped to make Salomon a challenger to the Big Four in bond trading.58

The U.S. government has been pressuring for greater access for U.S. firms to Japanese capital markets since 1984. For instance, Japanese government securities are predominantly sold through closed syndicates, in which foreign firms account for only about 8 percent of the total. Change has been slower than foreign investment banks and governments would like, but some progress has been made. The Japanese sold 40 percent of its 10-year bonds at an open auction in April 1989.59

Conclusion

Financial markets and financial services are becoming more globally integrated. As businesses expand into new markets around the
world, there is greater demand for financing to follow them. All major areas of international finance have grown far more rapidly than foreign trade in recent years. Trading of securities in U.S. markets by nonresidents, trading volume of foreign currency futures and options, and foreign exchange trading have been growing at 40 percent or more a year. This rapid growth of international financial transactions reflects the growth in cross-border capital flows.

The major markets for domestic as well as international financial services are the United States, Japan, and the United Kingdom, although it is beginning to make more sense to talk about the dominant markets as the United States, Japan, and Europe. The reduction of regulatory barriers and harmonization of rules among countries have allowed more firms to compete in more markets around the world. These markets are also competing against each other for a share of the world’s trading volume.

Today, a very large part of financial globalization involves financial intermediaries dealing with other, foreign, financial intermediaries. Consequently, prices in one market are affected by conditions in other markets, but, with a few exceptions, of which commercial lending is the most notable, customers do not have direct access to more suppliers. Again, this could change as Europe moves toward economic and financial unification.

Lessons from industries such as automobiles and petroleum, as well as lessons from geographic expansion in the United States, indicate that the financial services industry will become more consolidated, with firms from a handful of countries garnering substantial market share. International joint ventures will be common and often precursors to outright acquisitions. For smaller firms to survive as global competitors, they will have to find and service a market niche.

As the financial services industry and financial markets become more globally integrated, the most efficient and best organized firms will prevail. Also, countries with the most efficient—but not necessarily the least—regulation will become the world’s major international financial centers.

FOOTNOTES

2Ibid.
6During the Cold War, the U.S. dollar was the only universally accepted currency, and the Russians wanted to maintain their international reserves in dollars, but not at American banks for fear that the U.S government might freeze the funds. Therefore, the Russians found some British, French and German banks that would accept deposits in dollars. See Korth, p. 11.
10International Financial Statistics, International Monetary Fund, various years.
11Ibid.
12This does not apply in criminal cases, bankruptcy, or debt collection. The disclosure of secret information to foreign authorities is not allowed, unless provided for in an international treaty. In such a case, which is an exception, the foreign authorities could obtain only the information available to Swiss authorities under similar circumstances. See Peat, Marwick, Mitchell & Co., Banking in Switzerland, 1979, pp. 35-6.
13Eurobanks have specific rates at which they are prepared either to borrow or lend Eurofunds. In London, this rate is known as LIBOR (the London Interbank Offer Rate). LIBOR dominates the Eurocurrency market.
14Henry S. Terrell, Robert S. Dohner, and Barbara R. Lowrey, "The Activities of Japanese Banks in the United


18 Ibid.


20See footnote 17.

21*Annual Report*, Board of Governors of the Federal Reserve System, Banking Supervision and Regulation Section, various years; authors' calculations from Report of Condition and Income tapes, Board of Governors of the Federal Reserve System, various years.

22 Ibid.

23 Ibid.


25The Glass-Steagall Act is the law that separates commercial banking from investment banking in the U.S. Article 65 is its Japanese equivalent.


30 Ibid.


36 Ibid.


38 Ibid.

39 Ibid.


43 Ibid.

44 Various central bank statistical releases.

45 The underlying instrument is worth $1 million.


48 See *A supplement to Euromoney*, August 1987, p. 28.

49 Ginger Szala, "Financial walls tumble for German investors," *Futures*, January 1990, p. 44.

50 Ibid., p. 42.

51 See Thagard, p. 23.


54 Ibid.


Is Europe ready for 1992?

A half-dozen experts look at the difficulties of melding the regulatory philosophies and practices of the dozen members of the EEC into a single financial Eurosystem.

Kathryn Moran

The advent of the EEC’s 1992 economic plan for economic integration has European regulators and bankers examining the workings of their financial systems. For some, 1992 merely means fine-tuning their existing regulations and practices. For others, however, it will mean a whole new way of life.

At the November 1989 conference on globalization, co-sponsored by the Federal Reserve Bank of Chicago and the Mid America Institute for Public Policy Research, a panel of bankers, regulators, and academics gathered to discuss the implications of 1992. Panelists representing the United Kingdom (David Llewellyn, Loughborough University), the Federal Republic of Germany (Randall J. Pozdena, Federal Reserve Bank of San Francisco), Italy (Giorgio P. Szego, University of Rome), France (Jean-Pierre Patat, Bank of France), and Switzerland (Georg Rich, Swiss National Bank) discussed developments in these countries and a representative from the Bank for International Settlements (Joseph R. Bisignano) provided an overview on the effects of globalization throughout Europe.

Some are more ready than others

The panel members representing the United Kingdom, the Federal Republic of Germany, and Switzerland viewed the Europe 1992 plan as an extension of existing banking practices. Randall Pozdena, in addressing the German banking system, noted that “some argue that the evolution of the German banking and financial markets domestically might be a precursor of what will happen internationally, perhaps including providing a model of the potential political challenges posed by these developments.” Speaking of banking in the United Kingdom, David Llewellyn noted that the U.K. also has a very open system when it comes to wholesale banking, but that traditional, internal restrictions and the high entry costs to the retail banking industry may leave it vulnerable to global market pressures.

Perhaps the country with the longest experience in international finance is Switzerland, which has been a source of capital internationally since the 17th century. Georg Rich observed that the lack of restrictions and regulations on domestic and international finance, coupled with the banking secrecy laws, served to make Switzerland an attractive source of capital funds. However, on the eve of Europe 1992, Switzerland is finding that its competitive edge is eroding, the result of liberalization of banking laws in other countries.

The panelists representing France and Italy viewed Europe 1992 as a challenge for both regulators and bankers in those countries. In France, Jean-Pierre Patat stated, regulators and members of the financial services community have recognized the need to become more international in character. In the last decade, France has increased its participation in the international bond market from 1% of its Gross Domestic Product to 50–60%.

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However, Patat did not see deregulation as
an inevitable consequence of the opening of
the financial services market. Rather, regula-
tors “need now a pragmatic approach [to the]
diversified information” to encourage globali-
ization. That is, he believed that regulators
have an important role in the globalization of
French banking, and that the regulators must
recognize this and act accordingly.

