Financial Integration and Its Implications for International Cooperation

April 19, 2005

Timothy F. Geithner, President and Chief Executive Officer

Remarks at the European Commission Conference in New York City

Thanks for giving me the opportunity to join you today. The European experience with monetary union deserves the world’s attention. Europe is in important respects ahead of the rest of the world in dealing with the consequences of financial integration. The opportunities and challenges that now confront Europe in the financial arena tell us a lot about the issues all economies are facing in this increasingly integrated global economy.

I want to use this forum today to make a few points about the challenges facing central banks and supervisors related to financial integration and financial stability.

- The forces driving financial integration are powerful, and we are likely to see substantial further movement in the direction of more capital mobility and institutions with greater geographic scope.
- Financial integration offers great benefits, but requires both stronger national supervisory frameworks than exist today and greater international cooperation on all dimensions of supervision.
- We are some distance from these goals, even with the impressive achievements of the past. With further progress toward financial integration, all countries will have a greater stake in raising the overall quality of supervision globally.
- Future cooperation will need to focus on the next frontier in capital standards, improving disclosure, strengthening the global payment infrastructure and in provisions for crisis management.

The case for financial integration is compelling. As a general proposition, economic integration is one of the most powerful forces we know for raising living standards. The evidence for the gains from trade in goods and services has a convincing history, and when accompanied by a strong prudential framework of supervision and regulation, capital market integration brings substantial economic benefits as well.

The dynamic of financial integration is straightforward, though not universally appreciated. Greater competition and increased opportunities for capital to seek higher returns produce greater economic efficiency and higher growth rates. More integrated capital markets provide more opportunity for diversification and for risk to be diffused. Financial institutions that operate across borders, and financial markets that are open to foreign financial institutions, are more stable as financial integration progresses. A more financially integrated world, therefore, grows faster and should be more stable.

Although national financial systems are dramatically more integrated today, foreign financial institutions still play a relatively small role in many economies. Even with the dramatic increase in the mobility of savings across borders evident today, foreign assets still represent a relatively small share of domestic savings.

Further progress in financial integration by itself will not bring a smooth transition to a world with fewer national financial crises with less contagion. The degree of financial stability we face in the future will depend, as always, on a number of other factors, most importantly the wisdom of the choices governments make in economic policy. But negative shocks, whether they come from poor macroeconomic policy outcomes or from bad luck, will most likely be less acute for the system as a whole in a world of more integrated financial markets.

Integration gives us each a greater stake in the quality of financial supervision outside our borders. This is true not just to ensure a more level competitive playing field for institutions that operate across borders. It’s necessary to provide a stronger framework of protection for depositors and investors with claims on foreign financial institutions and to reduce our respective vulnerabilities to a failure of such an institution. In a world of more open capital markets, no national financial authority can achieve a mandate for domestic financial stability operating alone. In an important sense, financial integration means than no nation is fully independent in matters of financial stability.

The United States, Europe and Japan, working with other countries, have an impressive record of achievements in financial cooperation over the past twenty five years.

- We designed, put in place, amended and just recently substantially revamped a common framework for risk-based capital standards for banks.
- We developed broad principles that have played an important role in supporting efforts to strengthen national supervision and market regulation around the world. We provided technical and financial resources to support financial reform and institutional development in emerging and developing economies.
- We took a series of initiatives to address systemic risk in payments and settlement systems, most notably in foreign exchange settlement.
- We promoted a global effort to strengthen national anti-money laundering regimes.
- We are making meaningful steps toward convergence of accounting standards.

These long-standing efforts have been more extensive in scope, and have had more tangible impact on policies and institutions than the record in many other areas of international economic cooperation. They have helped improve the benefits of and mitigated the challenges that come from financial integration.

What are the next steps? Where is the return on future cooperation likely to be highest?
I want to highlight a few important areas that are on our agenda, and conclude with a few broad judgments on how we pursue financial cooperation in the future.

It is important to start with capital. The new risk-based capital regime we call Basle II is the most important priority for supervisors and risk managers. The framework that has been developed will bring about a dramatic improvement in the regulatory capital regime, with a much more sophisticated approach to measuring credit and operational risk and determining the appropriate level of capital banks need to hold against those risks. We still have a complicated mix of issues to resolve in the framework and in how it will be applied in practice, including the appropriate balance between the roles of home and host supervisor.

A key challenge in this effort of raising the bar on the global capital regime is to design a better way of capturing the risks institutions confront in the full range of exposures to market events. This requires a risk management infrastructure that can fully aggregate, in close to real time, the exposure of an institution across a wide range of business lines. It requires a more rigorous and sophisticated approach to measuring potential future exposure, market and credit risk across a wider range of possible outcomes, including events in the tail of the distribution, when prices behave outside the range of recent experience and correlations converge. It requires a closer integration of the result of scenario and stress testing into a firm’s internal limits, liquidity management and capital allocation decisions. And for the largest financial institutions that dominate the major wholesale markets for credit, interest rate risk and foreign exchange, it requires attention to the risk of the failure of a major counterparty, as well as to the greater constraints imposed by size on the ability of these core institutions to act in conditions of stress without amplifying the problem for the system.

