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December 15, 1988

To: Members of the Executive Board

From: The Acting Secretary

Subject: International Capital Markets - Developments and Prospects, 1988

There is attached for consideration by the Executive Directors a report on developments and prospects in the international capital markets, which is proposed to be scheduled for discussion at an Executive Board Seminar on Friday, January 6, 1989. The paper on International Banking Activity in the First Half of 1988 (SM/88/266, 12/7/88), together with a forthcoming further background material, will provide background information for the discussion.

As in previous years, it is planned that this report and the forthcoming background paper will form the basis for a publication in the Fund's World Economic and Financial Surveys Series. The revised text will reflect Executive Directors' comments and delete certain sensitive material.

Mr. Allen (ext. 8381) or Mr. Regling (ext. 7358) is available to answer technical or factual questions relating to this paper prior to the Board Seminar.

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INTERNATIONAL MONETARY FUND

International Capital Markets - Developments and Prospects, 1988

Prepared by the Exchange and Trade Relations Department

(In consultation with the Research Department)

Approved by L.A. Whittome

December 13, 1988

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I. Introduction

The 1988 report on international capital market developments has been prepared after a series of discussions with market participants and national authorities over recent months. 1/ After an overview, Section III of this paper considers broad trends in international capital markets, including the flow of finance from these markets to developing countries. Section IV looks at the challenges facing banks at the end of the 1980's, stemming from the gradual elimination of territorial and functional barriers to banking business, competitive market pressures, the responses as well as the requirements of the supervisory authorities, and the overhang of developing country debt. Finally, Section V considers the management of risk, by individual market participants and by national supervisory authorities in the banking and securities areas, and discusses the emerging consensus for enhanced international cooperation in this area. 2/

II. Overview

The international financial markets have shown themselves to be quite resilient over the last year, although there has been some reduction in activity. This reflected somewhat more settled market conditions, with market participants having generally higher expectations of stability in the main economic variables, partly because of some progress in reducing imbalances between major industrial countries; banks also showed restraint in acquiring more cross-border assets. Lending to developing countries has been negative in the first half of 1988, in contrast to the positive flow in 1987.

1/ A staff team, headed by Mr. M. Allen (ETR), and including at different times Messrs. D. Mathieson (RES), G.R. Kincaid (ETR), D. Folkerts-Landau (RES), K. Regling (ETR), L.M. Valdivieso (ETR), and A. de la Torre (ETR), together with representatives of area departments (ASD and WHD) and the Office in Europe held informal discussions with commercial banks, securities houses, stock and futures exchanges, regulatory and monetary authorities, and international organizations in Belgium, Canada, France, Germany, Hong Kong, Japan, the Netherlands, Switzerland, the United Kingdom, and the United States between May and November 1988. It should be noted that the term "country" as used in this document does not in all cases refer to a territorial entity which is a state as understood in international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

2/ Background documents for this discussion are "International Capital Markets--Developments and Prospects, 1988 - Background Information" forthcoming, "International Banking Activity in the First Half of 1988" (SM/88/266, 12/7/88), and "Recent Developments in Commercial Bank Financing and Restructuring for Developing Countries" (SM/88/172, 8/10/88).

The following broad themes emerge from the discussion in this paper which, in contrast to some previous years' papers, focuses on broader capital market developments, touching on the debt strategy only to a relatively minor extent. The debt strategy itself will be taken up in a separate paper before the next meeting of the Interim Committee.

The nature of international intermediation has changed since the 1970s, with the driving force now being the need to provide investors in surplus industrial countries with the sort of claims they want to acquire on borrowers in deficit industrial countries. The liberalization of capital markets and the spread of innovative techniques have increased the scope for matching investors' preferences and debtors' needs. However, developments over the last two years underline the importance of maintaining macroeconomic policies that generate market confidence, if the increased scope for intermediation through international capital markets is to facilitate the necessary transfer of funds, rather than to lead to sudden shifts in flows with adverse consequences for exchange and interest rate stability.

The regulatory requirements for higher capital bases, the recent and prospective erosion of geographical barriers to financial activity, and the growing integration of different kinds of financial business have led to considerable rethinking of corporate strategies by financial institutions throughout the world. Banks are paying particular attention to improving the structure of their balance sheets and their returns on assets, and are positioning themselves to take advantage of the newly emerging market opportunities, or to preserve existing niches from new competitors. The securities industry's inroads into banks' business with major corporate clients is leading many banks to reassess the potential of the retail and other markets, to attempt to capture more fee-generating business, and possibly to move into more risky and higher return lending activities.

In this environment, banks have taken steps to reduce their exposure to indebted developing countries, an action which has benefited their stock prices. The issue of the resolution of developing countries' debt problems is seen by most banks as of less relevance to their future than the repositioning on industrial countries' markets. While the interests of banks vis-à-vis developing countries are becoming ever more differentiated, many banks are recognizing the need for debt reduction in the solution of the debt problem. Some of the larger banks recognize too that there are some cases where the adjustment process and the ultimate value of their claims need to be supported by cash relief, although some of them stressed the need for such contributions to be backed with official guarantees, or for a penalty to be applied to nonparticipating banks.

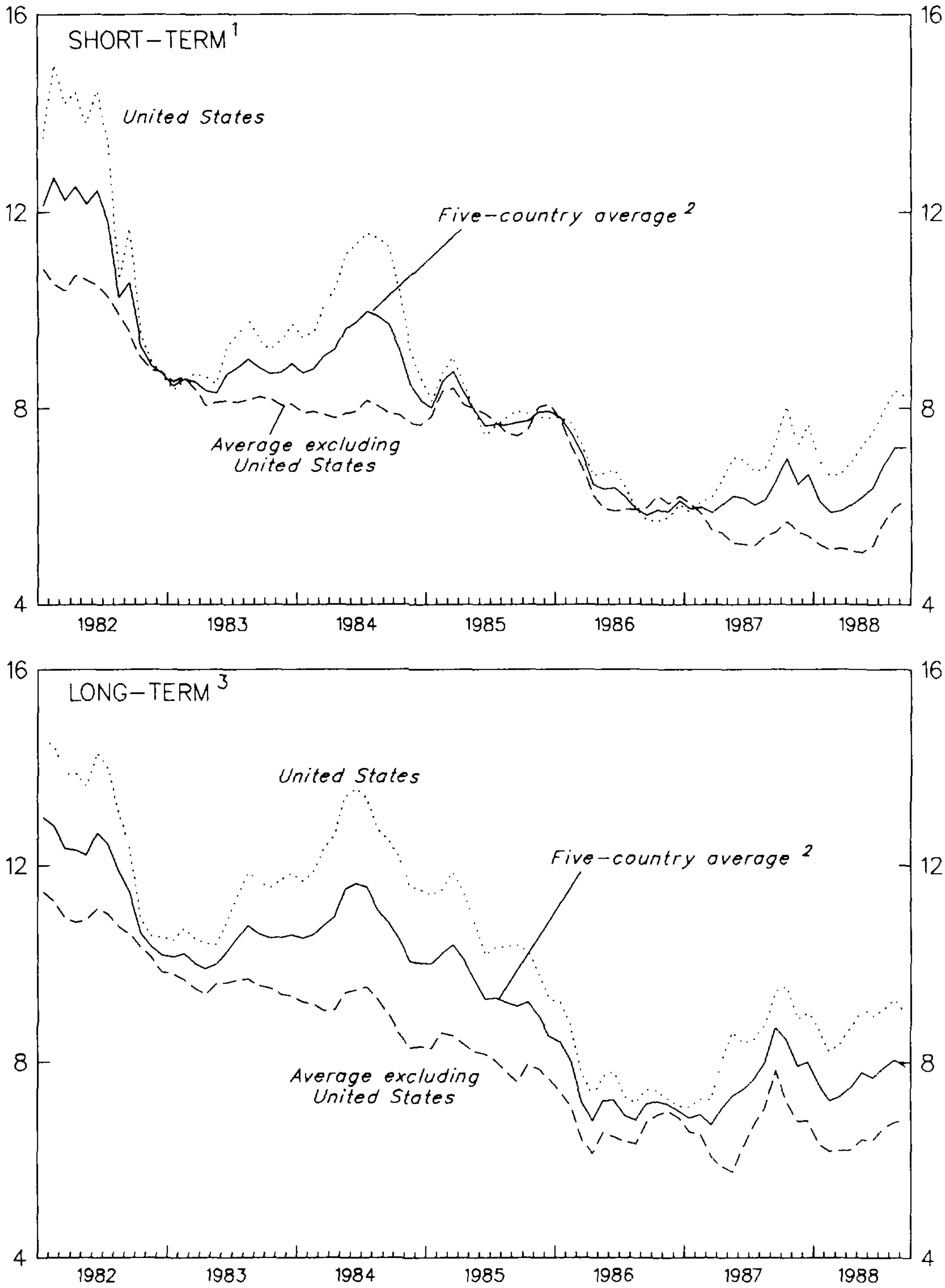
Financial liberalization, with the gradual erosion of barriers to cross-border flows and of distinctions between different kinds of financial intermediaries, together with technological change, have made the financial system more competitive. At the same time, the process has

CHART 1

FIVE MAJOR INDUSTRIAL COUNTRIES

NOMINAL INTEREST RATES, JANUARY 1982–SEPTEMBER 1988

(In percent)



Sources: International Monetary Fund, *World Economic Outlook;* and Fund staff estimates.

[1] *Monthly averages of daily rates on money market instruments of about 90 days' maturity.*

[2] France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States; using three–year moving average, GNP–based weights.

[3] Monthly averages of daily or weekly yields on government bonds, with maturities ranging from 7 years for Japan and 20 years for the United Kingdom and the United States.

involved changes in the nature, and possibly in the extent, of risk in the international financial system, with a pyramiding of financial transactions on a relatively small base of real transactions. As a result, authorities are reconsidering the scope of regulation of financial institutions and markets. The problem is to contain the risks in the expanding international financial system to manageable proportions, without losing the advantages of increased competition and without an excessive use of explicit or implicit guarantees that shift the burden of risk to the public sector.

III. Financial Market Trends

1. General

The major capital market trends evident in 1987 have been largely reversed in the first three quarters of 1988. The international securities markets, which were depressed during the second and third quarters of the year and suffered from the market break in October 1987, rebounded in 1988, with activity levels similar to those recorded prior to 1987. Activity in the international banking market during the first half of 1988, on the other hand, has been substantially below that recorded during the same period in 1987, although it has remained considerably above the levels of earlier years.

A number of factors underlie these developments, including macroeconomic factors, progressive liberalization, and significant market-specific events. On the macroeconomic side, the increase in current account imbalances among the major industrial countries in 1987 heightened uncertainties about exchange and interest rates, with investors concerned about a further fall in the U.S. dollar and rising interest rates (Table 1 and Chart 1). This led investors to avoid the relatively illiquid securities of the Eurobond market in favor of domestic bond markets and bank deposits, and to Eurobond investors' becoming reluctant to acquire U.S. dollar-denominated debt. This development was also reflected in a reduction in the share of private sector financing of the United States' current account deficit and increased official intervention in support of the dollar. The uncertainty about policies was a cause of, and was in turn exacerbated by, the stock market break of October 1987.

In the first three quarters of 1988, there has been a striking improvement in world trade and economic activity, a reduction in current account imbalances, and perception of greater exchange rate stability. Market participants have therefore felt less need to lay off foreign exchange exposure; the demand for U.S. dollar-denominated securities has increased; and the need for official intervention has declined. In response to the higher level of confidence in the stability of exchange rates, the Eurobond market has recovered faster than expected at the time of the market break. It remains to be seen, however, how permanent this shift in sentiment is, as external and internal imbalances in the

Table 1. Selected Economic Indicators, 1982-88

(In billions of U.S. dollars; or in percent)

	1982	1983	1984	1985	1986	1987	Est. 1988
Total of identified current account deficits 1/	176	158	196	200	250	244	241
Industrial countries	52	64	123	136	168	190	184
Of which:							
Seven major	27	51	110	121	146	170	162
Developing countries	124	94	72	64	82	54	57
Total of identified fiscal deficits for seven major industrial countries							
Central government	308	378	370	385	409	380	366
General government	262	288	244	256	303	263	255
Overall current account balances of developing countries 2/	-86.4	-63.1	-33.3	-24.3	-40.7	0.3	-17.6
Reserve accumulation of developing countries (accumulation +)	-39.6	3.8	14.5	18.2	4.1	56.1	14.9
Growth rate in value of world trade	-6.3	-1.9	6.1	0.9	9.6	16.4	12.6
Growth rate of real GNP of industrial countries	-0.3	2.8	5.0	3.3	2.7	3.3	3.9
Inflation rate of industrial countries (GNP deflators)	7.2	5.0	4.2	3.7	3.4	2.9	2.9
Interest rates (six-month Eurodollar deposit rate)	13.6	9.9	11.3	8.6	6.8	7.3	8.2