Giorgio Szego, on the other hand, viewed
Italian regulators as a barrier to the globaliza-
tion of Italian commercial banks. In Italy,
commercial banks operate as “the arm through
which the government monetary policies are
activated and [are] kept as legally separated
bodies” with a very limited range of permis-
sible activities. Therefore, multi-functional
financial services firms have developed that
offer many banking services domestically,
while Italian commercial banks have been
buying foreign branches in order to increase
the range of services they can offer in the
international market. As a result, Italian com-
mercial banks are losing market share domesti-
cally to nonbank financial services firms and
to foreign banks even as they are gaining mar-
tket share abroad.

Joseph Bisignano of the BIS provided a
broader view of globalization in Europe.
While concurring that many members of the
European community have begun to move
toward globalization, the sheer variety of fi-
nancial and regulatory practices that now exist
in Europe challenge the success of the 1992
plan. “I think one way to look at finance in
Europe [is] as basically a dual economy, ... as
developing country...[with] one sector which
has been, for a number of years, protected
from foreign competition, where prices and
commissions are very strongly regulated, and
where government has played a very strong
role in supporting that industry... The sector is
the more competitive... where you have substantial deregulation, substantial com-
petition in price and commissions, where the
industry is subject to large elements of foreign
competition, and where government has man-
gaged to stay away from overregulation.” Due
to this complexity in the European financial
market, no one form of banking or regulation
stands out as the solution for Europe 1992.
Bisignano agreed with the other panelists that
government regulation plays varying roles in
the financial services industry in Europe.
However, even in countries that seem to have
fairly open systems or very active universal
banks, regulation plays a greater role than one
might expect. For example, despite Ger-
many’s history of universal banking, its bond
market is highly regulated. Thus, even in
progressive countries the effects of govern-
ment control can be felt in international financial services.

**But everyone has concerns**

When the panelists addressed their con-
cerns about Europe 1992, their responses were
quite varied. Llewellyn saw wholesale bank-
ing in the U.K. as already global. It is in the
retail sector that the greatest internal restric-
tions exist and where he found the greatest
need for adjustment. As a result, the retail
banking structure will be vulnerable to global
restructuring pressure.

Pozdena believed that German banks are
ahead of their time. However, he sensed po-
itical concerns, both within Germany and
without, about the concentration of economic
power that universal banking presents. There
have been attempts in Germany to limit,
through legislation, the powers of universal
banks, and he believed that the similar legisla-
tive efforts could arise in the European com-

According to Pozdena, the German securi-
ties market presents a very real barrier to glo-
balization for the German financial services
industry. It is subject to many regulations and
has not made the inroads in the international
market that German banks have.

Rich expressed a similar concern regard-
ing the Swiss securities market. The Swiss
securities tax laws, coupled with a failure by
the members of the stock market to compete
on an international level, have caused the
Swiss securities industry to lose its edge.
Furthermore, Rich saw a parochialism in the
Swiss financial community that has allowed
price-fixing agreements and other restrictive
practices to exist. In order to compete interna-
tionally, he argued, Swiss banks must change
these practices and begin to improve their
service to their customers.

In France, Patat found that the French
government in general and the monetary regu-
lators in particular need to make adjustments.
Banks, he stated, have taken steps to become international. It is the regulators who must begin to think globally—both in the effects of their policies and in their relations with regulators from other countries.

Szego agreed that regulators must broaden their outlook. He argued that Italian regulators must enlarge the scope of permissible domestic banking activities. As long as domestic commercial banking remains highly restricted, Italian banks will be unable to compete domestically on an equal footing with foreign banks.

Bisignano found many different barriers to globalization. Government plays a pervasive role in financial services throughout Europe. But, that role is different from country to country. In some countries, government regulation is limited to a few areas, such as capital markets, while in others government regulation is visible in virtually all aspects of financial services.

Bisignano also argued that there is a general misconception about banking in Europe. Despite the advent of universal banks and the appearance of a highly international banking scene, economic power in Europe is not concentrated. Rather, many financial services are handled by small regional banks or any of a number of nonbank financial institutions, such as finance companies and trust companies. These may present a very real obstacle to rapid globalization.

**Common ground**

It was on the role of regulators that the panelists found common ground. As David Llewellyn stated, “So I think if globalization is about competition…it’s about competition between financial systems.” The panelists agreed that if Europe 1992 is going to work, regulators must recognize their role in the plan. They will need to review their definition of banking and the restrictions they have placed on banks. They will need to enhance the areas where they already have an edge, such as deposit insurance, underwriting, or universal banking. They must be aware of and communicate with regulators in other countries. Most importantly, they must assist their financial services industry domestically in order for it to compete globally. If they do, then the European community will be prepared to meet the challenges of 1992. If they do not, the pessimistic scenario described by Giorgio Szego may come to pass—“If home rule will be the rule, let us look for the most hospitable home.”
Foreign competition in U.S. banking markets

Herbert L. Baer

The global integration of the world's banking markets seems an inevitable, if not an already accomplished, fact. However, the accommodations that global integration will force upon U.S. banks may well be more disruptive and anxiety-inducing than those experienced in other sectors of the U.S. economy that have been integrated into the global marketplace. This article discusses the extent and nature of foreign competition in U.S. banking and argues that the increasing importance of foreign banking organizations is primarily a consequence of their superior capitalization.

Banking in perspective

Firms in most sectors of the U.S. economy have been free to sell their products in a nationally integrated market. And, despite tariff protection, these sectors have been subject to foreign competition for many years. In contrast, for most of its history, the American banking system has been simply a collection of local banking markets tied together by a correspondent banking network and the existence of large domestic corporate customers. For many bank customers, interstate competition, let alone international competition, has been rare. Indeed, as recently as twenty-five years ago, foreign and U.S. branches of foreign banks accounted for only 1.5 percent of total commercial lending by banks. At that same time, imports of manufactured and semi-manufactured goods were about 7 percent of the supply of U.S. manufactures.

Foreign penetration of U.S. wholesale banking already exceeds that of most other industry groups; unless market capitalization ratios for U.S. banks go up—or down for foreign banks—this trend is likely to continue.

The fragmented nature of U.S. banking is likely to place U.S. banks in a weak position as they compete for market share in an increasingly global market for banking services. Indeed, by 1988 foreign banking organizations accounted for 28 percent of wholesale banking in the United States (see Figure 1). Thus, foreign penetration of U.S. wholesale banking markets exceeds the levels achieved in primary metals, in electronic equipment, and in the transportation equipment sector. A higher level of foreign penetration been achieved in only one broad industry group—leather goods. In short, U.S. wholesale banking has gone from an extremely protected position in the 1960s to a quite exposed position in the 1990s.

