The New World of Banking

Four trends are fundamentally altering the financial world: consolidation of institutions, globalization of operations, development of new technologies, and universalization of banking. Each of these poses challenges for the effective supervision and regulation of the financial sector.

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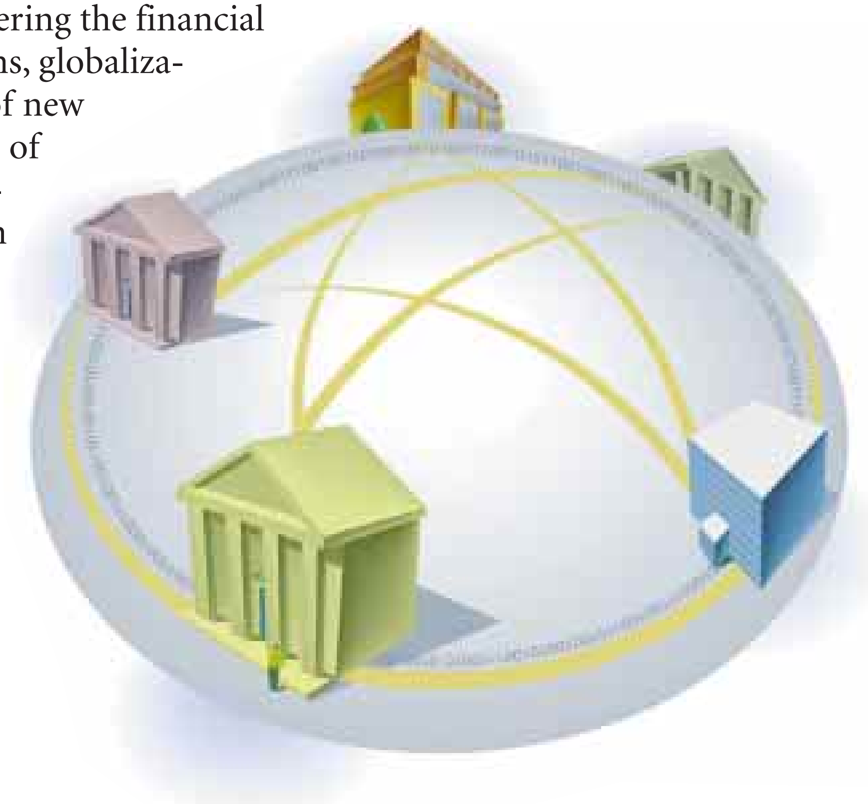


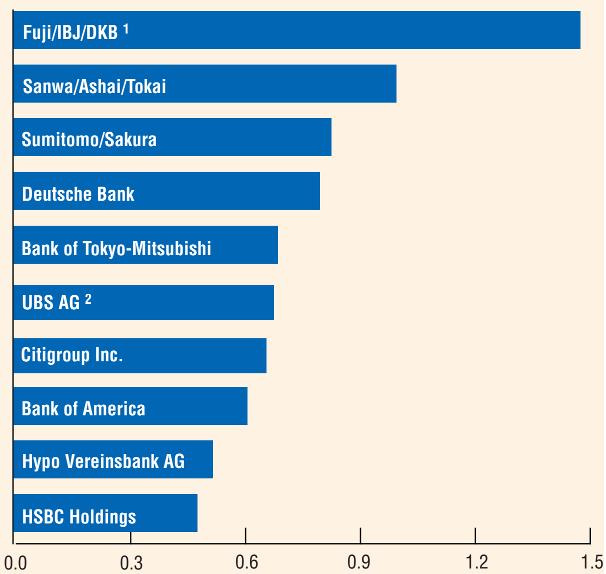
FINANCIAL institutions around the world are consolidating at a rapid pace. The number of institutions is declining, their average size is increasing, and it is a rare week when no new bank merger or acquisition is announced. Indeed, the last two years have witnessed the creation of the world's largest banking groups through several mergers (see chart on page 42). In the United States, the lifting of interstate banking restrictions in 1994 triggered a wave of mergers, and European integration has intensified consolidation in Europe—which the introduction of the euro in January 1999 has further encouraged. In many emerging markets, such as Argentina, Brazil, and Korea, consolidation is also well under way as banks seek to become more efficient and more resilient with respect to shocks.

