

***International Financial Cooperation:
A Central Banker's Perspective***

I am honored to have been invited to participate in this European Banking and Financial Forum 1996, and it is a special pleasure to be here as a central banker from the Gulf area. May I thank the organizers of the Forum, and especially Dr. Karel Muzikar, for having provided this opportunity to discuss some areas of international cooperation needed to meet the challenges before us.

I must admit from the beginning that this subject is enormously complex. It cannot be covered fully in a single presentation such as this, and so I plan to concentrate on several areas that are the particular concerns of central banks.

The old Chinese curse of "May you live in interesting times" was undoubtedly placed on central bankers. I think you will agree with me after I have explained the background to the situation we now find ourselves in.

In the 90s, we are moving ever more rapidly towards a borderless global economy, a process which cannot be stopped or reversed. Globalization's driving forces are numerous. They include the significant technological advances of the past ten years, the market innovation and liberalization, the huge and vast increases in international trade and capital flows, and the increasing levels of education and income, particularly in what we used to call the "third world".

From the available data on some of these driving forces, I would like to refer to the following facts:

- The increase in the world GNP per capita, according to World Bank statistics, was at an average annual rate of 1.2% during the period 1980-1991, and amounted to US\$ 4,280 in 1992.
- The expansion in world exports of goods and services, according to IMF data, was noticed in the increase from an annual average of US\$2,154 billion during the period 1977-1986 to US\$6,183 billion in 1995, i.e., an increase of 187%.
- The annual percentage increases in telecommunications coverage in low-and middle-income economies during the period 1975-1990 were 3.2% and 5.6% respectively, according to World Bank data. Thus, this coverage became in 1990 about 6 main lines per thousand persons for the low-income economies, against 81 and 442 for the middle and high-income economies respectively.
- The annual net capital flows to the developing countries exceeded US\$130 billion during the period 1990-1994, recording an increase of 400% over their annual value during the period 1983-1989. IMF statistics revealed that most of these funds were aimed at securities markets and direct foreign investment.

These interrelated forces have, among other things, contributed substantially in moving the national and international financial environment towards greater globalization. I will not spend time commenting in detail on the causes and effects of all these forces. However, I do want to stress three points as they relate to the increasingly borderless international financial markets⁽¹⁾:

(1) In this respect, it was emphasized by Mr. Trichet, Governor of the Banque de France, in his speech before the Tokyo Conference for the 10th year anniversary of the Plaza Accord, October 23, 1995, that the very powerful worldwide trend has led a number of central banks- with the Banque de France in the fore - to become independent.

First, the massive advance of technology and telecommunications has provided consumers with a wide range of financial services and products. This has not only lowered the cost of these products, but has also accelerated the speed of payments and transfers around the globe. Most importantly, technology has also accelerated the speed with which the financial markets react to events, resulting in a massive increase in the volume of transactions.

Astonishing statistics have been given as indicators of these expanded global financial activities⁽²⁾:

- Cross-border bank assets stock values have grown 4 1/2 times since 1980, and constituted in 1994 about 35% of the combined GDP of the OECD countries, compared with 20% in 1980.
- Cross-border securities transactions in most industrial countries have risen in the last 15 years from less than 10% to over 100% of GDP.
- The annual international bonds and equities issues have increased four-fold in the past decade; the notional principal of currency and interest rate swaps expanded five times in the five years between 1988 and 1993. Foreign exchange turnover worldwide tripled between 1986 and 1992.
- On the level of the payment system during the period 1988-1993, the value of securities settlements through Euroclear and Cedel increased six-fold; and the volume of cross-border payments handled by SWIFT increased 60 percent.

(2) In a speech on “Financial Globalization and the Role of Central Banks”, delivered by William McDonough, President of the New York Federal Reserve Bank, at the 5th Anniversary International Symposium of the Bank of Korea, Seoul, South Korea, June 19, 1995.

Second, the benefits of financial globalization are numerous and far-reaching for both the participants and the efficient performance of the financial markets. Market participants can now take advantage of borrowing, lending, and risk management opportunities available anywhere in the world on a real time basis, and are better able to diversify and hedge their risks.

In so far as the markets are concerned, it is obvious that globalization has caused an increase in their competitiveness and efficiency. Financial institutions are now able to choose in which country to base their activities, dependent on the profitability and the security of the specific location.