The next challenge at the frontier of international financial cooperation involves disclosure and accounting. Alongside a sustained focus on ensuring that the largest global financial institutions maintain an adequate margin of capital and liquidity above what regulatory capital requires and economic capital may imply, it is very important we make further progress in improving the effectiveness of market discipline.

Market discipline is an important complement to the supervisory process. It is only as strong or effective as the underlying accounting regime and the quality of disclosure. Better information, information that provides a more accurate and timely picture of risk to counterparties, is important not just to reinforce supervisory incentives for prudent financial management, but also to help mitigate the risk that uncertainty will amplify systemic distress.

Market discipline depends crucially on the comparability of financial disclosures, and the continuing work to bring U.S. and international accounting standards into greater alignment will go far to improve the ability of market participants to evaluate the financial performance of firms across jurisdiction. We need to see further improvement in the degree to which public disclosure provides a forward-looking view of the major risks facing the institution, the role of hedging in mitigating those risks, the range of uncertainty surrounding future revenues and potential losses and the underlying volatility of the business of the firm. We also need to continue to work on reducing the risk that an accounting framework creates a disincentive to economically sensible hedging and risk mitigation.

A third challenge is in the area of the global payments and settlement infrastructure—the back office foundation for financial intermediation. The increased scale of cross-border financial activity, the global scope of an increasing number of financial institutions and the cross-border nature of many core payments systems have placed a more substantial and more complicated burden on this vital infrastructure.

The challenge falls on the core systems themselves, in their effort to improve operational resilience and maintain a strong level of financial safeguards against risk. The challenge also falls on the firms that use these systems to make sure they understand and manage well the extent of their exposure across the complex array of multiple systems in which they operate. And the challenge falls on central banks and supervisors to make sure we have an adequate framework of oversight over these core systems, particularly when they operate across national jurisdictions.

One important area where we have a common challenge across the major financial centers is in the clearing and settlement system for OTC derivatives, including credit derivatives. The latest wave of growth and innovation in structured finance has moved far ahead of the pace of improvements in the back office. To cite only one aspect of this problem, the principal dealers in this business have a substantial outstanding backlog of confirmations, a problem magnified by the common practice of assigning trades without notifying the relevant counterparties in advance. This is a problem that needs to be fixed. It requires the collective commitment of the major dealers, reinforced by their principal supervisors and regulators.

A final challenge worth noting relates to how we handle systemic financial crises and the liquidity needs they can produce. Firms that operate across borders normally manage their liquidity market by market, and liquidity in any one market and in any one currency normally is not readily transferable to where it may be needed. This can limit access to liquidity where it’s needed most, and can also compromise the capacity of central banks to respond quickly and effectively to a liquidity problem of financial institutions it supervises.

As we demonstrated in the immediate aftermath of September 11, central banks have the capacity through swap arrangements to compensate for some types of problems like this. We need to make sure that our capacity to be effective in the future context is robust across a wide range of other types of circumstances. But this is an area where there is substantial unexploited room for the private sector to put in place arrangements, cross-border collateral pledging arrangements, for example, that can help reduce the risk that they are forced to rely on a cooperative response by the lenders of last resort.

This is a selective list, in summary form, of a number of important challenges on the supervisory horizon. How effective we are in pursuing these issues in the future will depend on a number of factors.

Central bankers and financial supervisors are going to need to find ways to speed up the pace of evolution on the international front. The increase in the pace of change in financial innovation and market structure means that, without a commensurate acceleration in the speed with which we reach consensus on change to the supervisory framework, we are at risk of lagging too far behind the market.

Those of us in the central banking and supervisory community in the major financial centers are going to have to find ways to work more closely with our counterparts in emerging markets at an early stage in the design of new standards.

We are going to face an increasingly difficult problem in addressing the consequences of various asymmetries produced by the process of integration. Among the new challenges for the balance between home and host supervisors are those where a small number of foreign banks account for the bulk of financial activity and those where the operations of an institution in markets outside its home country are very large in relation to those in its home country.

Recognizing the large degree of judgment required by the supervisory process in applying a more sophisticated risk-based approach to capital, we are
going to have to find ways to ensure that the range of differences in the exercise of national discretion of judgment does not create too great a variance in the effect of the regimes across countries.

We are also going to have to find new ways to encourage market participants, the lead financial institutions in the world that together account for the bulk of activity in the derivatives, prime brokerage, structured credit and other elements of the financial intermediation process, to work together to raise standards and address problems where they have a collective interest in doing so. The private sector effort now being led by Jerry Corrigan to look at counterparty risk management with respect to hedge funds and various issues in the structured credit world is a good example. This group brings together U.S. and non-U.S. dealers, banks and non-bank financial institutions, to recommend changes to market practice that bring important perspective to our efforts as supervisors.

Financial integration creates a strong pragmatic case for international cooperation in finance. But financial integration itself is not likely to lead us any time soon to a world in which nations cede responsibility for financial supervision to a global institution. As in national defense, nations are likely to want to retain a significant degree of authority over the terms and conditions that shape financial intermediation in their economy. This is appropriate, and financial integration can go a long way among nations that have very different financial systems and different preferences to balance competing regulatory objectives. But to be effective, national frameworks for financial stability are going to have to be complemented in the future with a more intensive process of cooperation.

Thank you.