Commentary on “Financial stability and globalization: getting it right”

Guillermo Ortiz
Banco de México

Introduction

I would like to make comments along two lines. First, I will briefly describe the financial and economic reforms that have taken place during the last decade in Mexico, and which have succeeded in delivering macroeconomic stability.

Second, I would like to make some remarks on the challenges that financial globalization poses to host-country authorities. Almost everyone agrees on the gains derived from globalization and the benefits that foreign investment brings to recipient countries. The benefits are well described in Mishkin’s paper, along with a series of recommendations for success in the process of financial globalization. What not everyone recognizes, however, including Frederick in his paper, are some of the challenges that come along with the globalization of financial markets and institutions. Hence, I would like to briefly describe the challenges on five counts:

1. Competition in host-country financial markets
2. The soundness of local banks
3. Market discipline
4. The impacts of foreign regulations on domestic financial markets
5. The resolution of troubled global banks

Mexico’s reform effort

The depth of the Mexican 1995 banking crisis made it clear that the incentives faced by financial-system participants were not correctly aligned. The combination of financial deregulation, the unprecedented availability of resources for lending to

the private sector, the absence of a risk management culture combined with a lack of experienced bankers after years of government-run banks and a weak supervisory framework, resulted in severe problems in the banking system. The current account imbalances, fixed-exchange rate regime, and the instability that characterized the Mexican political scenario during 1994 became unsustainable at the end of that year. A sharp depreciation of the peso, high interest rates, and the fall in real disposable income sharply deteriorated borrowers' capacity to service their bank debts. Banks suffered on both sides of their balance sheets: Many debtors defaulted on their obligations, and depositors demanded higher interest rates to compensate for inflation risk. The consequence was the bankruptcy of many banks and a severe economic crisis.

As a result, in the last ten years, Mexico has undertaken a series of reforms along the lines suggested by Mishkin's paper. Strict fiscal and monetary discipline, the adoption of a freely floating exchange rate, and an inflation targeting framework have gradually brought a degree of macroeconomic stability not seen in Mexico in the last 30 years.

The public-sector deficit dropped to 0.3% of GDP in 2005. The strategies used to reduce inflation have succeeded in anchoring expectations towards the central bank target and in reducing annual inflation from 52% in 1995 to 3.2% in April 2006. Strict fiscal policies and the development of domestic capital and derivative markets has allowed the government the substitution of domestic for foreign debt which has reduced its foreign indebtedness from 19.3% of GDP in 1998 to 9.4% in 2005. Private banks are now offering fixed-rate mortgages with 10 and 20 years maturities, and the market for mortgage securitization is growing rapidly; all of this was unheard of in our financial system a little over a decade ago. These strong macroeconomic fundamentals have facilitated the Mexican economy´s ability to absorb foreign shocks and the current de-leveraging process taking place in emerging markets.

The importance of undertaking reforms aimed at improving legal and institutional infrastructure and aligning the incentives of the various participants is well described in Mishkin's paper. In this respect, we have improved lender property rights by enacting a new bankruptcy law and initiating legal reforms that help to expedite foreclosure on credit guarantees.

The institutional framework has been further enhanced by the enactment of new regulation on credit bureaus that helps reduce information asymmetries. The blanket guarantee of deposits, which helped to prevent a large run on deposits during the banking crisis but increased the costs of its resolution, has been gradually rolled back. Stricter rules on connected lending were established, and accounting and auditing standards have been aligned to international guidelines. Banks´ balance sheets were gradually improved, and the entry of foreign banks – which started with the signing of a trade agreement with the United States and Canada – fully materialized, contributing greatly to the recapitalization of the banking system.

We have also moved gradually to a more risk-based kind of regulation, in which the central bank has played an important role by requiring banks wishing to operate in derivatives markets to comply with modern risk measurement and management techniques. Supervisory practices have improved radically, and legislation on prompt corrective actions and bank resolution procedures has been introduced recently.

In 2002, the Mexican Congress enacted a payment system law in line with the BIS “Core Principles for Systemically Important Payment Systems.” This law ensures finality in all systemically important payment systems and gives legal certainty to the guarantees submitted. The law also grants power to Banco de México to regulate and supervise financial entities managing systemically important payment systems. In addition, Banco de México developed and now manages a large-value payment system which allows a bank’s customers to transfer resources, in almost real time, between bank accounts established at different banks.