Accessing the U.S. market

Foreign banks provide services to U.S. customers through branches located in the United States, through subsidiary banks chartered in the United States, and through offices outside the United States. Legally, foreign-owned banks chartered in the United States are subject to exactly the same regulations as a domestically owned bank chartered in the United States. If the owner of the bank is a bank or some other corporation, then the owner is generally treated as a bank holding company for regulatory purposes. However, in practice, some attempt is made to accommodate differences in banking practices across countries. For instance, foreign banks that

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have controlling interests in commercial firms are permitted to own bank subsidiaries in the United States. At the other extreme, foreign banks lending to U.S. customers from overseas offices are entirely free of U.S. regulation. Foreign-owned banks can also serve U.S. customers using a third approach—setting up a branch in the U.S. In this case, the U.S. branch’s assets and liabilities are commingled with the rest of the bank’s assets and liabilities. Capital requirements and lending limits are set by regulators in the bank’s home country. However, the branch is subject to examination by the licensing state.

**Market shares**

Foreign banking organizations play virtually no role in the retail segment of the U.S. banking market. However, they are playing an increasingly important role in the wholesale banking market.

**Commercial lending**

The share of commercial and industrial (C&I) lending accounted for by U.S. branches of foreign banks has risen from 8.6 percent in 1980 to 14.4 percent in 1988 (see Figure 2). All of this increase is accounted for by branches of Japanese banks. In 1980, the U.S. branches of Japanese banks accounted for 2.7 percent of all C&I lending. By 1988, their share had risen to 8.5 percent. Over the same period, the market share of the U.S. branches of other foreign banks remained steady at 5.9 percent. The growth in C&I lending by foreign-owned banks chartered in the United States has been less dramatic, rising from 4.4 percent in 1980 to 6.3 percent in 1988. In contrast to the striking inroads made by branches of Japanese banks, the share of Japanese-owned U.S. banks has been relatively small, rising from 0.1 percent in 1980 to 2.4 percent in 1988.

The volume of C&I lending to U.S. firms through banking offices located outside the United States is more difficult to come by. The Bank for International Settlements (BIS) reports total foreign bank exposure to U.S. nonbank borrowers (including government and corporate bonds) while the Federal Reserve reports total loans by foreign firms (bank and nonbank) to nonfinancial firms. Neither source permits a breakdown by nation. However, using either definition, borrowing from offshore offices has grown dramatically. Using the Federal Reserve numbers, which include borrowings from banks and nonbanks, the share of C&I lending accounted for by offshore offices has risen sixfold from 1.2 percent in 1980 to 7.6 percent in 1988.

**Figure 1**

*Foreign penetration of U.S. markets*

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*Imports plus value-added by foreign-owned U.S. firms as a percent of new supply.

**Figure 2**

*Foreign share of commercial lending in the U.S.*

<table>
<thead>
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<th>Year</th>
<th>percentage</th>
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<tbody>
<tr>
<td>1980</td>
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<td>1984</td>
<td>10</td>
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<td>1988</td>
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*Estimates based on foreign borrowings of U.S. nonfinancial corporations as reported by Board of Governors, 1985. Includes lending by nonbank entities.*

Guarantees

Guarantees in the form of standby letters of credit (SLOC) represent another important wholesale banking product. When a bank writes a SLOC, it guarantees that the customer will meet a financial commitment. SLOCs are used to guarantee a wide array of financial agreements. Examples include loans, commercial paper, bonds, asset-backed securities, and futures margin payments. The market for SLOCs, while smaller than the market for C&I lending, is clearly sizeable. As of December 1988 there were a total of $288 billion in SLOCs outstanding to U.S. customers versus $660 billion in commercial loans. There are a number of reasons why banks may choose to intermediate indirectly through the issuance of SLOCs rather than through direct lending (Baer and Pavel, 1987). These include avoidance of reserve requirements, deposit insurance premiums, or other regulatory factors that place the bank at a disadvantage relative to its customer in raising funds and declines in the credit quality of the issuing bank (Benveniste and Berger, 1987).

The growth in SLOCs issued by foreign banking organizations has been explosive (see Figure 3). In 1980 U.S. branches of foreign banks accounted for only 10 percent of all SLOCs issued to U.S. customers. By 1988, they accounted for 53 percent. Moreover, in contrast to the market for C&I loans, branches of Japanese banks have been responsible for only a third of this increase. Market shares of banks based in Switzerland, West Germany, France, and the United Kingdom have all grown dramatically.

Factors promoting increased foreign competition

What explains the rapid growth in competition from foreign banking organizations? One possible factor is the continued integration of the nonfinancial portion of the U.S. economy through greater trade and increased foreign direct investment in the U.S. However, this increase is capable of explaining only a portion of the observed increase in the market shares of foreign banking organizations. U.S. imports have been growing at roughly 7.6 percent a year and foreign direct investment has been growing at 14 percent a year. However, total C&I loans outstanding have been growing at 8 percent a year. This means that, at best, taking into account the increased integration of the U.S. economy into the global economy would only explain half the growth in the share of C&I for foreign banking organizations. At worst, global integration of nonfinancial activities accounts for none of the growth in market share experienced by foreign banking organizations. Other data support the contention that the growth in foreign banking organizations is not simply the result of increased foreign trade and foreign direct investment.

Sales of domestic C&I loans by U.S. commercial banks account for a significant portion of the competitive inroads being achieved by foreign banking organizations. Banks voluntarily sell loans to other institutions (including foreign banks) to avoid violating lending limits; to achieve a more diversified loan portfolio; to reduce capital requirements; or to take advantage of lower funding costs available at other institutions. Loans are purchased by other banks because they seek to diversify their portfolios; because their ability to raise deposits exceeds their ability to generate loans directly; because they are attempting to develop a banking relationship with a customer; or because they are able to raise funds at a lower rate than the seller (see Pavel and Phillis, 1987). By all accounts, loan sales were relatively unimportant prior to the early 1980s. In 1985, the first year for which formal figures are available, loans sold to U.S.
branches of foreign banks accounted for 1.9 percent of total C&I loans outstanding and 24 percent of total loans held by U.S. branches of foreign banks. By 1988, they accounted for 2.5 percent of total C&I loans. Thus, U.S. banks have been directly responsible for over two-fifths of the 5.8 percentage point increase in the market share of U.S. branches of foreign banks that occurred between 1980 and 1988 (Board of Governors of the Federal Reserve System, various years).

Some observers have been concerned that the rapid penetration of the U.S. wholesale banking market by foreign firms is the result of lax regulation by foreign governments (for instance, Walters, 1987). Excessive regulation of banks in their home markets has certainly played a role in the growth of the Eurodollar activities of U.S. banks (Baer and Pavel, 1987) and the Eurodollar and Euroyen activities of Japanese banks (Terrell, Dohner, and Lowrey, 1989). However, the links between lax regulation in a foreign bank’s home markets and its competitive position in the domestic U.S. market is less well documented. Fears regarding the competitive advantages conveyed by lax regulation at home may be justified, particularly with respect to banks owned by foreign governments. And although no objective rankings exist, this concern would also appear to be valid where privately-owned foreign banks enjoy stronger guarantees from their governments than U.S. banks enjoy from the U.S. government. Whatever the particulars of the complaint, it ultimately boils down to the assertion that foreign banks are able to hold less capital per dollar of risk or pay less for the capital that they raise.

