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INTERNATIONAL BANKING AND THE MANAGEMENT OF RISKS
The Lessons of the 1980s

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**COMPETITION AND RISKS IN FINANCIAL SERVICES:
THE LESSONS OF THE 1980s**

1. The changes in banking, financial innovation and the emergence of new kinds of risk

I shall take advantage of the privilege of being the first speaker of this session of the Colloquium to start with some general remarks on the subject of banking risk and the changes this has undergone in recent years.

The management of risk with the aim of earning profits while complying with the regulations in force is the very essence of banking. Bankers have always had to take decisions about the size and composition of their balance sheets, with particular reference to the risk/return features of assets. Traditionally, risk management involved both day-by-day assessment of customers' creditworthiness and strategic choices, which were conditioned to a varying extent by regulatory constraints on fund-raising and lending instruments as well as interest rates.

During the last three decades, however, the nature of the problems encountered has changed very rapidly. At the end of the fifties, with demand for bank credit still high and liquidity in short supply, banks ceased to be passive takers of deposits and began to compete actively for funds. A few years later, negotiable certificates of deposit were introduced. At the same time a market was created in Europe for funds denominated in US dollars. The absence of reserve requirements and interest rate restrictions contributed to its uninterrupted growth in the sixties and seventies. Participation in these markets varied from one country and from one bank to another, but the general tendency was to rely increasingly on funds obtained wholesale at terms negotiated directly on the market.

With liabilities management, the nature of liquidity underwent a basic change: it no longer depended only on banks having reserves but also reflected their access to the market. This diversification and reduced stability of deposits increased the likelihood of maturity mismatching, thereby aggravating liquidity risk and giving rise to interest rate risk. Consequently, to meet the demand for medium-term credit with funds raised at short term on financial markets, banks had growing recourse to roll-over credits, with the result that interest rate risk was eliminated or, rather, transferred to final borrowers.

Risk management therefore increasingly involved the management of a wide range of short-term assets and liabilities. The money-market function became much more important and complex with the advent of floating rates in the early part of the seventies. The growth of the international financial markets in the following years and banks' increasing participation, at a time of high and volatile interest rates and unstable exchange rates, resulted in the corresponding risks being a conspicuous feature of banks' balance sheets and stimulated a shift towards their formal and integrated management.

The diverse trends and events of the eighties make it particularly difficult to analyze their links and effects on the management of risk in international banking. Two developments were exerting a growing influence at the turn of the decade: the application of **EDP and telematics** and the **deregulation** of banking and financial markets. The reduction in the time and cost of processing and transmitting information and the steady easing of the structural rigidities in banking regulations were major factors in the **globalization** of markets and the increase in **competition**. The dangers inherent in market **volatility**, the third factor carried over from the past, were clearly revealed in the early eighties, when the sharp rise in short-term interest rates inflicted heavy losses on numerous banks in various countries.

Higher interest rates also exposed the vulnerability of the non-oil developing countries, which had borrowed hand over fist from banks during the seventies at floating rates. Indeed, some observers consider the outbreak of the international debt crisis in 1982 as a watershed. The declaration by major debtor countries that they were unable to honour their commitments and the consequent rescheduling agreements gave material force to a risk that had until then been considered as little more than hypothetical, and in any case not significant.

A huge mass of bank loans was suddenly turned into assets that, to all intents and purposes, were locked in. Banks had to match these with medium and long-term funds and make special provisions. In addition to the direct consequences of this freezing of assets, there were others of a more general nature. In particular, banks sought to offset the tying up of a part of their loan portfolios by making the rest of their balance sheets more flexible and finding non-capital-intensive sources of income.

These forces are at the heart of the process of financial innovation and explain its off-balance-sheet bias. It was the interaction between the application of technology, regulatory change, market volatility and external imbalances that stimulated the demand for and supply of innovatory

products. Individual operators sought to achieve two basic objectives with such products: to enhance their liquidity and to hedge off interest rate and exchange risk.

The first of these ends has been pursued through products permitting **securitization**, whereby banks transform the risk arising from the possession of a non-negotiable financial asset -- loans -- into that involved in placing a negotiable financial asset -- securities. Lending power is replaced by placing power. The success of instruments serving to redistribute interest rate and exchange risk is directly related to the extreme volatility of the prices of financial assets in both the short and the longer term.

Can financial innovation really modify risks or liquidity? In systemic terms the answer is obviously no, since neither the **risks** nor the **liquidity** of the economy as a whole can be modified by internal transfers. For individual operators, however, the answer may well be yes. What many of the recently-introduced financial instruments can do is to alter the distribution among intermediaries of risks and liquidity, both of which are important for stability. This is all the more true because the sophisticated nature of these new instruments makes it difficult to record the related

risks properly in intermediaries' information systems. Indeed, risks are often estimated on the basis of statistical series, a method whose shortcomings and dangers are obvious.