Early this year, we asked the IMF and World Bank to conduct an update of the FSAP carried out in 2001. The FSAP has helped to identify some pending issues, such as a special bankruptcy chapter for banks in our general law, and the need to provide financial authorities with a sufficient level of autonomy and legal protection. In emerging market countries, where powerful elites can have undue influence in shaping policy and the regulatory agenda to their own benefit, strong and politically independent public agencies are much needed.

Let me now turn to the challenges that host-country authorities have to face with the globalization of financial markets and institutions, which I consider a necessary complement to Frederick’s agenda.

Competition

In order to acquire local depositors’ bases and gain access to profitable household sectors abroad, the main vehicle of expansion of cross-border global banks is through the acquisition of existing financial entities in target countries. This strategy allows global banks to offer credit cards, mortgage loans, and insurance products where profits are high. However, the acquisition of existing entities rather than the establishment of new ones leaves market structures largely unchanged. While improvements are tangible in the derivatives and money markets, efficiency gains in other sectors often result in higher profits to the exclusion of consumer benefits.

Banks´ efficiency improved notably in Mexico after the entry of foreign banks. Just to mention a figure, bank efficiency, measured as the ratio of operational costs to total income, decreased from 70% in 2000 to 53% in 2005. We are also witnessing lower prices and better conditions for mortgages. However, in other segments, such as credit cards and basic banking services, where banks face less competition, efficiency gains have translated only into higher profits. Interest

margins on a consumer loan are three times higher than on a corporate loan. Interest rates on credit cards are as high as 70% when annual inflation is close to 3%. Banks´ interest margins are much higher in Mexico than in the countries of origin the Mexican banks' shareholders, despite the fact that Mexican inflation, market volatility, and taxes are at levels very similar to those of the home-countries.

Benefits from globalization are not automatic, and in order to access them, measures should be taken to improve competition at the local market level. As in other areas, central banks can play the role of catalyst in improving competition in many emerging market economies.

The soundness of local banks

Subsidiaries are entities that are legally independent from parent banks and subject to different laws, regulations, and courts. However, global banks manage their subsidiaries as branches but keep their responsibilities limited to the invested capital.

The way in which global banks are managed could lead to many decisions that are good for the global bank but not necessarily positive for the subsidiary or host country.

1. There is a growing tendency to register transactions where funding and regulatory costs are lower. Although this makes sense from the global banks´ perspective, it shifts revenues away from the local bank where the business is originated.
2. Global banks also establish individual limits to credit exposure in each foreign country, according to the sensitivity of the overall portfolio. Thus, subsidiaries sometimes have to reduce their local exposures, even though these exposures are also financed locally.
3. Likewise, subsidiary banks invest in host-country sovereign debt according to capital risk weights which, having been set by parent banks and home-country authorities, are usually higher than those of the host country.
4. Global banks are also inclined to adopt matrix reporting arrangements by which local treasurers, comptrollers, and risk managers report directly to their parent bank's counterparts rather than to the local CEOs. Bank directors and managers usually are long-career employees of the parent bank. Holding them more responsible is not going to be enough.

These asymmetries between decision-making powers and economic rewards versus legal responsibilities are a matter of concern for host-country authorities when large local retail banks are involved.

One potential way to get local managers to look first to the subsidiaries' best interest could be to widen the ownership structure of large subsidiaries. Requiring minority shareholders to sit on subsidiaries' boards would encourage decision tak-

ing in the subsidiaries' best interest. It would benefit corporate governance and give meaning to the role of independent board members.

Why are widely held ownership structures considered to be highly important for global banks and not for systemically important local subsidiaries? The idea that subsidiaries automatically reap the benefits of belonging to a widely held parent bank ignores the legal separation between them.

Market discipline

The need to encourage market discipline to supplement the work of supervisors is widely recognized at the international level. Mishkin acknowledges that banks' disclosure requirements need to go beyond the simple publication of balance sheets and income statements. As he correctly states, this is because:

> "... financial institutions are able to take on more risk than many conventional businesses and because they are typically provided with a government safety net, ..."