Nor has consolidation been confined by national borders. In a drive that has created powerful "national champions" in many industrial countries, financial institutions have not waited for opportunities for growth and increased profitability to be exhausted domestically before transcending national frontiers. This process of globalization has been dominated by industrial country banking groups' exploitation of the growth potential in emerging markets, as witnessed by the expansion of Spanish banks in Latin America, German banks in Eastern Europe, and U.S. banks in East Asia. At a somewhat slower pace, cross-border consolidation is also taking place between industrial countries, initially in the form of strategic alliances that offer some of the benefits of diversification without the costs of merging different business cultures.

Developments in technology, and especially the impressive growth of Internet banking and brokerage services, have allowed globalization to go beyond the ownership structure of financial conglomerates and to reach the retail markets. In fact, many banks are using their online operations to expand into foreign markets, avoiding the costly process of building retail brick-and-mortar networks of branches. Moreover, the emergence of alliances between major banks and telecommunications conglomerates suggests that, in the future, competition in the electronic marketplace will be fierce. In addition, the appearance of virtual banks and the development of electronic money for the global Internet market have created the possibility for the growth of nonbank (and, possibly, largely unregulated) institutions that provide credit to,

The largest world banks by total assets

(trillion dollars, 1999)



Sources: Fitch-IBCA; and IMF staff estimates.
[1] IBJ: Industrial Bank of Japan; DKB: Dai-Ichi Kangyo Bank.
[2] UBS: United Banks of Switzerland.

and collect funds from, the public. Faster communications require faster reactions from both markets and policymakers but also quickly make information obsolete.

The final vehicle for this transformation of the financial sector is the universalization of banking, which is increasingly blurring the boundary between bank and nonbank financial services. This trend is already well developed in certain European countries—as exemplified by the widespread distribution of insurance products through bank branches, a phenomenon known as bancassurance—and presages the formation of conglomerates that provide all types of financial services. To some extent, this irreversible trend was confirmed in the United States by the merger of Citicorp and the Travelers Group and the subsequent repeal in 1999 of the Glass-Steagall Act (which restricted banks' involvement in equity financing and artificially separated investment banks from commercial banks).

Benefits and drawbacks

The advantages and disadvantages of these four trends have been the subject of many articles and much debate. On the plus side, bank mergers and acquisitions, if completed successfully, will lead to cost savings and improved profitability, benefiting both clients and shareholders. Globalization will facilitate risk diversification by banks and improve the overall performance of individual economies by improving resource allocation. On the minus side, if consolidation is taken too far, it could lead to abuse of dominant market positions and moral hazard issues, such as when institutions are considered to be too big to fail. In addition, excessive involvement in foreign markets without sufficient knowledge of local economic conditions could increase the vulnerability of individual banks.

An important issue that has only recently been considered is the implications of these developments for prudential and supervisory policy—that is, for systemic risk and the ability of the appropriate authorities to manage it. First, how should risk be assessed and managed in this environment? The growing use of derivatives and off-balance-sheet operations, coupled with the diversification across countries and sectors of banking activities, has quickly made traditional risk-management techniques obsolete. Second, how does one deal with a distressed bank? Experience shows that closing a large bank can create problems because of the systemic repercussions and the potential large disruption in the real economy. In this respect, the international consolidation of the banking sector introduces an important nuance: what is the relevant market to consider when deciding, for instance, whether to provide liquidity support or public funds to assist a distressed globalized bank? In the euro area, would the fate of a bank holding, say, 25 percent of national deposits in its country of origin but only 1 percent of euro-area deposits compromise competition and the stability of the system and therefore merit special treatment? If public sector intervention is appropriate, who should carry it out? International conventions provide for supervision of the worldwide operations of a bank to be the responsibility of the supervisory authorities of the bank's home country. Consider, for example, a bank domiciled in country *A* whose operations in country *B*, although small relative to the global operations of the bank, make it the dominant bank in country *B*. If that bank suddenly becomes insolvent, would the bank's home-country supervisors fully take into account the massive potential disruption of activity in country *B* that could result from the bank's liquidation and therefore be willing to provide financial support—which would entail a wealth transfer from country *A* to country *B*?