If this complaint is correct, then we would expect that those banks that have made the greatest inroads into the U.S. market—that is, the large Japanese banks (known as “city” banks)—would be the least capitalized of the major international banks. Yet, as Figure 4 shows, the large Japanese city banks, as a group, have the highest ratio of market capitalization (share price times number of shares outstanding) to assets of all the major international banks. As of January 1990, the lowest figure for a Japanese bank is about 16 percent while two have ratios over 20 percent.

The major U.S. money center banks, in contrast, have much lower market capitalization ratios. The highest market capitalization ratio for a U.S. money center bank is about 9.5 percent, while three money center banks have market capitalization ratios of under 3 percent. Banks based in Switzerland, West Germany, and the United Kingdom lie between the extremes of the U.S. and Japanese banks.

**FIGURE 4**

Market capitalization of U.S. and foreign banks
(Percent of assets)

- **Japanese city banks**
- **Swiss banks**
- **German banks**
- **British clearing banks**
- **U.S. money center banks**

While the market capitalization of Japanese banks is extraordinarily high, their reported book values are relatively low, with the major Japanese banks reporting book capital ratios ranging from 2.5 to 3.0 percent in early 1990. Much of the discrepancy between the relatively low book values of Japanese banks and their relatively high market values is accounted for by unrecognized gains on their holdings of equity investments in Japanese nonbanking firms (Hanley et al., 1989). Japanese banks are permitted to hold up to a five percent interest in a nonbanking firm. The Japanese city banks are members of "keiretsus" or clubs that are the postwar successors to the powerful "zaibatsus." Banks frequently hold equity positions in other firms belonging to the keiretsu and it is not uncommon for a bank to be a firm's leading shareholder (Tokyo Keizai, 1989). A bank will also hold equity stakes in firms that are not members of its keiretsu.

The value of the equity portfolios of the large city banks has soared in the last decade along with the dramatic increase in Japanese (as well as worldwide) share prices (see Figure 5). By 1988, unrealized gains on securities accounted for 45 percent of the market capitalization of Japanese city banks. Unrealized gains on real estate, while not currently disclosed, are also likely to account for a nontrivial portion of the gap between the market and book values of Japanese banks because each has an extensive branch network and Japanese real estate values are high relative to those in other countries. The remainder of the discrepancy is accounted for by discounted future earnings on banking activities. And, while book earnings of Japanese banks are low by Western standards the discount rates applied to these earnings are also typically quite low (French and Poterba, 1990).

Even ignoring the unbooked value of Japanese real estate and the present discounted value of future earnings—i.e., counting only book equity and unrealized gains on securities net of unrealized gains on LDC debt—Japanese banks, as a group, are the most heavily capitalized banks in the world. In 1988, the least capitalized Japanese city bank had an adjusted book value of 6.4 percent while the best capitalized city bank had an adjusted book value of 12.6 percent. Clearly, the impressive growth of Japanese banks cannot be explained by too little capital.

**Too much of a good thing?**

If too little capital does not explain the rapid growth of Japanese banks in the United States perhaps it is worth considering whether the high level of capital can explain their relatively high growth. Figure 6 plots the growth in international assets and market capitalization ratios for banks in Japan, Switzerland, the
United Kingdom, the United States, and West Germany. Banks from France and Italy are excluded because their ownership by a national government makes it difficult to measure their true capital. Figure 6 suggests that the success of Japanese banks is only the most dramatic example of a more general principle—banks that have high market capitalization ratios have made greater inroads in foreign markets than have banks with relatively low market capitalization ratios. Swiss and German banks, which also have relatively high market capitalization ratios due to unrecognized gains on equity portfolios, have also been expanding into foreign markets at a relatively rapid rate.

At the November 1989 conference on globalization, a well-known economist remarked that he had never met a bank that had too much capital. Many in the audience chuckled at this remark with knowing agreement. In the context of American money center banking, where large windfall profits have been fairly rare while losses due to regional downturns and poor performance by third-world borrowers have been large relative to capital, the remark is correct.

How should a bank holding an equity portfolio that experiences a significant appreciation respond? One possible response would be to realize some of the unrecognized gains and pay the proceeds to the bank’s shareholders through a special dividend. In the case of Japanese banks, however, both the shareholders and the bank want to avoid paying a special dividend. The bank owns much of its equity holdings as a direct result of its membership in its keiretsu. If the bank sells off its shareholdings in these firms, it risks weakening its ties to and influence over the keiretsu. The taxation of dividend income for individual investors is also an issue since dividend income is taxable while income from capital gains is not (Spicer and Oppenheimer, 1988). Furthermore, any capital gains realized when the bank sells securities are taxable at a rate of 52 percent (Hanley et al., 1989).

Clearly, there are strong incentives to avoid realizing capital gains in the absence of offsetting losses. As long as the discrepancy between the bank’s current and “potential” share price is less than the tax that would be paid on the special dividend, bank shareholders prefer to realize the capital gain by selling the bank’s shares rather than by having the bank pay a special dividend. Thus, for Japanese banks, strategy and shareholder tax avoidance both point toward retaining any capital gains within the bank.

The bank’s decision to retain its capital gains places it in the position of having too much capital. If the bank’s portfolio was previously in equilibrium, the bank now is able to issue uninsured liabilities at a lower rate than before. It is also able to take larger exposures to borrowers while maintaining the same level of diversification in its portfolio. The shift toward highly leveraged transactions by large U.S. and British firms in the latter half of the 1980s has accentuated this effect and surely explains a significant portion of the rapid growth of Japanese banks in the United States.1

Even if the bank is forced to raise book capital, it will still have strong incentives to grow. It can either increase book equity by realizing capital gains or by simply issuing additional securities. In contrast to banks with relatively low market capitalization, it will find securities issuance inexpensive, in large part because the issuance of additional securities does not generate an offsetting loss of government guarantees.2 As Edward Kane points out elsewhere in this issue, this factor explains why Japanese banks have had little trouble raising additional equity.

However, the decision to retain capital gains within the bank may also give managers the leeway to pursue goals that do not maximize shareholder value. One common tactic in such situations is to pursue rapid growth both internally and through acquisition. This has proved common in nonbanking firms and there is no reason to believe that banks would behave any differently given the opportunity (Jensen, 1986). However, the conglomerate merger wave of the 1960s was reversed in the 1970s and 1980s as shareholders came to realize that these mergers were not in their interests. It is equally likely that inroads by foreign banks that have been driven by runaway management will be reversed in the next decade.