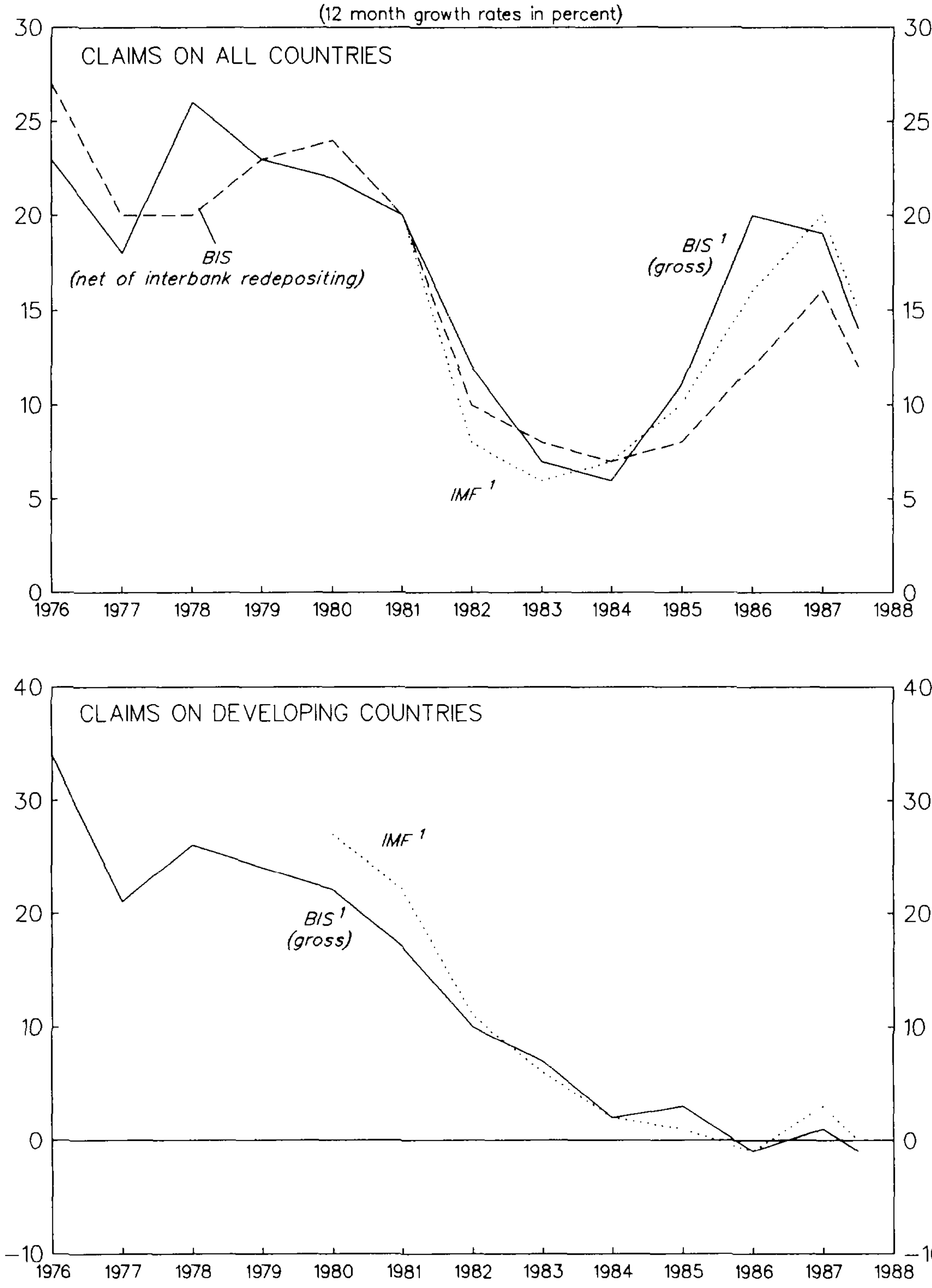
Sources: International Monetary Fund, World Economic Outlook, October 1988; and Fund staff estimates.

1/ Sum of all current account deficits, which includes official transfers.
2/ Sum of all current account deficits and surpluses, which includes official transfers.

CHART 2

GROWTH RATE OF INTERNATIONAL BANK CLAIMS, 1976–FIRST HALF 1988

(12 month growth rates in percent)



Sources: Bank for International Settlements, *International Banking* and *Annual Report;* International Monetary Fund, *International Banking Statistics, International Financial Statistics;* and Fund staff estimates.

[1] These data do not net out interbank redepositing.

major OECD countries remain large, and fears of an acceleration of inflation and of higher interest rates remain widespread. There may, in fact, be evidence in the most recent period of a renewed weakening of dollar-denominated issues, and higher levels of official financing of the U.S. current account deficit.

Activity in international capital markets has also continued to reflect the underlying trends towards liberalization of capital controls internationally and of restrictions on financial market activities domestically. This continues to further the integration of domestic and international capital markets and to bring about increased volumes of activity as participants operate on a more international basis and as investors' portfolios are increasingly spread across markets.

Finally, the markets were influenced by a number of more specific events. The collapse of the perpetual floating rate note market at the end of 1986, and the resulting concern of investors about the liquidity of instruments, contributed to the depression of the bond market during 1987. Fears were also heightened by the October 1987 market break, which led for a few months to a virtual halt of new issues of equity-linked bonds, and a generally increased awareness of the risks inherent in the markets. Also, the movement to higher capital adequacy standards that culminated in the agreement of the Basle Committee of Bank Supervisors in July 1988 has made banks more cautious about building up their on and off balance sheet assets, and this may have exerted a depressing effect on the growth of international banking activity in 1988.

International bank claims increased by 22 percent in 1987, at about the same rate as in 1986, as capital flows continued to be spurred by the impact of widespread relaxation of capital controls and restrictions on financial activities (Table 2 and Chart 2). 1/ Innovations in international banking continued to facilitate and encourage an increase in interbank cross-border flows; interbank lending accounted for 85 percent of total cross-border bank lending to industrialized countries. 2/ Particularly important in this regard was the establishment of the Japanese offshore market in December 1986.

International banking activity slowed considerably during the first half of 1988, with lending to industrialized countries down by 21 percent and deposit-taking by 46 percent compared to the levels recorded during the same period of 1987 (Table 3). The slowdown in deposit-

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1/ The liberalization is discussed in some detail in SM/87/194, 8/5/87, and SM/87/246, 10/22/87.

2/ The interpretation of interbank statistics has become more difficult due to a sharp growth in the discrepancies between the global totals of external interbank assets and liabilities. See the latest quarterly report on "International Banking Activity in the First Half of 1988" (SM/88/266, 12/7/88).

Table 2. International Lending, 1981-First Half 1988

(In billions of U.S. dollars; or in percent)

	1981	1982	1983	1984	1985	1986	1987	First Half 1987	First Half 1988
International lending through banks and bond markets									
Total 1/, 2/									
IMF-based	433	235	196	244	353	613	857	391	276
BIS-based (gross) 3/	294	230	152	186	311	604	674	303	209
BIS-based (net of redepositing) 3/	194	144	131	152	182	267	341	187	142
Bond issues (net) 4/	29	49	46	62	77	87	56	37	47
Bank lending 1/, 2/									
IMF-based	404	186	150	182	276	526	801	354	229
Growth rate	20	8	6	7	10	16	20	...	...
BIS-based (gross)	265	181	106	124	234	517	618	266	162
Growth rate	20	12	7	6	11	20	19	...	...
BIS-based (net of redepositing)	165	95	85	90	105	180	285	150	95
Growth rate	*20*	*10*	*8*	*7*	*8*	*12*	*16*	...	...
International lending to industrial countries									
Total									
IMF-based	244	162	132	178	271	494	604	290	246
BIS-based (gross) 3/	221	180	106	147	248	482	509	237	182
BIS-based (net) 3/	121	94	85	113	119	145	176	121	115
Bond issues (net) 4/	22	39	36	51	63	77	48	32	41
Bank lending 1/									
IMF-based	222	123	96	127	208	417	556	258	205
Growth rate	18	9	6	8	13	21	22	...	...
BIS-based (gross)	199	141	70	96	185	405	461	205	141
Growth rate	15	9	4	5	9	16	14	...	...
BIS-based (net)	99	55	49	62	56	68	128	89	74
Growth rate	12	6	5	5	4	5	7	...	...
International lending to developing countries 5/									
Total									
IMF-based	89	54	35	17	10	-1	20	8	-9
BIS-based 3/	55	37	28	15	18	-1	7	6	-7
Bond issues (net) 3/, 4/	2	3	2	3	4	2	2	1	2
Bank lending 1/									
IMF-based	87	51	33	14	6	-3	18	7	-11
Growth rate	22	11	6	2	1	-1	3	...	...
BIS-based	53	34	26	12	14	-3	5	5	-9
Growth rate	17	10	7	2	3	-1	1	...	...
Memorandum items									
Total gross bond issues	52	76	77	110	168	227	181	102	119
Of which:									
Industrial countries	39	60	60	91	137	201	155	89	102
Developing countries 5/	4	5	3	5	9	5	5	2	4

Sources: Bank for International Settlements (BIS); Organization for Economic Cooperation and Development; International Monetary Fund, International Financial Statistics; and Fund staff estimates.

1/ IMF-based data on cross-border lending by banks are derived from the Fund's international banking statistics (IBS) (cross-border interbank accounts by residence of borrowing bank plus international bank credits to nonbanks by residence of borrower), excluding changes attributed to exchange rate movements. BIS-based data are derived from quarterly statistics contained in the BIS's International Banking Developments; the figures shown are adjusted for the effects of exchange rate movements. Differences between the IMF data and the BIS data are mainly accounted for by the different coverages. The BIS data are derived from geographical analyses provided by banks in the BIS reporting area. The IMF data derive cross-border interbank positions from the regular money and banking data supplied by member countries, while the IMF analysis of transactions with nonbanks is based on data from geographical breakdowns provided by the BIS reporting countries and additional banking centers. Neither the IBS nor the BIS series are fully comparable over time because of expansion of coverage.

2/ Total lending includes offshore centers, international organizations, and other non-Fund members as well as industrial and developing countries.

3/ Estimates based on BIS and OECD data.

4/ Net of redemption and repurchases, and of double counting, that is, bonds taken up by the reporting banks to the extent that they are included in the banking statistics as claims on nonresidents and bonds issued by the reporting banks mainly for underpinning their international lending activity.

5/ Excludes the seven offshore centers (The Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore.

Table 3. Bank Lending and Deposit Taking, Total Cross-Border Flows, 1982-First Half 1988 1/

(In billions of U.S. dollars)

	1982	1983	1984	1985	1986	1987	First Half 1987	First Half 1988
Total lending 2/	186	150	182	276	526	801	354	229
Industrial countries	123	96	127	208	417	556	258	205
Of which:								
United States	61	40	36	55	94	110	27	21
Japan	...	10	20	40	154	223	111	97
Developing countries 3/	51	33	14	6	-3	18	7	-11
Offshore centers 4/	25	12	28	28	86	168	64	34
Other transactors 5/	-1	8	6	11	-7	20	8	9
Unallocated (nonbanks) 6/	-12	1	7	23	33	38	17	-8
Memorandum items								
Capital importing developing countries 3/, 7/	...	29	15	8	-2	17	6	-12
Non-oil developing countries 3/, 8/	41	26	16	5	-2	18	6	-13
Fifteen heavily indebted countries	...	11	5	-3	-2	2	2	-9
Total deposit taking 9/	188	178	184	300	596	744	310	169
Industrial countries	150	96	113	194	432	493	224	122
Of which:								
United States	107	35	7	22	82	56	5	5
Japan	...	15	12	42	114	148	64	67
Developing countries 3/	4	23	23	24	-1	-48	29	18
Offshore centers 4/	25	34	24	46	130	142	44	39
Other transactors 5/	4	10	2	9	-7	17	4	3
Unallocated (nonbanks) 6/	6	15	22	28	42	44	9	-11
Memorandum items								
Capital importing developing countries 3/, 7/	...	29	25	21	12	36	21	12
Non-oil developing countries 3/, 8/	17	29	22	18	22	36	23	12
Fifteen heavily indebted countries	...	13	15	5	-5	9	4	3
Change in total net claims 10/	-2	-28	-2	-25	-70	58	44	59
Industrial countries	-26	--	14	13	-15	64	34	83
Of which:								
United States	-46	5	29	32	11	54	22	16
Japan	...	-5	8	-2	40	76	47	30
Developing countries 3/	47	10	-9	-17	-2	-29	-22	-28
Offshore centers 4/	--	-22	5	-17	-45	26	20	-5
Other transactors 5/	-5	-2	4	2	1	3	4	7
Unallocated (nonbanks)	-18	-14	-15	-5	-9	-5	8	3
Memorandum items								
Capital importing developing countries 3/, 7/	...	--	-10	-13	-11	-18	-15	-24
Non-oil developing countries 3/, 8/	24	-2	-6	-13	-18	-18	-17	-24
Fifteen heavily indebted countries	...	-1	-9	-8	3	-7	-2	-12

Sources: International Monetary Fund, International Financial Statistics (IFS); and Fund staff estimates.

1/ Data on lending and deposit taking are derived from stock data on the reporting countries' liabilities and assets, excluding changes attributed to exchange rate movements.

2/ As measured by differences in the outstanding liabilities of borrowing countries defined as cross-border interbank accounts by residence of borrowing bank plus international bank credits to nonbanks by residence of borrower.

3/ Excluding offshore centers.

4/ Consisting of The Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore.

5/ Transactors included in IFS measures for the world, to enhance global symmetry, but excluded from IFS measures for "All Countries." The data comprise changes in identified cross-border bank accounts of centrally planned economies (excluding Fund members), and of international organizations.

6/ Calculated as the difference between the amount that countries report as their banks' positions with nonresident nonbanks in their monetary statistics and the amounts that banks in major financial centers report as their positions with nonbanks in each country.

7/ Consisting of all developing countries except the eight Middle Eastern oil exporters (the Islamic Republic of Iran, Iraq, Kuwait, the Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) for which external debt statistics are not available or are small in relation to external assets.

8/ Consisting of all developing countries except the eight Middle Eastern oil exporters (listed in footnote 7 above), Algeria, Indonesia, Nigeria, and Venezuela.

9/ As measured by differences in the outstanding assets of depositing countries, defined as cross-border interbank accounts by residence of lending bank plus international bank deposits of nonbanks by residence of depositor.

10/ Lending to, minus deposit taking from.

taking from nonbanks reflects the strong revival of the bond markets as a major source of international financial intermediation, particularly for sovereign borrowers and first-class names. Much of the decline in bank activity is accounted for by reduced cross-border lending and deposit-taking by banks in European countries.