Finally, the development of new financial techniques, the globalization of investments, and the introduction of new technologies have significantly increased the scope for, and speed of, contagion. Thus, an unexpected drying up of liquidity in a particular financial market can rapidly spread throughout the global capital market. Again, the reaction of the supervisory authorities may be affected by globalization. Would the Federal Reserve Bank of New York, for instance, have intervened to facilitate the restructuring of Long-Term Capital Management's (LTCM) hedge fund in the same way had LTCM's exposures been spread across many foreign markets rather than concentrated mainly in the U.S. market?

Addressing risks of globalized banking

In response to these challenges, financial regulators have focused on increasing transparency and on strengthening prudential regulation and supervision in a manner that takes explicit account of the risks arising from the increasing globalization of banking. A first step to better risk monitoring has been a push for greater transparency that facilitates market discipline and supervision by allowing both the public and bank supervisors to better assess the risk profiles of financial institutions. A more fundamental reform has entailed addressing the deficiencies of the Basel Committee on Banking Supervision's 1988 capital-adequacy ratio recommendations. The rigidity of these recommendations, compounded by the creation of new markets for credit derivatives and the unprecedented growth in loan sales and securitization, has allowed bank managers to actively manage their risks and engage in "regulatory capital arbitrage" practices. These practices help banks reduce the average riskiness of their portfolios, as measured by the capital-adequacy ratio, and thus also lower the capital required under the Basel recommendations without a commensurate reduction in the effective risks faced by the banks. This reduces the effectiveness of the capital-adequacy ratio as a prudential tool.

The Basel Committee has proposed a number of solutions to these problems. One proposal is for a "bucketing" approach, which would impose capital requirements based on borrowers' ratings provided by independent rating agencies. Alternatively, banks would be allowed to use their internal credit risk models, which they already use to assess market risks in their trading books. None of these options, however, is fully satisfactory. Credit-risk models are still at an early stage of development, and it may be difficult for supervisors to evaluate the adequacy of a particular bank's model and how the bank is using it. When rating agencies are used, how should credits from unrated firms be assessed? Another problem is that these ratings have not been designed to determine capital requirements, and events such as the 1997 Asian crisis suggest that rating agencies can swiftly swing from overoptimism to extreme pessimism, which will be reflected in their ratings. Moreover, rating agencies could also face a conflict of interest if their ratings were used to assess their clients' capital needs.

The second important regulatory issue is the complexity and globalization of financial transactions and the creation of large financial conglomerates spanning several countries, which make purely domestic assessments unsatisfactory. International agencies and groups (such as the IMF, the World Bank, the Bank for International Settlements, and the Basel Committee) have supported and complemented the work of national agencies in addressing the challenges that globalization poses for the stability of financial sectors.