**Conclusions**

Many explanations have been advanced to explain the rapid growth of foreign banking...
organizations in the United States over the past decade. Some have argued that this growth simply reflects the increasing globalization of financial markets while others have argued that it is the result of the relatively lax regulation of foreign banks that permits them to operate with too little capital. The facts support neither explanation. Increased trade and foreign direct investment are capable of explaining only a portion of recent inroads made by foreign banking organizations while data on market capitalization suggest that the fastest growing foreign banking organizations, the Japanese city banks, are four to five times better capitalized than the typical U.S. money center bank.

The rapid growth of foreign banking organizations in the U.S. is best understood as a result of three events. First, Japanese banking

FOOTNOTES

1Kane (1990) and (1988) makes a similar point.

2When a bank is poorly capitalized and deposit insurance is mispriced, the deposit insurance can account for a substantial portion of the bank’s market value. Issuance of new equity reduces the value of the deposit insurance and hence the overall value of the bank’s equity. Existing shareholders must compensate new shareholders for this decline in value. This makes new equity expensive to issue.

REFERENCES


The supervisory implications of financial globalization: Three views

At the 1989 Lake Bluff conference on globalization, three authorities presented their personal—and conflicting—views on international financial regulation in general, and the 1988 BIS-sponsored Basle agreement, in particular.

Competitive equality and supervisory convenience

Chester B. Feldberg

``Clearly the financial system has been undergoing dramatic and far reaching changes in the decade of the 1980s. And equally clearly, the supervisory and regulatory framework must adapt to this rapidly changing environment... Some major evolutionary trends have emerged in the 1980s that appear to me to be irreversible and to carry important supervisory implications. First, geographic barriers to competition have been falling, both in the U.S. and abroad. Among the more noteworthy developments are the growth in interstate banking in the U.S., the prospect of dramatic reductions in barriers to financial services competition within the European Community as 1992 approaches, and the strategic positioning of banking and securities firms in key global markets. These changes will inevitably result in an expansion in the geographic scope of the lead supervisor’s responsibility, and call for much closer coordination among supervisors in different jurisdictions. Implicit in such coordination is the need to develop mechanisms for the broad exchange of supervisory information among different authorities.

A second related trend of the 1980s, is that traditional barriers to competition between different types of financial institutions have been breaking down at an ever-quicker pace. Here too, there is a pressing need for banking and securities supervisors to expand their knowledge base in order to better understand and monitor the risks associated with a whole new range of activities and products.

Finally, the 1980s have produced rapid technological advancements that have led to important financial innovations in both markets and products. These changes have greatly reduced traditional operating constraints on risk taking and facilitated a shortening of performance horizons, allowing financial market participants to be more aggressive and markets more volatile.

Bigger burdens on regulators

``All in all, the growing interdependency among markets and among financial market participants is placing a greater burden on regulators and supervisors everywhere. Let me now try to briefly highlight some of these burdens in four major areas: financial structure, competitive access, supervisory convergence and payment system concerns.

As banks expand their operations into new activities, especially securities activities, and into new and more interdependent markets, important questions are raised as to what form of corporate organizational structure will enable them to compete most effectively and most safely. In the United States, bank holding companies have been permitted by the Federal Reserve Board to engage in a growing list of securities activities on the condition that such activities be carried out in separate, non-

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bank subsidiaries of the parent holding company. At the same time, extensive firewalls have been erected to guard against unfair competition, conflict of interest, and undue concentration, as well as to insulate the bank from potential risks of the securities activities.

"In Europe, there is broad agreement that banks can exercise both banking and securities powers, although the particular corporate structures will differ. Germany, for example, has a universal banking structure, in which securities and banking activities are both conducted directly within the bank, while in the U.K. banks typically establish separate subsidiaries to engage in securities activities. In practice, however, these two structures may not be all that different, since there are few outright restrictions on the flow of funds and capital between a U.K. bank and its securities subsidiary. Thus, banks having sufficient overall capital face few constraints in operating a securities business. In Japan, the Ministry of Finance is currently reviewing Article 65, their version of our Glass-Steagall Act, and seems likely to allow some overlapping of banking and securities powers, although the exact structure has yet to be decided.

"In my judgment the Federal Reserve Board’s basic firewalls approach represents a reasonable and appropriate first step in its efforts to grant new securities powers to bank holding companies in a gradual and carefully controlled way... Over the long haul, however, I do have some real questions, as to whether the firewalls approach may risk placing U.S. firms at a rather significant competitive disadvantage, by limiting important synergies and operating efficiencies that might otherwise be realized. This issue will have to be closely monitored, to ensure that a proper balance is maintained between our various supervisory concerns and the realities of the changing competitive environment.

**Competitive equality**

"As financial globalization proceeds, it should not be surprising to anyone that the pressures for competitive equality in all major markets have intensified. Two recent examples come to mind.

"First, the EEC has been struggling with the broad issue of reciprocity, in drafting its Second Banking Directive and, after considerable debate, appears to have settled on a policy, the main thrust of which might be termed reciprocal national treatment. Under that policy, firms from a non-EEC country will be granted full competitive equality in their operations within the EEC, on the expectation that EEC banks will enjoy equal competitive opportunities in their operations in the non-EEC country.

"Second, the U.S. Congress followed a basically similar approach last year with its passage of the Primary Dealers Act. That act prohibited foreign firms from being designated or from continuing their designation as a primary dealer in U.S. government securities, if the firm’s home country does not accord to U.S. companies the same competitive opportunities in the underwriting and distribution of government securities that the country accords to its own domestic firms. Moreover, the Federal Reserve is required to monitor changing circumstances in the relevant foreign securities markets, to assure that the requirements of the Act are met on an ongoing basis...

Looking forward, it seems to me, that there must be both the perception and the reality of a level competitive playing field, in all major markets, if globalization is going to work over the long term.

**Supervisory convergence**

"Let me turn now to the issue of supervisory convergence. Globalization can only work in a supervisory environment that both ensures the safety and soundness of the international financial system and encourages free and open competition among market participants to the maximum extent possible. As global markets have become more competitive, the pressures on profit margins have intensified. This process has helped to expose the differences in supervisory approaches from country to country, and how such differences can affect the competitiveness and profitability of a nation’s financial institutions. This in turn has led to recent efforts at international harmonization of supervisory policy. The major accomplishment to date is the BIS agreement on risk-based capital standard that was concluded in 1988 in Basle, Switzerland. The impetus for that agreement arose out of various concerns. Two that had international relevance were, first, the dramatic global growth of off-balance-sheet items, such as interest-rate and foreign-exchange rate swaps, whose risk...
characteristics traditionally had not been factored into the assessment of a bank's capital position. And second, the lack of differentiation in capital treatment between low-risk, low-yield assets and high-risk, high-yield instruments, which created an obvious incentive to take on additional risk.