As far as the market for syndicated credits is concerned, the high level of activity registered since the beginning of 1987 has been maintained. A major factor has been the continued large demand for credits associated with mergers, acquisitions, and leveraged buyouts. Moreover the syndicated credit market remains an attractive source of financing for second-tier borrowers who have found it more difficult to raise funds in the Eurobond market since last year's shakeout.

Despite its large current account surplus, Japan remains a considerable net borrower from foreign banks, although on a smaller scale than in 1987. Net banking flows to Japan, which almost doubled in 1987, declined by about one third during the first half of 1988 compared to the same period last year. 1/ The reversal was particularly pronounced for lending to the nonbank sector in Japan, which had been borrowing heavily abroad to finance purchases of international securities. As far as interbank lending is concerned, Japan now accounts for more than half of all lending to and deposit taking from industrial countries.

Net flows from foreign banks to the United States in the first half of 1988 compared to the same period last year declined by US$6 billion to US$16 billion, whereas Germany, which had provided US$18 billion to foreign banks on a net basis during the first half of 1987, borrowed net US$4 billion during the first six months of this year. The latter development was mainly due to net withdrawal of US$2.7 billion in interbank deposits during the first half of 1988 compared to a net increase of US$17 billion in such deposits during the first six months of 1987. These developments need to be seen in light of a large shift in portfolio investment in the opposite direction.

International bond markets recovered very strongly during the first three quarters of 1988 (Table 4 and Table 5). The gross issuance of straight fixed-rate bonds during the first three quarters of the year exceeded the issuance for 1987 as a whole, and the issuance of equity-related fixed-rate bonds are approaching the high levels reached prior to last year's stock market break. While scheduled amortization payments have continued to increase and early repayments remain substantial, net issuance during the first three quarters of 1988 was above the same period of last year. The share of dollar-denominated issues has increased significantly in 1988, although it remains well below the

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1/ For a discussion of the Japanese capital account, see Japanese Capital Flows--Factors Affecting Recent Developments (SM/88/55, Sup. 1, 3/9/88).

Table 4. Developments in International Bond Markets, 1982-Third Quarter 1988

	1982	1983	1984	1985	1986	1987	First Three Quarters 1987	First Three Quarters 1988
				(In billions of U.S. dollars)				
Total international bonds	76	77	110	168	227	181	149	172
Amortization	18	18	20	36	64	71	50	56
Net issues 1/	58	59	90	132	163	110	99	116
Bond purchases by banks	9	13	28	55	76	54	46	...
Net issues less bonds purchases by banks	49	46	62	77	87	56	53	...
Of which:								
Industrial countries	39	36	51	63	77	48	46	...
Developing countries	3	2	3	4	2	2	2	...
By category of borrower								
Industrial countries	60	60	91	137	200	155	129	150
Developing countries	5	3	5	10	5	5	4	5
Other (including international organizations)	11	14	13	21	21	21	16	16
				(In percent)				
By currency of denomination								
U.S. dollar	64	57	64	61	55	36	39	39
Deutsche mark	7	9	6	7	8	8	8	10
Swiss franc	15	18	12	9	10	13	13	12
Japanese yen	5	5	6	8	10	15	14	10
Other	9	11	12	15	17	27	28	29
				(In percent per annum)				
Interest rate developments								
Eurodollar deposits 2/	9.5	10.1	9.0	8.0	6.3	7.9	7.6	8.4
Dollar Eurobonds 3/	13.4	12.5	12.1	10.6	8.6	10.2	10.0	9.7
Deutsche mark international bonds 3/	8.2	8.4	7.4	6.9	6.6	6.5	7.0	6.4

Sources: Organization for Economic Cooperation and Development, Financial Statistics Monthly and Financial Market Trends; and Fund staff estimates.

1/ Gross issues less scheduled repayments and early redemption.
2/ Three-month deposits, at end of period.
3/ Bonds with remaining maturity of 7-15 years, at end of period.

Table 5 . Borrowing on International Markets by Major Instruments, 1984-Third Quarter 1988

(In percent)

	1984	1985	1986	1987	First Three Quarters 1987	First Three Quarters 1988
Fixed rate bonds	52	56	62	67	67	71
Floating rate notes 2/	34	35	22	7	5	9
Equity-related bonds	10	7	12	24	26	19
Other bonds 3/	4	2	4	2	2	1
Total	100	100	100	100	100	100

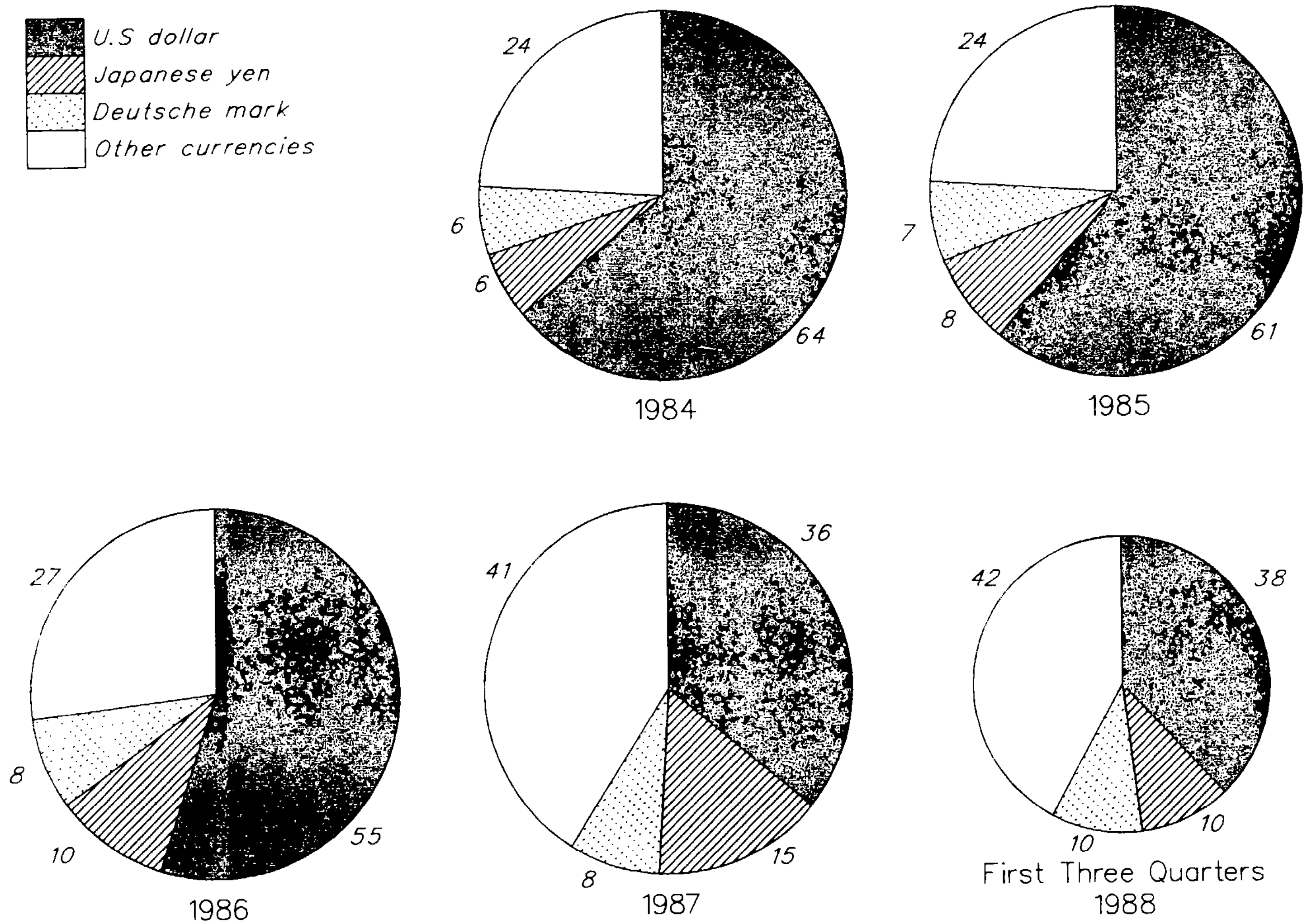
Source: Organization for Economic Cooperation and Development, Financial Market Trends.

1/ Data shown exclude merger-related stand-by agreements and renegotiations.
2/ Including medium-term floating rate certificates of deposit.
3/ Zero coupon bonds, deep discount bonds, special placements, and bond offerings not included elsewhere.

CHART 3

CURRENCY COMPOSITION OF INTERNATIONAL BOND ISSUES,[1] 1984–THIRD QUARTER 1988

(In percent)



Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.
[1]Based on exchange rates prevailing at time of bond issue.

levels prevailing prior to 1987 (Chart 3). Investors' expectations of higher interest rates have led to a revival of the market for floating rate notes, although the activity remains well below the levels observed in 1984-86, prior to the collapse of the perpetual note market.

It is noteworthy that the recovery in the issuance of fixed rate bonds in 1988 has taken place against a background of considerable uncertainty among investors about interest rate trends. Although the revival of the equity-related bond market was led by issues for Japanese companies, which benefited from the increase in stock market prices in Japan, it also showed the underlying strength of sentiment in the bond market, as prices on most equity markets remained below levels prevailing prior to October 1987.

2. Developing countries

Net repayments from developing countries 1/ to international banks, as measured by the Fund's International Banking Statistics (IBS), amounted to US$11 billion during the first half of 1988 following US$18 billion in lending in all of 1987. Bank lending has been mainly channeled to countries without debt servicing problems; US$9.0 billion of the total reduction in claims registered during the first half of 1988 was accounted for by the 15 heavily indebted countries (Table 6).

The IBS figures for bank lending are exchange rate adjusted changes in stocks of bank claims on developing countries. It has been argued that lending figures that are derived in such a way may give a misleading indication of actual cash flows between banks and developing countries because they include transactions that affect the banks' balance sheets without involving financing flows. For instance, loan sales to nonbanks and write-offs by banks reduce bank claims on developing countries without involving a cash repayment of principal by the debtor, while interest arrears that have been added to bank claims increase reported lending figures without voluntary lending decisions by banks or actual cash disbursements. Similarly, debt conversions, which have increased substantially in recent years, can reduce claims of banks on developing countries without a direct payment from a debtor to creditor banks. As the menu approach to the debt strategy has gained in importance, data based on exchange rate adjusted changes in stocks may not adequately reflect net cash flows from banks to developing countries, in particular flows to the 15 heavily indebted countries.

In light of this, the staff has attempted to adjust the exchange rate adjusted change in bank claims on the 15 heavily indebted countries for identified interest arrears included in bank claims, debt conversions and for net loan "write-offs" by banks. These and other adjustments, which provide only orders of magnitude because the required information is incomplete, are detailed in the accompanying background

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1/ Excluding offshore banking centers.

Table 6. Bank Lending to Developing Countries, 1983-First Half 1988 1/ 2/

(In billions of U.S. dollars; or in percent)

	1983	1984	1985	1986	1987	First Half 1987	First Half 1988
Developing countries	33.4	13.8	6.5	-3.0	18.4	6.9	-10.8
Growth rate	6	2	1	-1	3	1	-2
Africa	5.0	--	1.5	-2.0	-1.6	-0.7	-0.5
Of which:							
Algeria	0.2	0.1	1.8	1.0	-0.4	-0.2	0.3
Cote d'Ivoire	-0.1	-0.3	--	--	-0.1	--	-0.2
Morocco	0.3	0.1	0.1	--	--	0.1	-0.2
Nigeria	1.3	-0.4	-0.7	-0.2	-1.0	-0.3	-0.6
South Africa	3.0	-1.4	-0.3	-2.1	-0.1	-0.1	-0.3
Asia	8.9	8.0	6.8	5.0	14.7	4.6	-4.0
Of which:							
China	0.8	1.3	4.8	0.7	4.8	2.0	2.3
India	0.9	0.1	1.7	0.3	2.6	0.8	0.6
Indonesia	2.6	0.7	--	0.6	0.9	0.9	--
Korea	2.0	3.5	2.2	-2.3	-5.6	-3.6	-0.8
Malaysia	1.9	1.4	-1.4	-0.5	-1.9	-0.7	-0.9
Philippines	-1.3	0.1	-0.5	-0.1	0.1	0.1	-0.9
Taiwan, Province of China	-0.6	0.4	--	7.1	13.3	4.8	-4.6
Europe	0.7	1.4	1.9	-1.7	-0.4	-0.5	-0.6
Of which:							
Greece	1.3	1.2	1.2	-1.2	-0.9	-0.5	0.6
Hungary	0.9	0.2	2.3	2.0	0.9	0.6	0.3
Poland	--	--	-1.4	-0.9	-0.5	-0.3	-0.5
Portugal	--	-0.1	--	-1.9	-0.1	0.1	-0.8
Turkey	--	0.9	0.5	1.5	1.5	0.5	0.6
Yugoslavia	--	0.2	0.2	-0.9	-0.9	-0.6	--
Middle East	3.4	-0.9	-2.1	-2.4	0.9	1.1	1.2
Of which:							
Egypt	-0.7	0.6	-0.3	-0.1	-0.6	-0.1	-0.3
Israel	-0.3	-0.6	-0.8	-1.2	--	-0.2	-0.2
Western Hemisphere	15.2	5.4	-1.5	-1.9	4.7	2.4	-7.0
Of which:							
Argentina	2.3	-0.2	0.5	1.2	0.8	-0.4	0.5
Brazil	5.3	5.1	-2.9	--	3.9	1.7	-1.7
Chile	0.3	1.2	0.2	-1.0	-1.4	-0.7	-0.7
Colombia	0.6	0.1	--	0.4	-0.5	-0.2	0.3
Ecuador	0.2	-0.1	0.2	0.3	0.2	0.1	-0.1
Mexico	2.8	1.6	-0.8	-0.8	1.3	2.3	-5.1
Venezuela	-1.2	-2.2	0.5	-1.1	-0.3	-0.3	0.6
Memorandum items							
Fifteen heavily indebted countries	11.5	5.4	-3.4	-2.0	2.0	1.7	-9.0
Countries experiencing debt-servicing problems	8.1	6.3	-5.3	-8.2	0.3	0.6	-10.6
Countries without debt-servicing problems	25.3	7.5	11.8	5.2	18.1	6.3	-0.2
Gross concerted lending disbursements 3/	13.3	10.7	5.4	3.3	5.7	3.5	1.7
Total, BIS-based	26.4	11.6	14.4	-2.6	4.9	4.7	-9
Growth rate	7	2	3	-1	1	1	-1
Gross bond issues	3.1	5.0	9.2	4.9	4.9	2.4	3.9

Sources: Bank for International Settlements (BIS); Organization for Economic Cooperation and Development; International Monetary Fund, International Financial Statistics; and Fund staff estimates.