Finally, this development of financial globalization may prove to be a challenge to the effectiveness of the world's central banks. In particular, the implementation of monetary policy and regulations, such as supervisory regulations, will become more difficult as financial institutions' activities become increasingly global. More and more we shall see central bank policies having to pay greater attention to international developments as they decide their domestic policy issues.

One consequence of all these developments is that financial crises can no longer be easily contained within one country. Events from the currency crisis in Mexico to the collapse of Barings have all shown cross-border implications.

This has particular relevance for the supervisory role of central banks, and we now need to be ready to meet any potential systemic risk resulting from dealing in this global market. We see barriers continuing to fall, and also increased risks in the international payment and settlement systems, resulting from the massive increase in cross-border financial activity.

International financial cooperation is, therefore, increasingly important, and there are several areas in which it needs to be improved.

Prior to the collapse of the Bretton Woods Agreement and the failure of Bankhaus Herstatt in the early 70s, “international financial cooperation”, for bankers and central banks alike, usually meant providing financial assistance to a country in a time of crisis, such as a famine or an armed conflict. Back in those days, banking and finance was simple: a few loans, some cheques, the odd L/C, all in a comfortable fixed exchange rate regime. Those were the halcyon days, great but perhaps a little boring for some. The collapse of Bretton Woods and Bankhaus Herstatt put the seal on their end. Back to the Chinese curse: times became “interesting”.

Since then we have had plenty to interest us as central bankers, for example, currency crises, stock exchange collapses, commodity price shocks and, not least, bank collapses. Gradually, over the last twenty years or so, one lesson has been learnt from all the changes, the deregulation and the crises. This lesson is that we are all utterly dependent upon one another. We have no alternative but to cooperate with one another, in both the banking and financial business, and the policy-making areas.

Perhaps I can underline this lesson by concentrating on the “interesting” areas for us as central bankers. The most cogent of these, in my view, are supervision, payment and settlement systems, and communication⁽³⁾: areas that have acquired special urgency as globalization has increased.

Let me start with **supervision**. After all is said and done, this is the area, which is the subject of more criticism, comment and in some cases, anger than anything else. One might say that the history of supervision over the past twenty years is one of disappointment. I say disappointment, because the creation of the Basle Concordat, its

(3) President of the New York Federal Reserve Bank, William McDonough, gave attention to the area of financial policies aimed at dealing with international financial crises or major financial sector problems. See his lecture, “International Economic Cooperation”, delivered at the Guildhall, London, April 12, 1995.

subsequent revision in 1983, the Supplement to the Concordat of 1990, and the establishment of the 1992 Minimum Standards were all the direct results of banking failures.

The key aim of the Concordat in its present form is that no bank should escape adequate consolidated supervision. Commercial banks have repeatedly complained about the cost of regulation and supervision, but have nonetheless conceded that effective consolidated supervision has also brought them advantages, principally better assessment of financial risk and greater systemic stability.

Consolidated supervision provides clear advantages for both the supervisor and the bank⁽⁴⁾:

First, by requiring that all activities of international banking groups must be supervised, banks and financial institutions are less able to hide bad loans, high-risk activities or losses away in unsupervised subsidiaries or financial centers. Therefore, both banks and their depositors should be able to draw greater comfort from the fact that a banking group's activities in Frankfurt or New York are measured and supervised by a common method.

Second, equality of supervision requirements means that there is equality of burden when it comes to the costs of supervision. For example, if capital has the same definition in Frankfurt as it does in New York, then there is no regulatory reason for a bank to locate capital

(4) Consolidated supervision, and global supervision for global markets were among the issues discussed by the Deputy Director General of Banca D'Italia, Tommaso Padoa-Schioppa, in his speech on "Cooperation between Banking and Market Regulators" to the XXth Annual Conference of the International Organization of Securities Commissions (IOSCO), held in Paris, July 12, 1995.

in one center rather than another. A common definition of capital and common standards of supervision also have distinct advantages for the supervisor. He may take comfort from the fact that a banking group's activities are looked at in a consistent manner by his fellow supervisors, and therefore he has less reason to deny a foreign bank entry into the domestic market. Likewise, the domestic banks should have greater freedom to move into foreign banking centers because the foreign supervisors can rely upon the effectiveness of the supervision of the head office or holding company.