2. The relative importance of the various kinds of risk in the eighties

The spread of financial innovation and banks' active participation in the process have been accompanied by warnings of the danger of destabilizing repercussions. Attention has been drawn to the difficulty of correctly assessing the risk associated with new types of contract, which often involve insurance, in view of the lack of either practical experience of the problems or a satisfactory theoretical framework for analysis. It is widely accepted that risk assessment has also been complicated by the growing separation between final lenders and borrowers resulting from the proliferation of intermediate financial transactions, securitization and the disintermediation of banks. It has also been suggested that the availability of innovatory financial instruments may have contributed to the rise in the ratio of financial to real transactions and pushed up corporate gearing ratios -- developments that could prove destabilizing in a cyclical downturn.

These and other risk factors have been thoroughly analyzed in the voluminous literature on financial innovation. Indeed, if a systemic crisis is caused by the new market mechanisms created by innovation, the writing will have been on the wall. Nonetheless, while the possibility of such a crisis cannot be excluded, it appears only fair to note that banks and other financial intermediaries weathered last year's stock market crash with relatively small losses.

There are two aspects of the crash and its aftermath that I want to stress because of their bearing on the problems facing supervisors. Firstly, a new and as yet not fully understood development, the fact that prices fell almost simultaneously and by similar amounts on all the leading stock markets, despite the pronounced differences in economic and market conditions in the various countries. This can be seen as evidence of the strength of the integration of financial markets and of the dominance of financial over real factors. However, we still do not have a rational explanation of the rush to get out of stocks in every market, mainly into bonds and with little or no currency switching. It would be going too far to talk of panic, but there appears to have been a dangerous herd effect. The second point is that the resilience markets displayed probably owed more to the liquidity support provided by central banks than to any built-in stabilizing forces.

Even though the concern about the risks inherent in innovatory financial activities has not yet been followed by actual losses, there is no denying that international banking is passing through a phase marked by uncertainty and an increase in the number of failures. If one examines the losses incurred, one finds that they were directly related to traditional credit risk rather than to any of the new forms, although a part was also played by the radical change in condition in the banking market produced by internationalization and deregulation.

Both trends have resulted in banks and other intermediaries entering new and unfamiliar markets; they have also precipitated changes in competitive conditions. An additional indirect incentive to enter new markets has been provided by financial innovation, which to a large extent consists in the invention of contracts that are the result of unbundling and recombining features of existing financial instruments typical of the credit, insurance and capital markets. Accordingly, it has been a powerful force breaking down the barriers between the principal products, operators and markets, thereby undermining the justification for administrative segmentation and making operators' strategies more aggressively competitive.

With hindsight, it can be seen that even institutions with a record of prudent and conservative behaviour in their traditional habitats have often fared poorly in assessing risks in new markets. In trying to acquire a multinational status, banks have had to choose between the difficulty of penetrating foreign markets relying on their domestic organization and the risk of decentralizing decision-making to local units; cultural and information barriers have proved tougher obstacles than had been predicted.

The rush to lend to developing countries in the seventies is telling evidence of the risks associated with indiscriminate internationalization in response to competitive pressures. In turn, the plight of some savings and loans associations in the United States exemplifies the risks associated with deregulation.

One specific aspect of internationalization deserves special attention -- the creation of a unified European financial market. The process of integration is likely to be slower than expected by those who present 1993 as the start of a new era, but it will be much more far-reaching than what we have seen in international financial markets. The single market will comprise millions of consumers, affect the whole territorial network of banks and,

in contrast with the move to interstate banking in America, bring together a wide variety of banking systems.

Individual banks' development of retail activities in several countries will not only entail the risk assessment problems I mentioned earlier, but will also impose considerable standardization on banks that are currently marked by pronounced disparities in terms of size, range of operations and costs. Banks will have to reorganize on a massive scale, which will add to the costs and strains they face.

3. Responding to the "new financial world"

I am not implying, of course, that we should try to halt, or even reverse, the process of deregulation and internationalization, since it unquestionably can have a positive influence on economic efficiency. The lesson to be learnt is another, and of a dual nature.

Firstly, financial institutions must fully apply the principle of "self-responsibility". Managements must give top priority to ensuring that their organizations have effective systems for monitoring risk, with no gaps. Financial institutions cannot afford not to exercise integrated control over all the credit, market and operational risks they incur worldwide, and they will have to develop new instruments to cope with new risks as they emerge.

Secondly, I am convinced that the experience of the eighties reinforces rather than diminishes the need for financial markets to be regulated, but at the same time it shows that existing supervisory systems have to be overhauled and improved.

Allocative efficiency benefits significantly from both global financial integration and the highly competitive environment created by lower transaction costs, easier access to markets and faster transmission of information. Rent positions are eroded, the scope for risk diversification is increased and the social cost of intermediation is reduced.

It would nonetheless be wishful thinking to believe that credit and financial markets can achieve optimal solutions on their own. In particular, there is no denying the evidence undermining the claim that stock markets are efficient in pricing securities. Share prices sometimes diverge quite considerably from underlying asset values; speculative bubbles and bandwagon behaviour prevent prices from reaching equilibrium values; and credit intermediaries have not always found market forces to be a reliable guide to an efficient allocation of resources.