1/ IMF-based data on cross-border lending by banks are derived from the Fund's international banking statistics (IBS) (cross-border interbank accounts by residence of borrowing bank plus international bank credits to nonbanks by residence of borrower), excluding changes attributed to exchange rate movements. BIS-based data are derived from quarterly statistics contained in the BIS's International Banking Developments; the figures shown are adjusted for the effects of exchange rate movements. Differences between the IMF data and the BIS data are mainly accounted for by the different coverages. The BIS data are derived from geographical analyses provided by banks in the BIS reporting area. The IMF data derive cross-border interbank positions from the regular money and banking data supplied by member countries, while the IMF analysis of transactions with nonbanks is based on data from geographical breakdowns provided by the BIS reporting countries and additional banking centers. Neither the IBS series nor the BIS series are fully comparable over time because of expansion of coverage.

2/ Excluding the seven offshore centers (The Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore).

3/ Excluding bridge loans.

paper. Taking into account these adjustments, the estimated cash flow from banks to the 15 heavily indebted countries during the period 1985 to mid-1988 may have amounted to about US$7 billion, compared to a net repayment of US$12 billion measured by the exchange rate adjusted change in stocks as reported by IBS. The former number, however, should not be interpreted as the "contribution" of the banking system to the balance of payments needs of the 15 major debtors because banks were, in fact, partially repaid when debt was converted; and because bank lending of roughly $5 billion during this period was guaranteed by official export credit agencies and did therefore not represent an increase in banks' risk exposure to developing countries.

There was a significant increase in the financing obtained by developing countries through issuance of bonds, from US$3.9 billion during the first three quarters of 1987 to US$5.4 billion during the same period in 1988 (Table 7). This compares with a total issuance of bonds in 1987 of US$4.9 billion. However, among the developing countries with recent debt-servicing problems only Venezuela issued bonds for US$200 million in the international markets during the first three quarters of 1988; this was Venezuela's first issuance of bonds since the beginning of the debt crisis.

The decline in bank claims on the heavily indebted countries during the first half of 1988, even on an adjusted basis, was only partly explained by the decline in disbursements under concerted lending arrangements, which fell from US$3.5 billion in the first half of 1987 (reflecting the disbursement of US$3.5 billion to Mexico) to US$1.7 billion during the first half of 1988. Taking into account disbursements to Brazil and Yugoslavia in the second half of 1988, total disbursements under concerted lending arrangements during January-November 1988 reached US$5.95 billion, compared with the US$5.7 billion disbursed in 1987. New commitments under concerted lending arrangements amounted to US$5.7 billion during the first half of 1988, compared to US$2.4 billion for all of 1987, reflecting mostly an agreement in principle with Brazil in the amount of US$5.2 billion.

The process of restructuring commercial bank debt continued throughout 1987 and 1988. 1/ The average terms of reschedulings agreed in 1988 have continued their trend toward being more favorable to the debtor country, with average maturities now reaching 18 years, and spreads above LIBOR down to 13/16ths (Table 8). Among the interesting features of recent restructuring packages has been the increased use of exit bonds. These proved more acceptable to banks in the case of Brazil than they had earlier in Argentina, and a number of banks attributed this to the more attractive pricing of the former, at 6 percent compared

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1/ For a discussion of the features of rescheduling packages concluded in 1987 and 1988 see "Recent Developments in Commercial Bank Financing and Restructuring for Developing Countries," (SM/88/172, 8/10/88).

Table 7. International Bond Issues by Developing Countries, 1983-Third Quarter 1988 1/

(In millions of U.S. dollars)

	1983	1984	1985	1986	1987	First Three Quarters 1987	First Three Quarters 1988
Developing countries 2/	3,091.1	4,978.0	9,205.4	4,863.1	4,863.4	3,879.5	5,440.3
Capital importing developing countries 2/	3,091.1	4,703.0	9,180.4	4,863.1	4,863.4	3,879.5	5,440.3
Africa	592.5	1,013.9	1,322.5	125.6	49.2	—	363.6
Of which:							
Algeria	—	—	500.0	125.6	49.2	—	363.6
South Africa	532.5	1,013.9	802.2	—	—	—	—
Asia	2,171.1	2,951.0	6,005.4	2,915.4	2,410.7	1,925.1	2,155.2
Of which:							
China	20.5	81.7	972.8	1,362.1	1,415.1	1,129.2	642.2
India	60.0	297.6	417.8	323.2	377.0	227.3	614.6
Indonesia	365.7	50.0	—	300.0	50.0	50.0	164.7
Korea	546.8	1,056.0	1,730.9	783.0	332.3	282.3	80.0
Malaysia	884.6	1,141.2	2,001.9	43.0	215.6	215.6	360.6
Philippines	—	—	—	—	—	—	—
Thailand	253.5	283.3	861.7	50.0	—	—	261.0
Europe	117.8	630.7	1,601.7	1,110.0	2,018.2	1,820.7	2,602.5
Of which:							
Greece	41.6	200.8	744.7	150.3	539.1	341.6	314.9
Hungary	—	40.5	447.1	290.5	554.6	554.6	539.5
Portugal	76.2	389.4	347.4	502.5	613.0	613.0	943.2
Turkey	—	—	62.5	166.7	311.5	311.5	804.9
Middle East	175.0	—	82.0	—	35.0	35.0	—
Of which:							
Egypt	40.0	—	60.0	—	—	—	—
Israel	135.0	—	22.0	—	35.0	35.0	—
Western Hemisphere	65.0	107.4	168.8	712.1	350.3	98.7	319.0
Of which:							
Argentina	—	—	—	—	195.0	—	—
Brazil	—	—	—	300.0	—	—	—
Chile	—	—	—	—	—	—	—
Colombia	15.0	—	—	39.0	50.0	50.0	—
Mexico	—	—	49.0	313.3	—	—	— 3/
Peru	—	—	—	—	—	—	—
Venezuela	—	—	—	—	—	—	200.0
Memorandum items:							
Offshore banking centers	153.8	285.6	383.3	568.7	228.0	228.0	274.5
Developing countries, including offshore banking centers	3,275.2	5,263.6	9,588.7	5,431.8	5,091.4	4,107.5	5,714.8

Source: Organization for Economic Cooperation and Development, Financial Statistics Monthly.

1/ Foreign bonds and Eurobonds.
2/ Excludes offshore banking centers.
3/ Excludes issue of collateralized Mexican bonds related to the Mexican debt exchange concluded in February 1988.

Table 8. Average Spreads on Bank Financial Packages for Developing Countries, 1983-November 1988

(In basis points over LIBOR)

	1983	1984	1985	1986	1987	Jan.-Nov. 1988
Spontaneous commitments 1/	80	71	71	61	48	56 2/
Concerted commitments 3/						
All	225	185	179	84	89	83
Three largest debtors 4/	225	186	...	81	88	81
Others	223	174	179	140	100	108
Restructuring of existing debt 3/						
All	193	131	138	95	80	83
Three largest debtors 4/	193	128	...	85	81	81
Others	195	136	138	140	80	88
Memorandum items:						
Difference between spreads						
Concerted/spontaneous	145	114	108	23	41	...
Restructuring/spontaneous	113	60	67	34	32	...
Concerted/restructuring	32	54	41	-11	9	--
Largest/others						
Concerted	2	12	...	-59	-12	-27
Restructurings	-2	-8	...	-55	1	-7

Sources: Organization for Economic Cooperation and Development, Financial Market Trends; and Fund staff estimates.

1/ Weighted average of nonconcerted bank commitments to "Other LDCs" and "Oil-exporters" as defined by the OECD.
2/ Third quarter 1988.
3/ Based on term sheets agreed in principle.
4/ Argentina, Brazil, and Mexico.

to 4 percent; more than 100 banks have subscribed to exit bonds for more than US$1 billion. Also attractive in the case of the Brazilian package were bonds permitting conversion into cruzado-denominated Brazilian Government debt at par. Two of the most noteworthy developments in the last 12 months were the agreement of Bolivia with its banks to buy back a portion of its bank debt using funds donated from official sources and Mexico's issue of a collateralized 20 year bond in exchange for part of its debt. 1/ Finally, the amendment of the Chilean restructuring agreement contained a number of innovative features, including the waiver by banks of some clauses in loan agreements in order to allow Chile to use some US$500 million of its excess copper earnings to buy back its own debt, to collateralize some of its borrowing, and to hedge its interest rate exposure on its external debt.

Banks have been making a considerable effort to reduce their overall exposure to developing countries with debt servicing problems. The rate of disposing of claims on developing countries seems to have accelerated during the first half of 1988. Over this period U.S. banks' exposure to all developing countries declined by US$8.1 billion after a decline of US$10 billion in all of 1987 (Table 9). This decline was particularly marked among the smaller and regional U.S. banks. Similar trends are evident in the rest of the world, with the possible exceptions of Germany and Japan.

The decline in claims on developing countries combined with a strengthening of banks' capital base has resulted in a marked improvement in the ratio of developing country debt to bank capital in all major banking systems, leaving banks much less exposed to the problems originating in this sector. While the position of U.S. money center banks has also strengthened considerably (Chart 4), their levels of exposure in relation to capital generally remain among the highest in the world, in part because the decline in the U.S. dollar since 1985 has reduced the ratio of claims on developing countries to bank capital in most other industrial countries. In general, most banks felt that their ability to deal with the problems that might originate from developing country debt had been strengthened significantly.

Although bank provisions against developing country exposure continued to increase in 1988, this increase was much smaller than in 1987. 2/ Japanese banks were permitted to raise their provisioning levels from 5 percent to 10 percent of exposure to troubled debtor countries, mandatory provisioning standards in Canada were raised from 35 to 45 percent, and some other countries also increased provisioning

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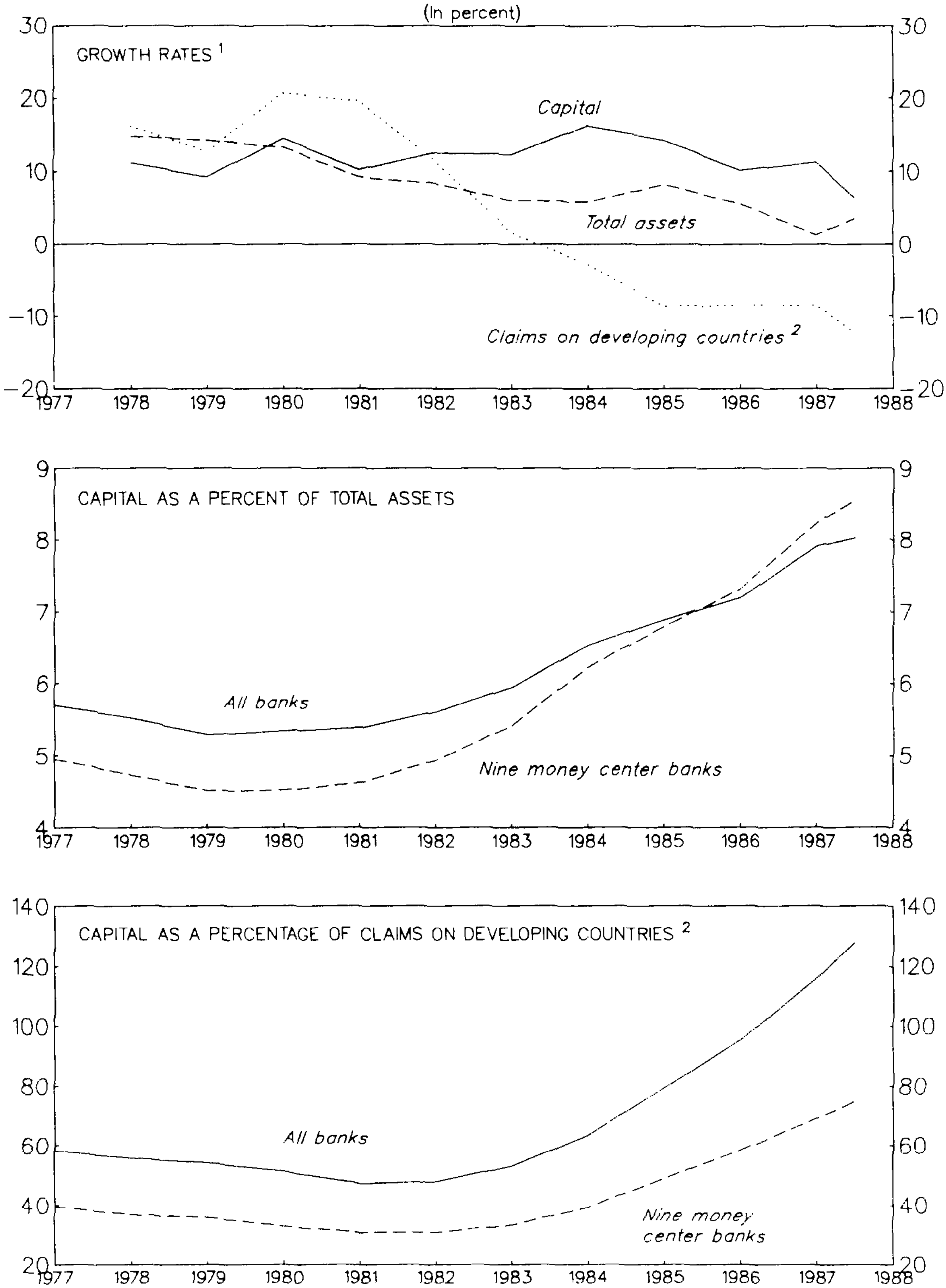
1/ These transactions were described in some detail in "Information Note on the Secondary Market, Mexican Debt Exchange and Bolivian Buyback" (EBS/88/98, 5/23/88).