Third, effective supervision contributes to the stability of the global financial system. Banks are more robust and able to handle shocks. Supervisors have more clearly defined responsibilities and are better able to prevent the failure of a single bank leading to a systemic crisis. Perhaps the example of the collapse of Barings shows this most clearly, since the futures exchanges continued to function effectively, despite the failure of one of the major players.

This all sounds good in theory, but in practice there is still much work to be done by supervisors. As far as consolidated supervision is concerned, there are certain activities of banks, which have either escaped supervision, or are not supervised adequately. In particular, I refer to banks' trading activities in the securities, foreign exchange and interest rate markets, most of which is off-balance sheet.

Our problems with trading activities are twofold. First, they have mostly escaped an effective means of capital weighing since the introduction of the Capital Accord in 1988, and so regulators and counterparties alike have not always had a full picture of a bank's risk profile in certain specialized activities. Second, the traditional financial information package of balance sheet and profit and loss account is simply inadequate in presenting the true risk profile of a financial institution in the '90s, and in allowing market participants to judge the overall risk of their financial institutions.

According to BIS figures, the notional principal in exchange traded derivatives outstanding at the end of 1994 was around US\$ 8.8 trillion. Roughly the same notional principal was outstanding at the same time in over-the-counter derivatives. However, by definition, the values at risk associated with these products, both in name and presentation, were restricted to a few voluntary paragraphs in the notes to the annual reports for many banks. This lack of transparency can lead to banks backing away from troubled institutions in time of stress, according to the Promisel Report issued by the BIS. In extreme cases, rumors alone may bring about bank failures in the future, unless there are greater disclosure and supervisory requirements for trading activities⁽⁵⁾.

I am pleased to see that the Basle Committee has pushed for standardization of both supervisory and published financial information concerning derivatives activities. I hope the November 1995 report by the Basle Committee and the International Organization of Securities Commissions (IOSCO) will provide the benchmark for such disclosure in the future, and that the banks themselves and their auditors will seek to provide the greater transparency required to avoid a repeat of the losses of confidence in certain counterparties which occurred in early 1994, following the US\$ interest rate movements.

If you recall, at this time (early 1994) certain hedge fund managers were forced by market conditions to make press statements concerning their losses, the value at risk of their portfolios and their solvency. This was clearly unsatisfactory and, hopefully, should provide the necessary impetus to the market to establish an international standard of transparency in the presentation of the off-balance sheet risk.

(5) The Chairman of the Board of Governors of the US Federal Reserve System, Alan Greenspan, elaborated on issues related to risk measurement and systemic risk at a "Research Conference on Risk Measurement and Systemic Risk", held in Washington, November 16, 1995.

The capital requirements of the amendment to the Basle Capital Accord released in January 1996 to cover market risks should complement the voluntary disclosure requirements and contribute to establishing a uniform cross-border framework for capital adequacy standards for market risk that would apply to all internationally active banks. I believe the failure of Barings not only highlighted the shortcomings of existing disclosure and supervision requirements of trading activities, but also demonstrated that the derivatives markets had become more robust since the early '90s.

This new robustness is due in part to the improvements in payment and settlement systems since the publication of the Lamfallussy and Noel Reports by the BIS in 1990 and 1993 respectively. This takes me to the area of the **settlement and payment systems**, which have not enjoyed as much attention from banking supervisors as the banks and financial institutions that use them. However, in view of the increasing volume of business handled by these systems, one has to ensure that the systems themselves are fundamentally sound. After all, central banks have an interest in limiting the level of systemic risk in the banking system.

The Lamfallussy Report established, for the first time, minimum standards for netting schemes for central banks to use in their role of securing the stability of the financial system. We have seen, in the USA and the EU in particular, structural changes in the domestic payment and settlement systems. Multilateral netting systems, such as those for futures exchanges, have continued to function well in times of stress. Domestic interbank systems have been updated and improved as the volume of international payments has expanded dramatically in recent years.