Mishkin also proposes to hold bank directors and managers responsible for timely and accurate disclosure of a wide range of information. He also suggests requiring financial institutions to be rated and even mentions the possibility of requiring the issuance of subordinated debt. These suggestions are very positive.

For market discipline to work, market participants need signals – in the form of prices – which reflect market perceptions, as well as instruments to enforce discipline and research carried out by independent analysts. The latter play an important role in markets, since financial information is not always easy for the common investor to come by or understand.

The presence of minority shareholders would facilitate the listing on local stock exchanges of systemically important subsidiaries. A public listing would provide market participants with price signals and instruments to exercise discipline. It would also provide independent bank analysts with a customer base and give meaning to the third pillar of the Basel II regulations. As it stands, the third pillar is simply one of disclosure, not of market discipline.

Impacts of foreign regulations on domestic financial markets

Regulatory differences among home countries could have adverse impacts on host-country markets. All banks incorporated in a jurisdiction have to comply

with its laws and regulations. However, when a local bank is a subsidiary of a foreign bank, it also has to observe the guidelines put forth by its controlling shareholder and the regulations of the jurisdiction where its parent bank is incorporated.

In general, we would expect the stricter regulation to prevail. Nevertheless, subsidiaries have to consolidate their books with those of their parent banks. In fact, parent bank shareholders follow the consolidated balances, not the local ones. This means that the subsidiaries' business and trading decisions are taken with close regard toward their impacts on the parent banks' balance sheets. This situation can have important adverse effects on host-country markets.

For example, capital adequacy rules usually establish a zero risk weight on local sovereign claims denominated and funded in domestic currency. Nevertheless, the New Capital Accord establishes risk weights on sovereign claims based on ratings provided by external credit assessment institutions or by internal rating methodologies. Although the Accord gives national supervisors discretion to apply lower risk weights to their domestic banks, it is very likely that subsidiaries of foreign banks will apply the capital weights established by their parent banks and by their home countries. Should this happen, it will increase the financing cost of host countries' sovereign debt denominated and funded in domestic currency.

The resolution of a troubled global bank

Finally, I would like to talk about the conflicts of interest that may arise when a global bank runs into trouble. Global banks are comprised of a constellation of entities incorporated in different jurisdictions. The failure of a global bank could easily lead to conflicts among the various parties involved, as their interests will diverge considerably.

The conflicts between home and host-country authorities could be particularly significant if the relative sizes of the parent bank and its subsidiaries are substantially different. Home-country authorities will not be very keen on supporting subsidiaries overseas, even if they are relatively important for a host country. On the other hand, host-country authorities could find it politically impossible to use public resources to support a foreign-owned bank.

There is no common understanding on how to deal with or resolve the failure of global banks. The absence of a common jurisdiction and supranational legal courts complicates the potential attainment of reasonable and fair solutions. Therefore, it is very important to devote more efforts to devising ways to improve existing frameworks so that cooperation among supervisors and central banks is encouraged.

These frameworks should include full and equal access to relevant and timely information on both a subsidiary's and a parent bank's global position as well as each one's risks. Home-country authorities should not have informational advan-

tages over host regulators unless they are willing to accept more responsibilities in terms of the resolution processes.

We welcome the recent changes introduced to the Basel Core Principles with regard to information-sharing arrangements between home and host-country supervisors. A major step forward is the recognition of the need of host-country authorities to have prompt access to all relevant information about their subsidiaries' parent banks. However, home-country supervisors still retain some discretion as to which information is to be shared with host-country authorities, and also can decide when it is appropriate to inform their counterparts. Further progress should be made in this area in order to ensure that during a crisis, host-country supervisors´ access to all relevant information will not be limited by home-country supervisors´ criteria.

Final remarks

The relevant question is not whether globalization is good or bad, but how to benefit from it. In this respect, we cannot ignore the challenges that host-country authorities have to face, especially in places where systemically important banks are owned by foreign global banks. There are no simple solutions to these challenges. I firmly believe the best way to accommodate the conflicting interests that may arise when banks operate across different jurisdictions is to have in place the right incentives to get economic agents to look after the soundness of all financial institutions involved.