2/ Developments in provisioning are discussed in the paper, "Recent Developments in Commercial Bank Financing and Restructuring for Developing Countries" (SM/88/172, 8/10/88).

CHART 4

SELECTED BALANCE SHEET DATA FOR U.S. BANKS, 1977–FIRST HALF 1988

(In percent)



Sources: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*.
1 Twelve month growth rates.
2 Excluding Offshore Centers.

Table 9. Assets and Capital of U.S. Banks, 1978-First Half 1988

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988 First half
					(In billions of U.S. dollars)						
External claims on developing countries 1/	81.5	91.9	110.9	132.6	147.7	150.0	145.6	133.1	121.8	111.5	103.4
Total assets	823.6	941.3	1,066.3	1,164.5	1,261.0	1,336.0	1,413.0	1,529.0	1,613.0	1,633.0	164.9
Capital	45.5	49.7	56.9	62.7	70.6	79.3	92.2	105.4	116.1	129.2	132.3
					(In percent)						
Memorandum items											
Capital to total assets	5.5	5.3	5.3	5.4	5.6	5.9	6.5	6.9	7.2	7.9	8.0
External claims on developing countries to total assets	9.9	9.8	10.4	11.4	11.7	11.2	10.3	8.7	7.6	6.8	6.3
Capital to external claims on developing countries	55.8	54.1	51.3	47.3	47.8	52.9	63.3	79.2	95.3	115.9	128.0

Sources: Federal Financial Institutions Examination Council, Country Exposure Lending Survey; and International Monetary Fund, International Financial Statistics.

1/ The data presented in this table are on an exposure basis; that is, they are adjusted for guarantees and other risk transfers.

levels. The provisioning levels of U.S., and even more Japanese, banks remain below those elsewhere in the world. In the case of Japan, this is accounted for partly by unfavorable tax treatment and partly by official indications to banks that their claims should be valued close to par. In the case of the United States, unfavorable tax treatment, combined with relatively low bank profitability, has probably contributed to the outcome.

Current provisioning levels in major banks, except for some German and Swiss banks, remain well below the discounts implied by the current secondary market prices for developing country debt, even before the sharp general decline in prices in this market, during the last few months of 1988. Between July and mid-November, the weighted average price for the debt of 15 heavily indebted countries declined by 10 percentage points, bringing the average prices for such claims to about 38 cents per dollar of face value (Chart 5). Particularly large declines were registered in the prices of claims on Venezuela (16 percentage points), Brazil and Ecuador (14 percentage points each). More moderate declines were registered for Colombia and Mexico (8 percentage points), Argentina (7 percentage points), and Chile (6 percentage points), while Uruguay (at about 60 percent of face value) and Yugoslavia (at about 46 percent) were among the few that resisted the downward trend.

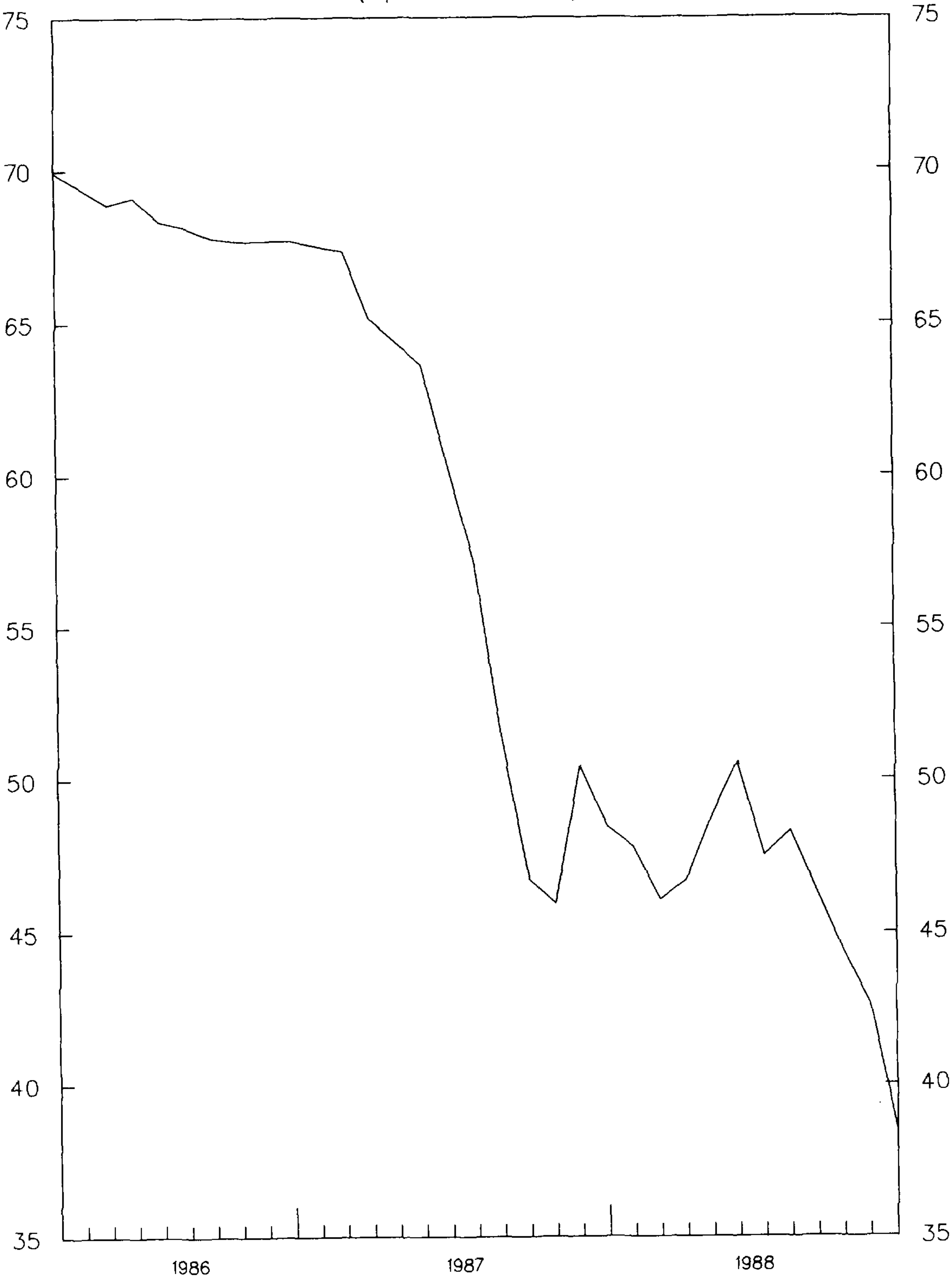
The recent across-the-board decline in secondary market prices for developing country debt may have been indicative of the market's tendency to respond sharply to changes in market perceptions. Whereas the sharp decline in prices in mid-1987 could be attributed to the combination of the introduction of a moratorium by Brazil and to Citibank's provisioning decision, it is less clear what has triggered the current decline. Possible factors include the reconsideration of aspects of debt/equity swap programs in Brazil and Mexico, the new money request of Argentina, and further exposure reductions by some U.S. regional and Canadian banks which preferred to incur the associated losses at a time when they received extra income from Brazil's clearance of arrears in the fourth quarter of 1988.

Market participants agreed that day-to-day movements in prices and transactions were fueled essentially by opportunities for debt/equity transactions. There remains little demand for developing country debt from the nonbank financial sector, and efforts to repackage developing country loans as marketable securities have so far been unsuccessful. It is estimated that the volume of underlying debt/equity demand in the first three quarters of 1988 was US$4.5 billion, in addition to the unofficial debt conversions that have occurred during this period. This represents an increase in the volume recorded in the whole of 1987. Reflecting this, total market turnover is estimated to have doubled from about US$10 billion in the first half of 1987 to US$20 billion in the first half of 1988.

CHART 5

SECONDARY MARKET PRICES FOR DEVELOPING COUNTRY LOANS[1]

(In percent of face value)



Source: Salomon Bros.
[1] Weighted average for 15 heavily-indebted countries.

Many transactions involve swaps of one form of debt for another, with the aim of accumulating a sufficient quantity of the right kind of debt to be eligible to participate in a given debt/equity swap arrangement. Demand for equity in developing countries by foreign investors may be limited by a number of factors. Some market participants noted that many corporations had left their subsidiaries in Latin America undercapitalized for some years and were now faced with the need to recapitalize them, which explained a good part of the current demand. Banks also stressed the need for countries to have appropriate privatization programs and a liberal attitude toward foreign investment.

Banks' attitudes toward the secondary market have evolved in the last year. As its size has increased considerably, banks in general seem more willing to recognize that the prices in this market contain a certain amount of information, and are prices at which some, if not all, of their claims could be theoretically liquidated. Banks have also become more aware of the possibilities that the secondary market offers them for reorganizing their portfolios. Several of the larger banks have accordingly reorganized their developing country debt operations to merge them with asset trading operations, with the aim of managing their developing country debt portfolios in a coordinated way. Such banks are actively seeking opportunities for reducing those portfolios through the secondary market and debt/equity swaps. This was not, however, the case for Japanese banks, which are generally not encouraged to utilize the secondary market on their own account.

IV. Challenges Facing Financial Institutions at the End of the 1980s

1. Introduction

Intensifying competition and changing regulatory requirements characterize today's banking environment. Competition has been fostered by the internationalization of financial markets, the liberalization of domestic capital and credit markets, technical advances in the data processing and communication area, and financial product innovation, particularly with the wider use of the securities markets to raise capital. For their part, regulators have responded to the changes in financial markets, albeit with a lag, with attempts to strike a balance between fostering competition, protecting investors and depositors, and safeguarding the stability of the financial system. In particular, regulators have both tightened supervisory and capital adequacy standards and taken further steps to liberalize the banking environment, especially through the gradual relaxation of geographic and functional restrictions on banking activities.

With increasing competitive pressures on traditional lines of business, requirements of supervisors in most countries for a stronger capital base, and opportunities for expansion and threats of takeover stemming from the dismantling of functional and geographic barriers, profitability has become the prime concern of banks. Securities houses, too, face similar challenges, and the events of October 1987 brought home the need for larger capital bases in this sector, which is in turn facilitated by higher profitability. Financial institutions thus need to achieve operational efficiency backed by strong balance sheets. In effect, a major restructuring is already underway, as evidenced, for instance, by the proliferation of closures, mergers, and acquisitions, substantial cuts in staffing, the selling of certain types of low-yielding assets, and the reduction or rationalization of LDC debt. Since the evidence of economies of scale in banking is mixed, this merger and acquisition activity appears mainly to be driven by the desire to acquire existing banks in newly opened markets rather than to establish new capacity from scratch.

For the years ahead, banks face a more vigorous competitive and more uncertain regulatory environment. As discussed in the sections below, increased competition can be expected as a consequence of forthcoming liberalization, particularly through the further breakdown of geographic barriers to financial activity within the United States, in North America as a whole, and in Europe. Similarly, the continuing pressures of securitization and the breakdown in barriers between different forms of financial activity are expected to continue. And as regulators allow the scope of the operations of financial institutions to expand, they will also need to safeguard certain public interests through more comprehensive supervision, the extension of appropriate capital adequacy standards beyond banks, and the development of common standards for other aspects of financial institutions' activities.

These challenges, concentrated in industrial countries' financial markets, are becoming more pressing at the same time that the LDC-debt problem is becoming more manageable from the banks' viewpoint. As a result, banks increasingly feel that their strategic plans must focus on industrial countries' capital markets and, at the same time, are showing a greater willingness to shed burdensome LDC debt.

2. Capital adequacy

The proposal of the Basle Committee of Bank Supervisors (the Cooke Committee), endorsed by the G-10 in July 1988, specifies minimum capital bases for international banks of 8 percent of risk-weighted assets and off-balance-sheet commitments, to be phased in over a five year period ending in 1992. 1/ These are minimum capital requirements and leave national authorities free to impose more stringent requirements. Other countries, including some OECD countries and major offshore banking centers, have indicated their intention to adhere to the Basle standards.

1/ See both Recent Developments in Commercial Bank Financing and Restructuring for Developing Countries (SM/88/172, 8/10/88), pp. 28-31, and the background paper to this document.

Initial indications are that most banks in most G-10 countries will be able to meet the 1992 standards, although not in general without taking certain actions (Table 10). In particular, major regional banks in the U.S., British clearing banks, and the major Swiss banks are already in rough conformity with the 1992 standards, and the transition for large German and Japanese banks is expected to be eased, inter alia, by large undisclosed reserves. By contrast, some significant balance sheet adjustments are expected to be required particularly in the case of some French, Italian, Belgian and several U.S. money center banks, as of various smaller banks elsewhere.

Bank strategies to meet the new capital standards will in part depend on the flexibility provided by the authorities during the transition period. In the United States, for instance, the Federal Reserve has attempted to ease the transition of relatively undercapitalized banks by utilizing the latitude contained in the standards to broaden the types of preferred share issues qualifying as core capital. By contrast, British authorities felt justified in advancing the deadline for compliance to June 1989. And in the case of Japan, the authorities are expected to provide a wide range of options for banks to raise core capital at home.