The Noel Report considered ways and means to reduce risk and increase efficiency in the settlement of cross-border interbank transactions. However, there is still much work to be done in this area, principally because the duration of settlement risk remains a fixed feature, as long as domestic banking systems continue not having 24-hour real time settlement capability. There is, as recently noted by Mr. Brian Quinn of

the Bank of England⁽⁶⁾, a need to consider whether there should be mandatory common minimum international standards for the payment and settlement systems used by internationally active firms. This should be a logical expansion to the minimum standards put forward in the Lamfallussy Report for netting schemes.

Central banks in developing or transitional countries need to monitor the development of any domestic netting, payment or settlement systems against the minimum standards suggested by the Lamfallussy Report, and where necessary should contact other central banks before setting up cross-border or multi-currency systems. Such contact among central banks is vital since central banks are the lenders of last resort, and would therefore be involved in clearing up any failure in the settlement or payment systems.

Last January 1996, Bundesbank President Hans Tietmeyer, the Chairman of the G10 Central Bank Governors' Committee, indicated at the BIS that the Committee had endorsed a strategy, drafted by the Committee on Payment and Settlement Systems, to avoid and reduce potential risk in the field of settlement on the foreign exchange market. I am sure that central bankers are receiving this strategy with appreciation, especially the fact that the G10 will continue to monitor the implementation of the strategy over the next two years.

Now, let us shift to the third area, which is the subject of contact and **communication** among supervisors. Without communication, there is no such thing as cooperation. One of the most commonly observed phenomena in bank failures is a perceived lack of openness and communication on certain points among the supervisors themselves. There are many reasons for this lack of communication. Confidentiality constraints is one. In many countries, the banking supervisor is legally constrained from discussing with third parties bank-related matters,

(6) Speaking at a symposium on "Risk Reduction in Payments, Clearance and Settlement Systems" held in New York on January 25, 1996, his speech was on "The Role of Supervision and International Coordination".

which have come to his attention. This situation is gradually being corrected through legislative and other measures, which I will mention in a moment. Others have pointed to certain supervisors being wary of each other's need for the information that is necessary for the supervisor to carry out prudent consolidated supervision, due to competitive pressures among rival financial centers.

I believe, however, that the real reason why supervisors have not always communicated effectively with each other is more simple. It is because in the past they didn't think they needed to. A banking problem was often perceived as purely domestic, without any other consequences. Overseas activities were out of sight and out of mind. If something went wrong in an overseas branch, it was regarded as a local problem, which would not involve the parent bank. However, the experience of the last few years has shown that supervisors do need to communicate with each other on a routine and not just on an exceptional basis, because of the high risk activities that are increasingly taking place away from the domestic bases of banks.

I think central banks have appreciated the usefulness of concerted action in times of crisis for currencies, but not so much in banking supervision. This is changing. Supervisors are beginning to formalize information exchange arrangements through the establishment of memoranda of understanding or common legislation, such as the second consolidated supervision directive in the EU. This cooperation should have important benefits for banks, preventing needless duplication of reporting on the one hand, and ensuring a clear identification of supervisory responsibility among supervisors on the other.

The Basle Committee has been the major driving force in establishing communication lines among not only banking supervisors, but with other financial regulators, such as securities or insurance regulators, as the forces of deregulation have blurred the dividing lines between banks and other financial institutions.

I expect further growth in the importance of supranational organizations, as banks, payment systems and currencies become less tied to individual countries. However, there is the recurring problem of nationalism and self-interest, which may hinder the development of supranational or global supervision. I think this problem of self-interest, which is often politically motivated, has progressively increased in importance, ironically as trade and other national barriers appear to be breaking down.

As international interbank business in the G10 countries has quadrupled to over US\$ 5.7 trillion outstanding since 1983, so the number of bank employees has fallen. Technological developments have led to much basic work being automated. Disintermediation has led to a contraction in the number of banks and branches. This has led to calls for protectionism in certain countries, denying foreign banks the privilege of opening branches or having majority ownership of domestic banks. Such calls may be effective in the short term in preserving jobs or ensuring a tame and compliant domestic banking sector for monetary policy purposes.

However, such measures in the longer term usually result in the opposite of what was originally intended. The domestic banks protected by such barriers do not develop, and the country can become isolated and suffer capital loss as banking and finance activities become concentrated in centers with lower barriers to entry and freer controls on capital movements.