Furthermore, the restructuring that banking systems must undertake may prove to be extremely costly in terms of

the destruction of resources, especially when one considers the systemic risks inherent in financial intermediation and that the "natural selection" would take place in a market that is far from being atomistic. It would thus be foolhardy to entrust it entirely to market forces.

4. A strategy for banking supervision in Europe

4.1 With regard to innovation

The authorities are responding to the faster rate of change in the economic environment by speeding up the revision of prudential controls. While capital requirements were only adopted in the various supervisory systems over a period of several years, the preparation of instruments for dealing with market risks is proceeding apace and has been on an international footing from the start.

The capital ratios agreed in Basle by the G-10 countries already cover off-balance-sheet business, and therefore apply to most innovatory operations. Supervisory authorities are nonetheless convinced that the adequacy of capital should be assessed in relation not only to credit risk but also, and in some cases above all, to market risks, in particular position risk. In the immediate future, efforts will need to be concentrated on establishing appropriate ways

to measure such risks and agreeing suitable capital requirements.

The regulation of position risk will probably see the first serious efforts in the leading countries to coordinate the prudential controls on banks and other intermediaries, in this case securities firms. Recent events have clearly shown that shocks are propagated extremely fast in an integrated system; that the size to which some securities operators have grown means the problem of their control for the purpose of protecting system stability cannot be ignored; and that efforts to ensure uniform competitive conditions for the various categories of intermediary must be pursued.

There is increasing recognition of the desirability of some form of comprehensive regulation of financial intermediation, though the solutions proposed, or implemented, in various countries have so far differed widely in their attempts to reconcile the need to include all the most important activities while not making the system too rigid or extending the safety net provided for banks any more than necessary.

In Italy, new legislation is being proposed with the aim of extending prudential supervision to all intermediaries that grant credit, invest customers' savings or trade in or underwrite securities. It is planned to vary the

intensity of the controls according to the category of intermediary, depending basically on the extent to which the activity involves a delegation to make discretionary investment decisions on behalf of their customers.

4.2 With regard to internationalization

The internationalization of banking raises problems not only for the banks that decide to enter new markets, but also for the supervisors who have to assess and control the risks they incur.

The theory of optimal currency areas can provide the basis for a more general philosophy: when trade within an area increases, the effectiveness of public control over only a part of that area decreases, but can be restored by extending the control to the whole area.

We are faced with a similar situation with regard to banking and other forms of supervision. Banks are going international, and this is bound to result in some European banks doing only a small proportion of their business in their countries of origin. Consequently, responsibility for the stability of banks and the relevant information on markets and individual borrowers will increasingly be in the hands of different national supervisors.

If supervision is to remain effective in Europe, the authorities will have to cooperate more and more closely and some form of institutional coordination will have to be put in place. The problem is complicated by the existence alongside banks of numerous other financial intermediaries with their own systems of supervision, which are organized differently from one country to another and whose activities are bound to overlap in the case of financial conglomerates and intermediaries undertaking several activities.

Conclusions

The "new financial world" harbours risks that were previously unknown, or which existed, but in different or less threatening guises. The accelerated pace at which banking activity is being transformed by innovation, deregulation and internationalization is a cause for concern because the assessment of risk, which lies at the heart of banking, is necessarily based on knowledge and information that can only be acquired through long experience in a market.

While the new forms of financial contracts and the multi-currency nature of business almost certainly involve increased risks, actual losses in recent years have been concentrated in traditional lending operations. All three

factors of change thus appear to have had their greatest impact on risk-taking in an indirect fashion, by inducing banks to enter unfamiliar markets, where judgment errors are more likely, especially under competitive pressure.

This situation requires a two-pronged strategy, aimed at controlling the risks arising both from new operations and from traditional ones in new markets. This strategy should be adopted first and foremost by the intermediaries themselves by organizing their internal control systems to provide continuous and integrated monitoring and assessment of the risks to which they are exposed.

But supervisors -- and lawmakers -- are also faced with important and complex tasks. Relying on the self-stabilizing properties of financial markets is a dangerous illusion. Accepting that the market should be left to take care of inefficiencies through a selection of the fittest would have unbearable costs, when a fundamental restructuring of the banking system is on the horizon, as is the case in many European countries. Regulations will also have to be introduced to limit new risks, and supervisory authorities will need to be able to control the adequacy of capital to cope with them while seeking to create conditions that will encourage operators in their efforts to adapt.

Care will have to be taken to ensure that regulations do not result in some activities being protected and, more generally, that the playing field is acceptably level, especially as regards competition for securities business between banks and other intermediaries.

The systemic risks surfacing in some non-bank financial activities, the blurring of frontiers between intermediaries and the close integration of their activities call for a new and more comprehensive approach to supervision, which would eliminate dangerous gaps in prudential controls while avoiding a mechanical extension of the regulations applied to banks.

Finally, a new chapter in the international cooperation of control authorities needs to be written, especially in Europe, to cope with the danger of a widening rift between supervisory responsibility and the availability of the information required to exercise it, as a result of banks going international and supervisors remaining within their frontiers. This objective implies the need for a universally-recognized -- and therefore authoritative -- multilateral forum.