The reaction of banks to the generally higher capital standards is a combination of three responses: raising more capital, shedding or restructuring assets, and generating a higher return by improving margins. The first response, raising more capital, has already led banks all over the world to raise either primary or secondary capital. However, the ability of banks to raise new capital depends on the markets' assessment of a bank's prospects, and in this process, a rising share price both lowers the cost of capital for the banks and reassures the market. The market's response to the shedding of developing country debt by banks recently has been an important incentive for a growing number of North American banks to sell developing country debt in the secondary market and to consider menu items in restructuring packages that involve debt reduction; this effect is less marked in countries with less stringent disclosure requirements.

Sales of developing country debt in the secondary loan market is just one technique to meet the new capital adequacy standards. Other techniques include the securitization of claims and their sale to nonbank investors, a process that was underway even before the pressure for higher capital ratios. The new standards have also led some banks to slow the growth of their assets. As a result, despite the general impression of pressing competition within the banking industry, the complaints from non-Japanese banks about the pursuit by Japanese banks of market share gains were much less in evidence this year than in previous years.

The new standards also require banks to allot capital to various off-balance-sheet activities, particularly in the swap and options areas. This has resulted in a reconsideration of pricing for these

Table 10. Capital-Asset Ratios of Banks in Selected Industrial Countries, 1979-87 1/

(In percent)

	1979	1980	1981	1982	1983	1984	1985	1986	1987
Canada 2/	3.2	3.0	3.5 3/	3.7	4.1	4.4	4.6	5.0	4.8
France 4/	2.6	2.4	2.2	2.1	2.0	1.9	2.2	2.6	2.7
Germany, Fed. Rep. of 5/	3.3	3.3	3.3	3.3	3.3	3.4	3.5	3.6	3.7
Japan 6/	5.1	5.3	5.3	5.0	5.2	5.2	4.8	4.8	4.8
Luxembourg 7/	...	3.5	3.5	3.5	3.6	3.8	4.0	4.1	4.1
Netherlands 8/	4.3	4.2	4.3	4.6	4.7	4.8	5.0	5.2	5.6
Switzerland 9/									
Largest five banks	7.6	7.6	7.4	7.3	7.1	7.1	7.8	7.8	7.9
All banks	7.6	7.6	7.5	7.5	7.3	7.4	7.8	7.9	8.0
United Kingdom									
Largest four banks 10/	7.2	6.9	6.5	6.4	6.7	6.3	7.9	8.4	8.2
All banks 11/	5.1	5.0	4.5	4.1	4.4	4.5	5.5	5.4	6.0
United States									
Nine money center banks 12/	4.5	4.5	4.6	4.9	5.4	6.2	6.8	7.3	8.2
Next 15 banks 12/	5.4	5.5	5.2	5.3	5.7	6.6	7.2	7.5	8.4
All country reporting banks 12/, 13/	5.3	5.4	5.4	5.6	5.9	6.5	6.9	7.2	7.1

Sources: Data provided by official sources; and Fund staff estimates.

1/ Aggregate figures such as the ones in this table must be interpreted with caution, owing to differences across national groups of banks and over time in the accounting of bank assets and capital. In particular, provisioning practices vary considerably across these countries as do the definitions of capital. Therefore, cross-country comparisons may be less appropriate than developments over time within a single country.

2/ Ratio of equity plus accumulated appropriations for contingencies (before 1981, accumulated appropriations for losses) to total assets (Bank of Canada Review).

3/ The changeover to consolidated reporting from November 1, 1981 had the statistical effect of increasing the aggregate capital-asset ratio by about 7 percent.

4/ Ratio of capital, reserves, and general provisions to total assets. Data exclude cooperative and mutual banks. This ratio is not the official one (ratio of risk coverage), which includes loan capital and subordinate loans in the numerator, while in the denominator, assets are assigned different weights depending on the quality of the assets. The official ratio provides the groundwork for the control of the banking activities by the Commission Bancaire (Commission de Controle des Banques, Rapport).

5/ Ratio of capital including published reserves to total assets. From December 1985, the Bundesbank data incorporate credit cooperatives (Deutsche Bundesbank, Monthly Report).

6/ Ratio of reserves for possible loan losses, specified reserves, share capital, legal reserves plus surplus and profits and losses for the term to total assets (Bank of Japan, Economic Statistics Monthly).

7/ Ratio of capital resources (share capital, reserves excluding current-year profits, general provisions, and eligible subordinated loans) to total payables. Eligible subordinated loans are subject to prior authorization by the Institut Monetaire Luxembourgeois and may not exceed 50 percent of a bank's share capital and reserves. Data in the table are compiled on a nonconsolidated basis and as a weighted average of all banks (excluding foreign bank branches). *An arithmetic mean for 1987 would show a ratio of 12.6 percent.* Inclusion of current-year profits in banks' capital resources would result in a weighted average of 4.3 percent for 1987. Provisions for country risks, which are excluded from capital resources, have been moderately increased in the last year. The 1987 level of provision represents five times the level of 1982.

8/ Ratio of capital, disclosed free reserves, and subordinated loans to total assets. Eligible liabilities of business members of the agricultural credit institutions are not included (De Nederlandsche Bank, N.V., Annual Report).

9/ Ratio of capital plus published reserves, a part of hidden reserves, and certain subordinated loans to total assets (Swiss National Bank, Monthly Report).

10/ Ratio of share capital and reserves, plus minority interests and loan capital, to total assets (Bank of England).

11/ Ratio of capital and other funds (sterling and other currency liabilities) to total assets (Bank of England). Note that these figures include U.K. branches of foreign banks, which normally have little capital in the United Kingdom.

12/ Ratio of total capital (including equity, subordinated debentures, and reserves for loan losses) to total assets.

13/ Reporting banks are all banks which report their country exposure for publication in the Country Exposure Lending Survey of the Federal Financial Institutions Examination Council.

products. Banks have also started to adjust their balance sheets to switch the relative weight of capital absorbing assets in favor of those with low risk weights. This is a process that will benefit sovereign borrowers from the OECD-GAB area. The quest to raise returns on assets, with the aims of both generating more funds internally and improving the market assessment of the banks, thus facilitating the raising of capital, has led banks to look for ways of earning fee income, as margins on traditional banking business have been squeezed by what many participants regard as the excess capacity in the industry. This may have led banks into more risky areas, of which leveraged buy-outs were mentioned by a number of market participants and officials.

3. The breakdown of geographical barriers

The removal of restrictions on cross-border banking and on the establishment of banks in other countries has been proceeding for some years. However, financial institutions are now facing some further, very profound liberalization measures to which they will have to adjust. In the United States, the movement to interstate banking is growing, and is widely expected to be virtually complete by 1992; the United States and Canada have just concluded a Free Trade Agreement, which provides, inter alia, for the removal of barriers to trade in financial services between the two countries; finally, the European Communities have adopted measures to bring about a single European market by the end of 1992, including a single market for banking and investment services. These moves are forcing banks and other financial institutions to reconsider their strategies: will they be in a position to move into the new markets, or will they face a threat to their traditional activity? Can they expand by taking over other organizations, or do they face a threat to their own independent existence? Can they continue with their traditional business; should they try to specialize in some niche or should they move into new fields of activity?

In meeting these challenges, a strong balance sheet and capital base are of crucial importance. For this reason, banks and other institutions are paying particular attention to their share prices and thus their ability to raise capital for aggressive or protective reasons. Banks are also trying to shed that part of their business which does not agree with their adopted strategy. Management, once having taken a strategic decision, frequently does not want to be bothered with the continued treatment of issues that have no place within that strategy.

a. Interstate banking in the U.S.

U.S. banks, which have for a long time operated internationally, are now confronting the challenges and opportunities of interstate banking at home. A growing number of regional agreements among states has gradually eroded the 1927 McFadden Act's effective ban on interstate retail banking, leading to the emergence of new "super-regional" banks in the U.S. based outside the traditional financial centers. These banks, less constrained by the burden of LDC debt, have become formidable competitors, being generally more profitable and more capable of raising capital than the money-center banks.

Indications are that progress toward eventual nationwide banking in the U.S. is accelerating. Nine states already allow reciprocal nationwide banking, while an increasing number of the remaining states have passed or are passing laws to permit nationwide reciprocal banking after specific future "trigger" dates. Federal and state regulators, for their part, have continued to encourage the removal of geographic barriers, not least because of the need to resolve the situation of ailing thrifts and troubled banks by facilitating cross-state mergers or acquisitions.

b. The Canada-U.S. Free Trade Agreement

The Canada-U.S. Free Trade Agreement (FTA), now pending passage of implementing legislation by the Canadian Parliament, promises a further opening of North American domestic financial markets. The key element under the agreement on financial services is Canada's commitment to remove for U.S. financial institutions most of the discriminatory practices--such as restrictions on ownership, asset growth, and market share--currently facing foreign banks operating in Canada. In turn, Canadian banks are guaranteed the same treatment in the United States as U.S. banks, even in the event of future limitations on the activities of other foreign institutions.

The potential impact of the FTA on North American capital and credit markets is difficult to gauge, given that a substantial degree of freedom already exists in the treatment of financial services between Canada and the U.S, but it is expected to increase competition in the Canadian securities market. It is not clear whether, as a direct result of the FTA, U.S., or Canadian financial institutions will gain an enduring competitive advantage over financial institutions from other countries. Such a gain may in fact not be forthcoming, especially considering that the financial services chapter of the FTA implicitly endorses the principle of national treatment, defined in terms of equality of competitive opportunity; and judging by the recent opening of Canadian securities markets to foreign firms, it appears that Canadian authorities may be prepared to grant similar benefits to financial institutions of third countries. Nevertheless, the demand for U.S. financial assets by Canadian institutions should increase, and vice versa. Some Canadian banks also considered that their experience with retail banking across several time zones, and the proprietary technology that makes this possible, might give them a competitive edge when interstate retail banking barriers are eliminated in the United States.

c. The single European market

The European Community plans to create a full-fledged common market among its twelve member countries by the end of 1992. The prospect of an integrated Europe--with free movement of goods, services, capital, and people--opens opportunities for EC residents and raises challenges for the rest of the world. European companies and foreign companies resident in European Communities are considering the rationalization of their manufacturing and distribution activities to take advantage of the single market. It is expected that the level of merger, acquisition and financial restructuring activity in the EC will intensify substantially. Banks too are considering how to adapt their activities in response to their customers' moves and to take advantage of the single European market in financial services.

For banking, the proposed Second Banking Coordination Directive promises major changes in both the supply and demand sides. On the supply side, by virtue of a "single banking license," a bank authorized to operate in one member country will be automatically entitled to offer a wide range of listed services--including leasing, securities underwriting and trading, and funds management--throughout the Community, provided only that the service is permitted by home-country rules. While banking supervision will be exercised by the authorities in the country of incorporation, such a harmonization will necessarily imply Community-wide minimum standards regarding deposit guarantee schemes and required levels of capital, and should be accompanied by an effective competition policy. On the demand side, with the abolition of remaining capital controls, the single market will give consumers of financial services the freedom to decide where, by whom, and how their investment and borrowing needs are met.

In the field of investment services, preparatory work is less advanced than in banking; however, the intention is again to establish a single European market by 1992. This should involve granting securities houses established anywhere in the Community the freedom to operate freely throughout the region. Securities prospectuses acceptable to one country would have to be acceptable in all. To meet this goal, the European Communities are drawing up common minimum standards in the securities area so as to permit the mutual recognition of regulations.

Uncertainties still remain, of course, as to whether the schedule of financial liberalization will be fully implemented by twelve countries where, in many instances, the structure of the financial sector and its supervision and taxation, have differed greatly. However, agreements reached so far on various proposed directives, including the directive on the liberalization of capital movements in the European Communities adopted in June 1988 1/, and concrete steps taken to date have already changed the competitive environment for financial institutions.

1/ For details see SM/88/158, 7/26/88.

Banks residing in the EC are now pondering and experimenting with varying strategies aimed at exploiting forthcoming freedoms--including the freedom to open branches without the need for prior host-country authorization; the freedom to broaden the range of services, and thus take advantage of opportunities such as those offered by the internationalization of securities markets and of funds management; and the freedom to provide services directly from their home countries, without the need to maintain expensive physical operations in host countries. And in maneuvering for position in 1992, banks are faced with a complex set of challenges, including those related to decisions on appropriate product lines, scales of operations, methods of expansion, and defenses against takeover.

The implications of EC 1992 for financial institutions based outside the Community are no less challenging. Internationally-minded banks, bent on retaining or expanding market share within Europe do not, of course, want to be left out of the potential benefits of a unified European market. Their strategic plans, however, are complicated by uncertainties about the Community's policy toward institutions based outside the EC. Under the proposed directive on banking, while existing bank subsidiaries will be treated as Community undertakings--i.e., subject to the "single license" scheme--existing bank branches will remain under the jurisdiction of the authorities in each country where they operate. This differentiation in treatment could put pressures on non-EC banks to open subsidiaries, with the attendant competitive disadvantage associated with the need for subsidiaries to hold their own capital--as opposed to the general entitlement of branches to draw on the full resources of their parents.

As regards entry of non-EC banks after 1992, uncertainties appear to be greater. In effect, the proposed directives authorize the Commission to deny entry to banks from a non-EC country that fails to offer "reciprocal treatment" to the banks of any EC member-country. The precise interpretation of "reciprocal treatment" is still taking shape. The Commission has, nevertheless, already attempted to dispel notions that the policy of reciprocal treatment will be applied retroactively or that it will seek "mirror image" rules of access from non-EC countries. Instead, the less stringent requirement of "global, comparable access"--presumably something close to national treatment--has been publicly emphasized. Banks, for their part, do not seem intent on waiting until after 1992 to find out how, in fact, "reciprocal treatment" will be applied. Many are already planning preemptive methods of expansion, including friendly alliances, joint ventures, mergers, acquisitions, and new establishments.