"The bank supervisors recognized that any meaningful effort to address these concerns needed international cooperation. Going it alone could have put their domestic banks at a severe competitive disadvantage and could have risked driving certain businesses offshore. While the BIS agreement is less than a perfect document, representing as it does a compromise of diverse national interests and concerns, it is, nevertheless, an important milestone in international bank supervisory cooperation. Hopefully the agreement will be just the first step in international efforts to address other types of risk, such as interest-rate and foreign-exchange rate risk, and perhaps also, liquidity risk.

"The goal of achieving capital convergence is not limited to just the banks. Recently an international organization of securities supervisors, IOSCO, has begun to address similar issues in an effort to improve coordination. This is an extremely useful and welcome development, which hopefully will result in the adoption of a uniform risk-based capital requirement for securities firms that is at least functionally equivalent to the capital approach adopted by the bank supervisors.

"All this quickly leads to difficult questions about the future structure of supervision: Whether there should be consolidated supervision of individual institutions under a single regulator, pure functional supervision, or functional supervision with a lead regulator overseeing the consolidated entity.

"It seems to me that there is a need to assure that all major participants in the global financial system are appropriately supervised by some recognized regulatory authority. Given the interdependence of markets and firms, and the size and speed with which transactions occur, as well as the systemic risks if a major player cannot honor its obligations at the end of the day, we are at a point where there is no room for unregulated or only partially regulated participants. U.S. investment

bank holding companies, which are not supervised on a consolidated basis by the SEC and which carry out some important risk-generating activities at the unsupervised holding company level, are a good case in point.

**Payment risk**

"The final area of international supervisory concern is less glamorous and until recently, often ignored. And that is, the payment risk in the clearing and settlement of financial markets, which Gerald Corrigan, President of the New York Fed, likes to refer to as the plumbing of the system. This is an important issue for all supervisors, but is a particularly important one for the U.S., given that the dollar is the currency of choice in a large number of financial transactions. Earlier this year, the Board of Governors of the Federal Reserve System proposed changes in its payments risk reduction program that would impose explicit prices on daylight overdrafts and expand the use of collateral in order to control the risk. The Board also issued two new policy statements, designed to reduce credit exposures on domestic and offshore payment systems. Among other things, the two policy statements call for appropriate supervisory oversight over all such systems to assure that credit and liquidity risks are properly understood and managed, and that settlement occurs in a timely manner.

"I might add that the Federal Reserve is not the only group actively concerned with clearing and settlement risk on a global basis. The Group of 30, earlier this year, recommended the establishment of global standards for national clearing and settlement of corporate securities. Also, the central banks of the G-10 countries under the auspices of the BIS are currently engaged in a major study of netting arrangements, with a view to identifying possible approaches to netting, that offer the potential to significantly reduce risk...

"My crystal ball is a bit cloudy as to how all of the supervisory issues I’ve touched upon will ultimately be resolved. But, one thing does seem absolutely clear to me, and that is, that the world of supervision cannot stand pat during this process, it must react and it must adapt to the changing financial scene."
Incentive conflict in the international risk-based capital agreement

Edward J. Kane

"There is little reason to doubt that a globally integrated pattern of financial regulation would exist in the global village. What can be doubted is that authorities either know how to minimize or always strive to minimize unfavorable movements in the long-run safety and soundness of the financial system as it moves toward a globally integrated pattern... Incentive incompatibilities inherent in representative democracy make it less dangerous for the adjustment process to be driven by world-wide competition among differentially regulated private firms pursuing opportunities for diversification and growth than to be led by multilateral cooperative agreements negotiated from time to time by imperfectly accountable national regulatory entities...

"This assertion is based on analysis that shows that regulatory performance tends to be compromised by important defects in governmental accountability. These defects create incentives for a nation’s politicians, regulators, or regulatory clienteles to favor the interests of decapitalized deposit institutions at the expense of taxpayers as a whole... The perversity of such strategies is that they foster financial instability and allocational inefficiency in the long run. These perverse incentives make it likely that governments whose deposit-insurance schemes have been supporting cartel-like rents and concealing substantial taxpayer losses will use international regulatory agreements as yet another device for postponing regulatory adjustments that their society desperately needs...

"The producers of financial regulatory services can be thought of as constituting an industry, the members of which establish an equilibrium market structure. This industry consists of private self-regulatory associations and state, federal, foreign, and international bureaus. We may envision these entities as continually making adjustments in the services and regulatory burdens they offer, in hopes of winning regulatory business away from each other. We may also envision their managers as occasionally investigating possibilities for establishing some kind of cartel...

The Basle agreement

"Using the cartel analogy, the rest of this article analyzes the fruit of one major international regulatory accord: the Basle risk-based capital agreement... The analysis seeks to show that the benefits of establishing this common supervisory agreement were misadvertised. The new capital requirements will not, as claimed by some, noticeably raise the funding costs of rapidly growing Japanese banks. What the agreement will do is to paper over and to prolong serious tensions in individual countries’ regulatory tactics and strategies in the short run (particularly, the existence of deposit-insurance subsidies to risk-taking and barriers to foreign entry into Japanese deposits) and to refocus rather than to curtail international regulatory competition.

"Bank for International Settlements (BIS) General Manager Alexandre Lamfalussy ties the case for common bank-capital standards to the hypothesis that, when capital requirements are set in isolation, competitive pressure prompts authorities to set capital requirements too low relative to the aggregate riskiness of bank portfolios and leads financial institutions to migrate to regulators that set low capital requirements... In 1987 congressional testimony,

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Gerald Corrigan described the purpose of the BIS negotiations more plainly: ‘...the single item on which I place greatest emphasis relates to bank capital adequacy standards and specifically the goal of moving Japanese bank capital standards into closer alignment with emerging international standards.’

‘The low core-capital ratios recorded for the various classes of Japanese banks give the Lamfalussy-Corrigan argument considerable plausibility. However, the argument neglects two important distinctions and incorporates what appears to be a counterfactual assumption. First, the argument fails to distinguish the market value of bank’s net worth or capital from the book (or accounting) value. Second, the argument fails to distinguish the separate effects of bank capital, capital requirements, and deposit-insurance guarantees on bank funding cost and risk-taking behavior. Most importantly, BIS and Western capital requirements apply only to book-value capital so that increases in capital requirements need not require any increase in the market value of capital or any decrease in funding cost or risk-taking... Third, the argument fails to explain why both banks that are poorly capitalized on a market-value basis and previously low-requiring regulators should not reasonably be assumed to find and exploit loopholes to circumvent the agreements.