To enhance transparency, these international agencies and groups have begun developing guidelines to consolidate financial statements and achieve greater cross-country harmonization in accounting and auditing standards and in disclosing information. They are also working to identify and close gaps in regulatory and supervisory regulations in order to avoid problems such as regulatory arbitrage—that is, taking advantage of looser regulations in a particular jurisdiction or applying to certain types of institutions. Adopting and monitoring compliance with standards are part of these efforts. The IMF, for its part, has introduced the Special Data Dissemination Standard, the General Data Dissemination System, and the Code of Good Practices on Fiscal Transparency and on Monetary and Financial Policy Transparency. The IMF and the World Bank—in an effort that also involves international standard-setting bodies and national supervisors—have begun to assess the stability of financial sectors in member countries that have volunteered to participate in this process (the Financial Stability Assessment Process (FSAP)), which is currently operating on a trial basis. The FSAP framework takes into account the links between the various financial institutions and markets, as well as those between the financial sector and macroeconomic conditions. It also assesses compliance with relevant standards and codes.

In launching their efforts, the IMF and the World Bank have come up against important obstacles. Regulations have a basis in national law and cannot simply be transplanted from one country to another. Also, national practices for financial operations and institutions have developed over time, and changing them can be costly. As noted above, a major effort is under way to revise the Basel Accord of 1988, which was designed for internationally active banks. However, over time, more and more banks and countries have sought to apply the requirements of that accord, because doing so is viewed as a way to enhance the reputation of banks (even those that have a limited international presence). This provides further evidence of the globalization of financial markets but also raises questions as to how to adapt such requirements to a wider range of institutions. Similarly, the Basel Core Principles for Effective Banking Supervision have become a key element of the move toward improved banking supervision worldwide.

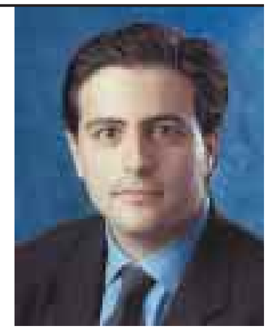
Remaining challenges

Despite significant progress, challenges remain. For instance, for capital-adequacy requirements to be meaningful, the definitions used in the calculations must be consistent across countries. Also, further progress is needed to ensure an adequate flow of information between supervisory agencies. Efforts are under way to deal with both these issues. The Basel Committee, for instance, has developed guidelines for sharing information on cross-border operations; further work in this area will be needed. Another challenge—how to provide the right incentives for compliance—may be particularly complicated for offshore centers, where most transactions in the financial system involve only nonresidents.

As noted earlier, the universalization of banking is leading firms to conduct operations that had been the preserve of a different type of institution. Moreover, the growing sophistication of finance has resulted in closer links between financial institutions of different types. These developments have made necessary a comprehensive approach to risk assessment that cuts across the boundaries of institutions. Some countries (for example, Korea and the United Kingdom) have addressed this concern by consolidating prudential supervision and regulation of financial institutions in a single agency. Others have improved coordination among various supervisors. These links have also been recognized at the international level. The Financial Stability Forum, a forum of national and international financial agencies set up in 1999, is mandated to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. In fulfilling its mandate, it seeks to identify gaps in regulation and take steps to eliminate them. Also, as noted above, the FSAP exercise takes a comprehensive approach to identifying financial sector vulnerabilities shared by various types of institutions.

Globalization and the increasing ties between financial intermediaries also pose problems for such safety nets as deposit insurance and lender-of-last-resort arrangements. What institutions and operations should be protected? Who should bear the cost of safety nets, and when should they be activated? These questions have been difficult to answer even in simpler contexts, such as a domestic banking system that operates only with residents. They are much harder to answer in a globalized financial system and are becoming even more difficult as Internet banking undermines the validity of concepts based on domicile, such as the home-country supervisory principle.

In short, the banking sector is entering a new world in which national and institutional boundaries are becoming less important. Inevitably, supervisory and regulatory systems will have to adapt their work methods in order to remain effective. The growing emphasis on risk management, exchange of information, and coordination at the international level is evidence of efforts to adapt. Nevertheless, some questions, such as the specific measures to be taken for banks in difficulty, are not easily answered. Adapting regulatory and supervisory frameworks to rapidly changing financial markets will remain a daunting challenge and will require further cooperation between supervisors, markets, and individual market participants. F&D



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