4. <u>The breakdown of functional barriers</u>

Technological developments and regulatory relaxation are leading to a gradual dismantling of the functional barriers between different kinds of financial organizations. Perhaps the most obvious development under this heading has been the gradual spread of universal banking from its base in Germany, Switzerland and some other European countries to other parts of the world. Measures in the United Kingdom, Australia, and Canada, among other countries, have recently permitted banks to own securities houses. As discussed further below, only Japan and the United States among the major countries have resisted this trend, and even there, the pressures to break down the barrier between commercial banks and investment houses are evident. Outside their national frontiers, U.S. and Japanese financial institutions frequently practice some form of universal banking.

This development partly reflects pressures from regulators as well as from the banking community. Regulators have been prepared to relax functional constraints on financial institutions in order to widen their financial base, to make new profit opportunities available to institutions which do not seem able to expand in their own field, and to reduce competitive disadvantages in domestic financial markets vis-a-vis foreign markets. With banks' major corporate clients finding it cheaper to issue securities in their own names than to borrow from the banks, commercial banks continue to request access to powers that will enable them to provide more services to their traditional clients, including the underwriting and arranging of such securities. At the same time, securities houses have wished to expand the services they could offer their corporate clients by moving into more traditional commercial banking areas.

The eventual removal of the restrictions on commercial banking activity in the U.S. and Japan (imposed, respectively, by the Glass-Steagall Act and Article 65 of the Securities and Exchange Act) appears possible. Particularly in the U.S., a process of erosion of those restriction has been underway, with federal and state regulators already allowing commercial banks to engage in limited underwriting of of commercial paper, municipal bonds, mortgage-backed securities, and consumer-related receivables. Despite protracted debates in the U.S. Congress, pressures from the banking community and from federal and state regulators are such that there is a growing sense that Glass-Steagall, as it now exists, is on the way out. Uncertainties remain, of course, as to the precise timing and extent of the further broadening of banking activities in both the United States and Japan.

The erosion of other functional barriers is no less significant. *Barriers between banks and building societies have been largely eliminated* in the United Kingdom. Limitations on the activities of some of the specialized Japanese banks will be relaxed, and the creation of a single European market will result in a further erosion of functional barriers. In many countries, relaxation of the barriers between insurance and banking activities is being considered. As discussed in Section V of the paper, moving into new areas of activity can involve risks, as institutions enter fields outside their traditional experience.

In the United States, for example, regulators have relaxed the traditional limits on the activities of savings and loan associations (S&Ls) in part to allow them to diversify their assets and to take advantage of more profitable activities. This has led some S&Ls, bolstered by a government-insured deposit base, into particularly risky activities. In the United States, about 500 Savings and Loan Associations (S&Ls) with total assets of about $300 billion are insolvent. Estimates of their accumulated losses vary between $50 billion and $100 billion and their additional operating losses amount to about $1 billion per month. 1/ By now, the S&L problem has become so large that it cannot be solved by the industry itself without imposing unacceptable costs on solvent institutions. It appears unavoidable that eventually some support from the public sector will be needed.

5. <u>Debt and the financing of developing countries</u>

A bank's attitude to the debt situation and the financing of developing countries is heavily influenced by the factors described above, particularly by the market's perception of the bank's portfolio, the role that lending to developing countries plays in the bank's strategic plans, and the tax and prudential environment.

1/ Market participants saw the S&L problem as a result of past economic problems in the industry, magnified by a lack of effective supervision, as deregulation and a government safety net provided indirect incentives for risky business activities. A large number of S&Ls experienced serious difficulties in the early 1980s when interest rates, and thus the S&Ls costs of funds, rose to unprecedented levels while rates on existing mortgages, which dominated thrifts' portfolios, remained at much lower fixed interest rates. Despite the subsequent decline in interest rates, many institutions remained weakened by a fall in real estate prices, particularly in the southwest of the United States where the overall economic situation was influenced by falling oil prices. Difficulties in farming also created problems for some S&Ls operating in predominantly agricultural areas. In response to these developments, many S&Ls sold their best assets to offset operating losses, just as regulators allowed them to diversify their portfolios into other, but ultimately riskier, nontraditional areas. At the same time, certain prudential controls were relaxed. This action delayed the closing of insolvent institutions but, in the absence of sufficient supervision, contributed to the rise of today's problem. Under these circumstances, S&Ls near insolvency had strong incentives to take risks in search of higher yields, an option made possible by deregulation efforts of the early 1980s. Gains from such a strategy promised to benefit managers and owners, while any losses could effectively be shifted to the deposit insurance fund, and perhaps ultimately to the public.

As already noted, bank share prices, particularly in North America, have responded very sharply to indications that individual banks have significantly reduced or eliminated their exposure to developing country debt. This was evident in early 1987, for example, when Citibank's announcement of large provisions for cross-border risk was reflected in an increase in the market valuation of its shares. Since then, Citibank further announced that it had reduced its claims on 33 developing countries by US$2.4 billion or about one sixth of total claims on those countries between mid-1987 and mid-1988 and had done so at a reported average loss of only 18 percent of face value.

For strategic reasons, many small and some larger international banks have made the judgment that lending to developing countries has no place in their strategies. Other banks still see profit opportunities in cross-border business with developing countries, but primarily in support of their established domestic customers that are in need of trade or project financing. However, other banks, including some major international banks, see themselves as having a permanent interest in developing countries. In particular, those with branch networks in developing countries felt that these networks were either profitable or could be restored to profitability in time.

This divergence in bank strategies implies that banks may respond differently to the same opportunities. Some banks may be prepared to pay a premium for the liquidity gained by eliminating their assets in developing countries and for the possibility of utilizing the resources so freed in pursuit of their underlying strategy; but these banks can be expected to be very reluctant to participate in any future involuntary lending. By the same token, other banks may feel that their claims on developing countries are worth more than the current general market valuation and may be prepared to lend new money to developing countries at a time when others are disposing of claims at a loss. In these circumstances, a menu approach represents the only feasible way to accommodate the disparate interests of the creditors. Banks welcomed the further development of the menu, while stressing the unrealism of generalized proposals intended to appeal to all banks within the creditor group.

In discussing the regulatory environment for lending to developing countries, banks noted that the new capital adequacy standards made lending to developing countries, regardless of their creditworthiness, more costly than lending to OECD-GAB countries. National regulators in the G-10 countries maintained that while the concept of an OECD-GAB club would be kept under review, in practice they did not expect it to introduce any new distortions into the market. Capital adequacy standards were not meant to replace the exercise of judgment by banks on credit risk. Regulators also pointed out that bank lending to countries outside the club carried the same risk weight as for lending to the most creditworthy nonbank corporations within the OECD. While these standards may lead to a difference between the profitability to banks of lending to developing countries within the OECD and to those outside, the view was expressed that provisioning policy was more important than capital adequacy standards in determining the cost and availability of loans.

The provisioning standards set by regulators were generally regarded as appropriate by banks, although Japanese banks wished to be able to provision at levels similar to those available to banks elsewhere in the world. Relatively profitable banks often expressed a willingness to establish higher provisioning levels, provided that they received tax credits for such provisioning. Some banks used secondary market prices as one of the elements in determining appropriate provisioning levels. Others believed that the potential recoverability of many claims on countries with debt servicing problems was greater than the secondary market discounts implied and that provisioning levels should remain well below these discounts. Some banks felt certain types of lending to developing countries would be profitable if they did not entail the same degree of provisioning that is required for medium-term balance of payments loans. In their view, relatively less provisioning should be required for short-term trade credit when extended to countries with a good record of servicing this type of claim. Others suggested that banks might be more willing to contribute new money if they were given seniority over other claims, thus justifying lower provisioning levels.

Most tax authorities in industrial countries consider provisioning to be a tax deductible expense; the major exceptions are Belgium, Japan, and the United States, where a bank must in general realize a loss before it can receive a tax credit. For the time being, in the United States general transfer risk provisions form part of regulatory capital, as does the non-tax-deductible portion of provisions in Japan. One issue is whether the tax credit associated with provisioning encourages banks to reach accommodation with their debtors, or instead, by giving them a fiscal advantage early, reduces the incentive to reach such an accommodation. Banks in countries with tax deductibility for provisioning usually have higher provisioning levels than do banks from other countries. In general, highly provisioned banks felt less pressure from the developing country debt situation, and expressed a greater willingness to consider a wider range of possible approaches to its resolution. The fact that a bank had already received the advantage of tax credits did not seem to make it less willing to consider reaching accommodation with the debtor, but the incentives for such banks to reduce their exposure through secondary market sales seemed to be less. Banks which needed to realize a loss before they could receive the tax credit were perhaps more assiduous in seeking a reduction in their LDC portfolio. While this might lead them into accommodation with the debtor, they might also achieve such an outcome through transactions on the secondary market with no benefit for the debtor country.

a. <u>Prospects for bank lending</u>

In response to questions about prospects for spontaneous lending to developing countries, bankers took a favorable view of many Asian and certain other developing countries and were willing to provide trade finance to a broader group of countries which had not rescheduled their trade claims. Moreover, some banks have made a number of secured deals connected, for instance, with aircraft financing or the prefinancing of exports. The more general return of troubled debtors to the markets for larger amounts of finance was seen as problematic. Some bankers noted that if countries were to return to the market for general purpose finance, or for the financing of large national projects, they would need to pay prices that were more closely related to bond yields, i.e., several hundred basis points above LIBOR. In this connection, they noted that the fineness of recent rescheduling terms was not a sign that these countries had become more creditworthy. New financing could also be encouraged by credit enhancement, particularly through collaterali-zation, guarantees by the official sector, or cofinancing with official institutions.

Bankers expressed little or no enthusiasm for concerted new money packages. Nevertheless, a number of the major banks recognized that countries' adjustment efforts merited and required cash relief--a role that new money has played--and that such support could increase the ultimate value of their claims on indebted countries. They thought, however, that contributions in the form of new money were only feasible for the larger debtor countries where interest arrears could have a strong negative impact, and that smaller countries with large bank debt might have to rely more on straight debt-reduction techniques. Most banks stressed the importance of linking cash relief to credible adjust-ment programs, preferably supported by the Fund. Association with a Fund program would help managers to persuade their boards of the impor-tance of such deals and would help ensure appropriate regulatory adaptations. Given the lack of appetite for new money packages, it is not surprising that bankers also stressed the importance of substantial financing from the bilateral and multilateral official sector in parallel with any contribution on their part. Some felt that the banks' contribution should be a reduction in the face value of their claims as they were exchanged for new, more secure, claims, leaving all concerted new money to official sources.

Some bankers found the association of new money with debt reduction techniques to be objectionable in itself; some others saw the possible advantages of such a strategy in increasing the value of their assets, but did not think their boards would entertain such proposals. In practice, banks welcomed such techniques as debt/equity swaps or colla-teralized debt exchanges, which themselves contain an essential element of debt reduction, and most did not object in principle to the further extension of these techniques. However, only a few banks are likely in practice to be willing to engage in outright debt reduction and new money support simultaneously.

Substantial concern was expressed about the problem of "free riders," i.e., banks that refuse to participate in new money deals and yet expect to reap the full benefit of the agreement in terms of receiving full interest income. Banks agreed, however, that it was legitimate for banks to exit from the creditor group, but at a cost. They were less clear on what and how such a cost could be imposed upon participants. Reference was made to capitalizing interest at a lower rate for "free riders." While this might be subject to suit, some European banks expressed the wish to see the courts entertain a legal challenge from a "free rider." Some U.S. banks, however, felt that such an approach to dealing with free riders might not be upheld in U.S. courts.

One approach to "free riders" that appears to be gaining ground is the tiering of debt and the attachment of more seniority to new claims. In this connection, it might be noted that in the last few months Argentina has continued to service new money bonds and the 1987 new money package while ceasing to pay interest on certain other claims. Alternatively, holders of old claims who have contributed to new money packages could be given special rights, including more favorable terms in debt/equity exchanges. This was done in the case of Mexico by distinguishing "clean" (new money paid) or "dirty" (free rider) paper for pricing purposes, and more recently and more explicitly in Brazil.

b. Debt reduction

Most banks recognized that debt reduction needed to be an essential part of the menu, since viability in many countries required reducing the overhanging stock of debt. However, they opposed generalized schemes of debt forgiveness and stressed the need for debt reduction to be voluntary and market-based. As already discussed above, some banks expressed difficulty in linking debt reduction with the provision of new money, but others felt that this would not be an insuperable problem. Some banks were concerned that debt reduction schemes might encourage countries to take steps to reduce the market price of their debt, and thus preferred to link debt reduction to strong adjustment programs. In practice, further agreements on debt exchanges and buybacks will require banks to waive sharing and pari passu clauses in rescheduling and new money agreements.

One recent example of debt reduction, the Mexican bond exchange, was generally welcomed by banks, but some would have preferred more involvement of the bank steering committee or the official sector in the deal, including a link to an internationally supported adjustment program. In general, banks wanted a more secure claim in return for taking a loss through a debt exchange. Some banks made the point that highly publicized schemes such as the Mexican one gave rise to problems, with stock analysts second-guessing their decisions. Such banks would prefer quieter "tap" schemes which banks could utilize as and when it suited them. Banks repeatedly stressed their desire for official guarantees for debt exchanges and for the collateralization of interest in addition to principal, although some recognized that this could prove very expensive.

V. The Management of Risk in the System

1. Introduction

A fundamental task of financial intermediaries is to appraise and assume risk and to charge for it appropriately. As a result of liberalization, deregulation, the growth of derivative product markets, and technological change, competitive pressures appear to be increasing the general level of risk assumed by intermediaries, while only partially providing the tools needed to manage that risk. To many market participants, the need for better risk control is becoming increasingly clear, in particular after the stock market events of October 1987.