‘An alternative interpretation is that regulatory authorities in the U.S. and Europe conceived of capital-adequacy standards partly as a way to restrain Japanese banks, penetration of European and American financial markets by raising their capital ratios to 8 percent. These standards may be seen as a reaction to a sustained redistribution of financial market shares toward Japanese banks and securities firms which now dominate lists of the world’s largest institutions in each category.

‘Declines in the international market share of non-Japanese firms wrought simultaneous declines in the market shares of these firms’ home-country regulators. Once this decline was recognized, it created pressure for regulatory innovation in the world’s other financial centers... Negotiated under the auspices of the BIS, the Basle risk-based capital agreement embodies serious misconceptions about the sources of Japanese banks’ relatively low funding cost. Economic analysis indicates that Japanese deposit interest rates are low relative to parallel rates in other countries for three interconnected reasons:

‘First, Japan has been a nation with a high rate of savings, a condition that by itself would tend to place its domestic interest rates below those of low-saving, weaker-currency countries...

‘Second, Japanese regulators assist Japanese banks not to compete as aggressively against each other for low-denomination domestic deposits as free foreign-bank entry would require...

‘Third, Japanese banks are known to possess a relatively high level of market-value capital. In recent years, market capital has averaged several times the book-value net worth of Japanese banks.

**Bank capital levels**

‘A paper written with Haluk Unal and Asli Demirguc-Kunt shows that in 1987 and 1988 the ratio of market-value to book-value capital reached a peak over 8.5 for each of the three largest size categories of Japanese banks. These banks’ strong market-value position generates two complementary benefits. First, it lowers Japanese banks’ cost of raising debt capital at home. Second, outside of Japan, a high level of bank capital gives foreign depositors an important form of comfort. While the banks of all major countries receive at least conjectural back-up guarantees of their deposits and other debt from their home-country governments, Japanese banks offer corporate and other large customers for deposits and loan commitments the additional prior protection of substantial amounts of stockholder-contributed capital.

‘Thus, any hope that the Basle risk-based capital agreement would check the international growth of Japanese banks is rooted in a false theory of corporate finance. U.S. and European regulators blamed defects in Japanese capital regulation rather than anticompetitive elements in Japanese patterns of entry and deposit-rate regulation as the principal reason for the lesser international competitiveness of U.S. and European banks. They claimed that the relatively low levels of book-value capital for large Japanese banks constituted a funding advantage conferred on them unwisely by growth-minded Japanese regulators. Such a view is strikingly at odds with the
efficient-market theory of corporate finance. This theory holds that increases in the market value of capital lower the cost of issuing or rolling over formally uninsured deposit debt, but that exercising accounting options that serve to inflate artificially the book value of a bank’s capital does not favorably affect deposit interest rates. ...

“In foreign markets, Japanese banks’ and securities firms’ advantage is partly real and partly apparent. The merely apparent part of Japanese financial firms’ international growth is rooted in the dialectical efforts of Japanese banks and their large customers to lessen the regulatory burdens of domestic controls on interest rates. ... However, Japanese banks’ real and potentially lasting advantage lies in their having privileged home-turf access to domestic savings and being more strongly capitalized on a market-value basis...

**Bargaining for access**

“Richard Wright and Gunter Pauli see Japanese strategies for penetrating world financial markets as conditioned on ‘government policies that both protect the home market and actively promote the position of Japanese financial institutions abroad.’ In free deposit and loan markets, competition would only allow the export of Japanese savings to be intermediated by Japanese banks if these institutions were more efficient intermediators than banks from other nations. In Japan, deposit-rate ceilings, branch-banking laws, and deposit-institution charter segmentation greatly limit the size of the deposit base a foreign bank can hope establish. While Japanese banks operating in the U.S. have been able to progress to more than 10 percent of the U.S. market for commercial-bank deposits, foreign banks operating in Japan have gained only about 3 percent of the corresponding Japanese market.

“Foreign governments and trade associations of ‘guest’ firms have placed mounting international political pressure on Japanese officials to widen foreign access to their domestic financial markets... The U.K. has moved to halt branching in Britain by Japan’s regional banks until Japan more fully liberalizes British firms’ ability to participate in the Tokyo Stock Exchange. France is reported to have held up an application by a Japanese bank to establish a branch office in Paris until Credit Lyonnais received a seat on the same Tokyo exchange. Similarly, the U.S. Congress passed legislation in 1988 that called on the Federal Reserve not to recognize as ‘primary dealers’ in U.S. government securities financial institutions from countries that deny similar competitive opportunities to U.S., firms.

“What should disturb U.S. and European citizens about the strategies being pursued by Western regulators is that, authorities are trading banking privileges in their countries for securities privileges in Japan. Because in the long run it would be impossible for the Japanese to insulate securities markets effectively, this strikes a series of prototypically short-sighted regulatory bargains. These deals perpetuate Japanese banks’ capacity to exploit Japanese savers domestically and to use this funding-cost advantage to compete advantageously for foreign business with Western banks outside of Japan...

**Ties that bind**

“It is ironic that the costs that U.S. banks face in trying to arbitrage Japanese restrictions on the operations of their branches and affiliates in Japan are reinforced by parallel U.S. limitations on these institutions’ domestic investment banking and other nonbank activities. The effects of these restrictions are lessened but not eliminated by structural arbitrage. For example, large U.S. banks (such as Morgan) have adapted their foreign securities affiliates to develop and support a variety of domestically impermissible securities activities on an offshore basis. Federal Reserve restrictions on interaffiliate transactions and the higher costs of exercising expanded powers in convoluted ways make structural arbitrage an imperfect substitute for direct entry into a product market. The easier it becomes for U.S. banks to enter U.S. and foreign securities markets as banks, the less costly they should find it to adapt their organizations and operations to penetrate Japanese banking markets and to compete with Japanese banks in third countries.

“The downside to relaxing U.S. restrictions on bank activities comes from unrepaired weaknesses in the federal deposit insurance system. Difficulties that government deposit insurers face in trying to police innovative forms of client risk-taking mean that new activities often are able to extract large unin-
tended subsidies from the federal deposit insurance funds. However, the solution to this problem is to fix the defects in the deposit insurance system, not to make it hard for U.S. firms to compete effectively in financial markets around the world. ... “In conclusion, intergovernmental regulatory cooperation is fundamentally cartel behavior and subject to principal-agent conflict. In negotiating the 1988 risk-based capital agreement, many Western officials’ unstated goal may arguably be described as postponing the pain of adapting their domestic regulatory schemes to the watch of successor officials. They hoped they could relieve immediate pressure for substantive change by raising book-value capital requirements for Japanese banks.