As I approach the conclusion of my remarks, I am left with the vexing question of what the international community can do in order to reap the full range of benefits accruing to the expanding process of financial globalization. This kind of question economists refer to as “normative economics”, that is, what ought to be done; and not as the “positive economics” of what is happening. It can imply different matters to different central bankers. This might explain the difference in opinion among those who are concerned with deeper and on-going central bank cooperation regarding the proper institutional

framework through which international financial cooperation can be identified, studied, implemented and monitored.

I think many of us would put our emphasis first, at this current stage of the international financial system, on efforts needed to solve the financial issues that have been impeding central bank cooperation in recent years. Although there are cogent reasons for giving priority to a new institutional framework, I am standing with those who advocate building and expanding on what we have achieved so far⁽⁷⁾. No one can deny the great progress achieved by the existing international financial institutions, such as the IMF, the World Bank, the BIS, and the IOSCO.

Now, let me turn to some specific proposed suggestions to strengthen the current situation:

First, the world's central banks need to re-think their approach to financial problems. National supervision, for example, will have to move towards an international basis. It is easy now for banks to place financial activities in LDCs, where the standard of supervision can be less stringent. On the level of the Central Bank of Kuwait, the Bank has instructed all Kuwaiti banks, as of December 1992, to comply with the Basle Capital Accord and maintain a minimum risk asset ratio of 8%. Tighter credit concentration regulations were issued in November 1993; these regulations, and other supervisory policies, very closely follow the guidelines set in 1991 by the Basle Committee.

Second, auditors need to establish global standards for derivatives, so that financial institutions can be assessed on a common basis. Banking and financial system units subject to Central Bank of Kuwait

(7) In the speech "Central Bank Cooperation in the Asian Region", delivered by Bernie Fraser, Governor of the Reserve Bank of Australia, to the 24th Conference of Economists, Adelaide, held on September 25, 1995, pointed out that a good case can be made for establishing a new institution to promote cooperation among central banks of the region (not a regional central bank).

supervision have been obliged to prepare their financial statements in conformity with international accounting standards, starting from the end of 1992, and we would recommend others to follow this practice.

Third, common definitions for national periodic statistics should be adopted with the use of standard forms. This would allow greater transparency, easier exchange of information and harmonized national rules. In cases of earlier warnings of emerging financial developments or major crises in any part of the world, it will then be easier to develop effective contingency plans to deal with the problem.

We are aware that the need for cooperation regarding this exchange of information would raise a question about the breaching of bank confidentiality, which is fundamental for building confidence in the banking business and for creating a stable banking environment. Thus, legislation that hinders the exchange of information should be reviewed with the aim of facilitating greater cooperation among financial institutions worldwide.

Fourth, it is well known that the G10 countries already meet at Basle to coordinate policies. With the development of global banking and collective responsibility for maintaining the safety and stability of the international financial system, it is now even more important that the countries outside the G10 be included, somehow, in the decision-making process. For these countries to be fully cooperative, they need to be involved in the decisions. Without their cooperation, any rules can be circumvented.

This call for wider participation raises one issue of special interest to the central banks and monetary authorities of the Gulf Cooperation Council countries (the GCC), regarding the “Country Risk Approach” adopted by the Basle Committee and involving a differentiation between two groups of countries. One group consists of members of the OECD and any country that has concluded special arrangements with the IMF, and the other group represents the rest of the world.

It is not my intention to discuss the pros and cons of this country classification method; rather, I am raising this issue as an example of the possible tasks which would require international cooperation to reach common ground. As a matter of fact, a proposal has come from within the GCC to establish a working group composed of **representatives** of major regional economic groupings from various parts of the world to work together with the Basle Committee to modify the country transfer risk approach, and present its results to a special conference. It was suggested that this proposed working group, as a fully international cooperative approach, would start its discussion on that subject with the use of these facts: the size of the country's quota and the Reserve Tranche at the IMF, the general financial position with the Fund, the general position of the country in SDR accounts, and the overall financial position of the country and its economic potentialities.

I understand that bilateral discussions are already taking place, but there is an increasing need for wider representation, so that a common policy is not only formulated but also accepted by all.

In closing, I hope that this Forum will fortify our hopes for more future international dialogue on cooperation among all the policy-makers and participants of the financial markets. As we can see, there is much to do during this decade's "interesting times".