“The missing ingredient in current efforts at financial harmonization is increased ac-
countability for individual-country financial regulators. Of course, we should not suppose that improving the quality of information about financial regulatory performance would put an end to regulatory subsidies. But economic theory does promise us that selective subsidies can be constrained by making their production more costly to those who currently benefit from their creation.

“Western financial-services firms and regulators appear to have counted on the Basle agreement and increased foreign entry into Japanese securities markets to slow down future penetration of international financial markets by Japanese banks and securities firms. Financial markets have been teaching them some useful lessons about how differently from U.S. and European regulators the markets themselves analyze an institution’s unbooked earnings and net capital positions.”

Implications of globalization for regulation and safety

Grant Reuber

“The dominant feature of the world economy during the past three decades has been the dramatic growth and development of international financial markets...What we have in fact is a regulatory system that has never had an international perspective. Rather, it is an idiosyncratic network of national regulatory systems that evolved largely in response to domestic considerations. The gaps, disparities, and inconsistencies in international regulation have always been there. But the difficulties they create have become more pronounced during the past three decades, as a result of the dramatic transformation of international financial markets.

“The regulations in most countries have four basic objectives. One is to reinforce the safety and soundness of the system. The second is to maintain fair and reasonably high levels of competition. The third is to maintain an acceptable level of honesty and integrity in the system, along with satisfactory levels of protection for consumers and investors. The fourth is to try to harmonize activities among various agencies of different governments... However, pursuit of these objections has been overlaid by a supplementary range of objectives in each country. Among these have been industrial strategy, nationalism,...and monetary and

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fiscal policy. A major influence in all this, not to be understated, has been a variety of strong vested economic and political interests within each country.

**Strengthening the machinery**

“A major difficulty in trying to update and rationalize this network of national regulatory systems to form a more satisfactory international system is that the machinery for doing so is weak and dispersed. It consists largely of consensus building among governments and multilateral agencies meeting in various international groups such as the OECD and the Bank for International Settlements [BIS]. The recent extension of the GATT into the area of financial services may strengthen that process somewhat and it may also be reinforced by steps to integrate Europe by 1992...

“The most important achievement, and I call it an achievement contrary to the previous speaker,...in harmonizing national regulatory systems, has been the agreement among industrialized countries on a common set of risk-related capital requirements for banks...Of particular importance has been the application of a consistent set of capital requirements against off-balance-sheet items. As a consequence of the agreement,...the safety and soundness of the system has been strengthened and the competitive playing field has been somewhat leveled...

“In the remainder of my remarks I’d like to focus on three categories of risk and how globalization has impinged upon them. Those three categories are credit risk, position risk, and operations risk.

**Credit risk**

“How have the globalization of financial markets and recent regulatory changes affected credit risk? Increased international competition has resulted in a secular decline in profitability for many financial institutions. Moreover, as the pressure on profits is increased, so has the temptation to move further out along the risk curve.

“At the same time, much greater attention has been given to selling off loans as rapidly as possible...in order to increase profits from fee income. As a result, credit risk has been spread more widely throughout the system. How much this diversification has reduced risk for the system as a whole is difficult to say, since it is now much harder to determine who is bearing what risk. Moreover, the prospect of selling down loans has probably increased the willingness of institutions to take on larger and weaker loans initially. It has also increased the risks of not being able to sell off loans as expected.

“The growth in the securitization of assets and junk bonds has added further uncertainty to the system as well. Highly leveraged loans have become much more common during the past decade, promoted and supported in many instances by nonbank institutions. These nonbank institutions function within quite a different regulatory framework and in some instances may be less cautious in their credit assessments.

“Finally, as the playing field for financial services has been leveled, both domestically and internationally by market forces and deregulation, the market protection that some financial activities have enjoyed in the past has eroded. Marginally profitable activities in institutions have been squeezed, giving rise to consolidations, reorganizations, and failures—situations laden with increased risk.

“That said, it is also evident that the quality of bank assets may have improved in recent years...Many institutions have strengthened their internal controls...Loan loss provisions have been bolstered and capital reserves are stronger, particularly when one recognizes that under the BIS definitions, the off-balance-sheet commitments are included for purposes of capital requirements...But while the BIS agreement has rationalized and set minimal levels of capital resources for the large category of private risk assets, no distinctions are made among risks arising from a wide range of assets qualities. Nor is much attention given to such basic questions as diversification of assets by industry and by location.

**Position risk**

“Let me turn to position risk, the second major category on which I wish to focus. It arises when a firm’s assets and liabilities including off-balance-sheet obligations are not fully matched as to currency and term...The globalization of financial markets has had mixed effects on position risk. By expanding markets and making them more liquid, globalization has reduced it. Moreover, a variety of instruments have been developed to hedge...
position risk. On the other hand, the enormous volume and speed of transactions and the cross-border integration and interdependence of institutions and markets have magnified both the impact and the speed that a problem in one national market has on others.

**Operational risk**

"Let me turn finally to operational risk...particularly to the risks of self-dealing and fraud...These are hardly new, but they have probably increased in recent years...In addition to the integrity of the internal control mechanisms and the quality of management of financial institutions, control of these risks has essentially relied upon regulation.

"In some countries, major financial activities, particularly banking investment underwriting and dealing, trust or fiduciary business have been separated from each other as a means of trying to limit these risks. And, in some countries...commercial and financial activities have been clearly separated for the same reason. These traditional separations are disappearing...under the impact of international market forces and reregulation. As the traditional pillars have crumbled, the risks of self-dealing and fraud have increased, and although cooperation and coordination have improved, the regulatory system within and among countries remains fragmented.

"As financial markets have become more integrated internationally, the ability of national regulators to monitor transactions moving at split second speeds through complex international daisy chains has become more difficult. Compounding the risk of self-dealing and fraud even further, are differences in attitudes, regulations, and practices found among different financial sectors and different countries. As a result, the willingness to enact and enforce stringent rules varies considerably from market to market and country to country. Because of today’s highly integrated financial markets, regimes with weak standards pose a bigger problem for the system than they used to. Nor, for political reasons, can the damage caused by inadequate regulation in some foreign countries be overcome by efforts to extend extra-territorially the sounder rules and regulations of other countries.

**One last risk**

"In these remarks I have focused on three categories of risk—credit risk, position risk, and operational risk. There is also another major risk to be recognized domestically and internationally. This is the risk that under the guise of safeguarding the system and making it more effective and efficient, the evolution of the regulatory system internationally will continue to be distorted in order to advance narrow nationalist and protectionist purposes. To the extent that this occurs, less progress will be made in advancing the primary objectives of regulation—safety and soundness, competition, integrity, and consistency. In addition, the international system will fall short of developing its potential to facilitate economic growth and development."

**FOOTNOTES**

1Copies of the paper on which Mr. Kane’s remarks are based are available from the Research Department, Federal Reserve Bank of Chicago, Chicago, IL 60690.