Regulators welcome the positive effects of liberalization on the efficiency of the provision of financial services, but wish to ensure that the financial system remains sound and thus able to support the real economy. They are concerned that confidence in the system be maintained, and for this reason have always sought to ensure that banks and other relevant financial institutions have proper risk management systems in place and limit their risks to levels that can be carried. They are also usually concerned to protect the clients of financial institutions. In this process, to the extent that they provide guarantees, regulators need to be sure that they are not encouraging banks and other institutions to take on excessive risk at the ultimate expense of the taxpayer; the crisis of the savings and loan system in the United States underscores this potential problem. The increasing complexity and volume of financial transactions, their internationalization, the speed with which disturbances can be transmitted, and the breakdown of barriers between different kinds of financial intermediaries are leading supervisory authorities in a number of countries to reassess the adequacy of arrangements both nationally and internationally. 1/

2. Major risks for market participants

The most important single source of risk in banking has been and remains credit risk, that of a counterparty being unable to reimburse the bank when an obligation falls due. Credit risk can be increased by the incidence of large exposures to single entities, excessive concentration of loans to particular sectors, and geographical areas. There

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1/ The potential macroeconomic impact of structural changes in financial markets was discussed in the 1987 report on "International Capital Markets--Developments and Prospects" (SM/87/194, 8/5/87), pages 24-27.

is also the risk in cross-border activity that the authorities of a borrower's country will not make the foreign exchange available to settle claims.

There are indications that the amount of credit risk incurred by the international financial system is increasing. Some market participants expressed the concern that, in an effort to raise rates of return on assets to help raise stock prices and needed capital, banks were moving into riskier fields in search of higher rates of return. The expansion of merger and acquisition and leveraged buy-out financing in some countries, for example, were seen as part of this trend, as was the effort by banks to increase fee income associated with financial innovation. Consequent effects on the quality of bank portfolios were seen by many observers as exacerbated by the movement of the most creditworthy borrowers to commercial paper and other direct financing markets. Finally, the degree of credit risk is also connected to the level of uncertainty about the stability of developments in the world economy. It is worth noting here that the number of bank failures in the United States has been relatively high in the last five years, despite the strong performance of the economy; a downturn in economic activity could worsen the situation significantly.

A second traditional source of risk has been liquidity risk, the risk that a bank would not have on hand or be able to obtain from the market sufficient liquid assets to meet current demands. In this area too, there is evidence that risks are increasing. A number of innovative products in recent years have shown themselves to be less liquid than originally envisaged. In addition, as banks move into securities businesses or extend more credit to underwriting houses, sudden changes in securities market conditions can quickly transform growing short-term credits into illiquid assets. This has led some banks to examine more carefully the credit ratings of other intermediaries and to seek new mechanisms for limiting exposure. In related moves, banks and their supervisors have also been paying more attention to the functioning of interbank clearing and settlement systems in an effort to minimize risks during settlement.

A third type of risk to which financial institutions are exposed is interest rate risk. With the gradual elimination of interest rate controls and consequent reductions in sources of low cost funding, banks could become more exposed to interest rate risk to the extent that the interest structure of their liabilities is not matched with that of their assets. With banks being funded on a floating rate basis in the wholesale money markets, they have tended to put their lending on a similar basis. This reduces the degree of interest rate risk, but at the expense of turning it into increased credit risk. Banks that "ride the yield curve" to an excessive extent, however, are exposed to higher risks, as the volatility of interest rates has increased in recent years. Finally, a mismatch of the currency composition of assets and liabilities can expose a bank to risk as exchange rates change.

Financial institutions have followed a variety of strategies to control the level of risk they assume. One has been to improve their internal risk management systems. While credit risk continues to be dealt with through traditional procedures for screening the credentials of customers, control of other market-related risks has sometimes involved the development of extensive data processing systems that allow traders to check that their transactions are within the limits set by internal guidelines, and allow senior managements to keep track of exposures in real time. Some major banks continue to decentralize exposure limits branch by branch, allowing the possibility of branches taking positions against each other, while others have developed systems for controlling exposure on a global basis. In a few cases where an institution has extensive operations on the major markets around the world, the "book" is formally passed from New York to Tokyo to London and back to New York during each 24-hour period, allowing a continuous monitoring and adjusting of worldwide exposure. Reliance on associated data processing systems, while allowing the better control of some risks, carries with it a number of additional risks. Such systems are only as good as the data entered, and are vulnerable to hardware and software failure. 1/ There is a shortage of expertise that allows such systems to be properly checked and to make communications linkages fully secure.

The growth of derivative products markets, such as financial futures, options and swaps, partly reflects the desire of market participants to hedge risks. Such new instruments have their own risk characteristics, however, and these may be difficult to appreciate until there has been longer experience of their functioning or until they have been tested in conditions of economic downturn. With many institutions turning to innovative products to generate more fee income, there has been concern expressed that, on occasion, such risks may be taken on without a full appreciation of their extent or without adequate compensation. This may be because of the arcane nature of some of the new instruments, the computerized strategies that often drive their use, or an inadequate understanding of their implications by senior management. By requiring banks to take their off-balance sheet exposures fully into account when deciding on appropriate levels of

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1/ In November 1984, for example, a fire in an underground telephone circuit cable duct in Tokyo shut down some bank on-line services and interrupted certain banking operations; as an emergency measure, the clearing house had to extend certain deadlines. Similarly, in November 1985, a computer failure caused by software problems at the Bank of New York, a clearing agent for Treasury bonds, resulted in the bank paying the seller for the Treasury bonds sold but being unable to deliver the bonds to the buyer or to collect payments. Massive overdrafts of the bank could have spread to the entire clearing system for government securities and triggered a chain reaction of defaults. This was avoided by the Federal Reserve Bank of New York extending a $22.6 billion loan to the Bank of New York.

capital, the Basle capital adequacy standards have begun to address such concerns.

3. <u>The response and concerns of supervisory authorities</u>

The supervision of banking activities has a long history at the national level. At the international level, the coordination of national supervisory policies in this sector received new impetus from the work of the Basle Committee. The supervision of securities houses, on the other hand, has been less systematic and less comprehensive, and its international coordination has lagged. Concerns related to securities clearing and settlement systems have, for example, only recently, stimulated efforts to improve the effectiveness of such systems on a global basis.

The capital adequacy standards for banks established by the Basle Committee had three main objectives: to harmonize the competitive conditions under which international banks operate, to bring indirect financial commitments within a general prudential framework, and to inject more capital into the banking system. Early moves by banks to raise capital, restructure balance sheets, and change the pricing of certain products may be seen as consistent with these objectives. But in the overarching effort to foster the prudent management of financial institutions, supervisors have never limited themselves to establishing capital standards. Nor, indeed, have high levels of capital in the past prevented bank failures. Other items that supervisors typically consider include the composition and diversification of bank loan portfolios, accounting standards, the level and severity of problem and classified assets, the quality, trend and variability of earnings, dividend payout ratios, the level and trend of retained earnings, the liquidity and structure of liabilities, the degree of interest and maturity mismatch between assets and liabilities, the effectiveness of loan and investment policies, and the overall ability of managements to monitor and control risks. The need for international coordination in many of these latter areas is considered less pressing by most supervisors, except within the European Communities, where coordinated supervision is a precondition for a sound integrated financial market. Finally, the increased internationalization of finance can imply for financial institutions more exchange rate risks and country transfer risks.

While the international coordination of banking supervision is well advanced, steps are also underway to coordinate the supervision of securities houses, to define the relative responsibilities of the supervisor of the parent company and that of the branch or subsidiary, and to give markets adequate confidence that all participants are appropriately regulated. Multilateral agreement in this area, however, is much less advanced than in the banking field. Whereas the Basle Concordat of 1975 established the principle that supervision of banks would be done on a consolidated basis, with the parent bank being liable for the quality of subsidiary operations, supervision in the securities business is typically done on the basis of physical location. Complicating the problem are differences in the types of securities supervision; in some countries supervisory responsibility rests with the central bank, in others with the ministry of finance or with nongovernmental agencies. There are also considerable differences in the structure of securities businesses, with securities houses in some countries having banking subsidiaries abroad which they are not permitted to have at home, and banks which are prohibited from engaging in securities activities domestically being permitted to do so abroad. Furthermore, the focus and objectives of securities market regulation have differed from country to country. 1/ In most, however, the primary task has been investor protection. This has led to regulations concentrating on matters of disclosure, ensuring that markets are transparent, open, and liquid, and discouraging fraud by market participants. As financial markets become more fully integrated across borders, the need for a more comprehensive and internationally consistent approach to protecting investors and ultimately the payments system is becoming apparent.

Work underway within the International Organization of Securities Commissions (IOSCO) and the OECD is attempting to clarify the various issues involved and elaborate appropriate responses. In the meantime, the Draft Directive on Investment Services of the European Communities proposes to lay down certain minimum standards in this area for the member countries of the Community to facilitate creation of a single European securities market. There has also been considerable bilateral contact between national securities commissions, in particular those in the U.S. and the U.K., aimed at the reciprocal recognition of national standards.

Increasing attention is also being paid nationally and internationally to the safety and efficiency of clearance and settlement systems for both banking and securities transactions and to the necessity of coordinated responses to emergency situations. The main issues in this area are limiting credit risk in settlement systems, expanding their capacity, and ameliorating their vulnerability to external shocks while still facilitating their linkages across borders. The time taken to effect a transfer of funds or to complete a change in ownership of a security varies widely across different systems. During this settlement period, a counterparty is exposed to the risk that the other party may go out of business before the transaction is closed. Information on the creditworthiness of the counterparty may in any case be hard to obtain. For this reason, much effort is being put into

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1/ In determining appropriate minimum levels of capital for securities houses, for example, the supervisors in some countries have worked on the basis of a "haircut", where--analogous to risk weights in banking transactions--the volatility of the value of each instrument is assessed and capital amounting to some fraction of the product of the volatility and the exposure is required. Such systems are rather imprecise, but the failure of other countries to apply even such rough standards tends to distort international competition.

shortening settlement periods, with many countries moving towards overnight settlement (and those with overnight settlement considering same-day settlement), and into considering limitations on the size of overdraft a participant can run at any time. 1/

The integrity of clearing systems themselves is of considerable concern to monetary authorities and regulators because their failure could set off chain reactions of cascading defaults. Central banks have usually been unwilling to take on the job of formally guaranteeing such systems, for fear that this would lead to the inadquate evaluation of counterparty risks by participants. They have, however, often taken pains to encourage participants in these systems to protect themselves adequately against undue risks. They have, for example, supported efforts to preserve the physical security of the computerized systems which lie at the heart of counterparty settlement procedures and have encouraged the establishment of reserve funds to insure systems against widespread counterparty failure. Private settlement systems have also recently been making efforts to improve their self-insurance schemes.

The gradual breakdown of functional barriers within the financial services industry also poses new challenges for regulatory authorities. While the most obvious trend is the gradual integration of the banking and securities business, there are also trends toward the integration of banking, insurance, and other types of financial services. Regulators are increasingly concerned, therefore, about the supervision of diversified financial conglomerates, the possibility that problems can spread quickly from one sector to another, and the danger of extending implicit guarantees. To many observers, the case for functional rather than institutional regulation is becoming more persuasive. This is the approach taken in the U.K. Financial Services Act, which makes no attempt to define, say, a bank or a securities house, but regulates in a consistent fashion all participants in specific lines of business. Such approaches have been stimulated by a concern that there should be uniformity in the regulation of financial activities regardless of who conducts them. Up to the present time, most attention has been paid in this respect to the relationship between banks and securities houses. The regulatory reforms that have recently taken place, for example, in the United Kingdom, Australia, France and Canada, had among their objectives both the elimination of restrictive practices in securities markets and the injection of capital into securities companies.

In countries with universal banking systems, together with those where regulatory changes have meant that securities houses are often subsidiaries of banks, the issue of preventing problems in the securities operations from spilling over into the bank has been important.

1/ The Group of Thirty, a private sector advisory group, is currently undertaking technical work on the improved coordination of settlement systems.

Under the capital adequacy standards of the Basle Committee, the capital of subsidiaries dedicated to the securities business is netted out of total capital. While this is helpful, it does not guarantee that banks will not have implicitly or explicitly committed themselves to their securities affiliates for far greater amounts. Indeed, those affiliates can be expected to trade on the name of the parent bank, and it is presumed that a parent bank will not risk damage to its reputation by letting its affiliate default. As functional barriers erode in the United States and other traditionally segmented markets, regulations appear to be encouraging institutional structures which include internal "firewalls" in an effort to keep parent banks' liability from securities operations strictly limited. Such barriers would ideally prevent the transfer of increased risk from securities affiliates to the parent, protect impartiality in credit approval procedures, and limit the scope of central bank safety nets. Regulators remain aware, however, that temptations exist to breach such firewalls, especially during times of crisis. *The gradual integration of securities and other financial markets* both nationally and internationally and the now-evident possibility of the rapid transmission of shocks from one market to another are prompting supervisors to review their controls over the risks to the entire financial system that may originate in securities markets. This is a relatively new area, and the conceptual and practical understanding of the problems involved are less well developed than in the banking sector. A great deal of work among supervisors and regulators appears to be required before coordinated arrangements in the securities sector are as evident as they have become in the banking sector.

Many of the concerns discussed above in general terms were underscored when an important sector of the securities business, the equity market, experienced a serious shock in October 1987. 1/ The rapid spread of price declines from one market to another made it clear that the integration of markets had become more extensive than realized. Countries with short settlement periods reported exceptional pressure from foreign market participants seeking to utilize the liquidity of such markets to meet their obligations elsewhere. There was evidence during October 1987 of the effects of trading halts or price limits in one market spilling over into other markets. With the multiple listings of stocks and instruments on a number of exchanges growing, such phenomena are expected to become more widespread. These events have stimulated new international cooperative efforts in the regulation and coordination of securities markets.

The strains on the markets evident in the October 1987 events have also led market participants and regulators to focus on a number of weaknesses in the functioning of equity markets. The first of these involves the performance of trading systems under the one-sided selling

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1/ For a detailed review of the equity market problems in October 1987 see the background paper section on "International Equity Markets and Macroeconomic and Financial Market Stability."

conditions that prevailed at the start of the break. Problems arose on some markets in handling the large volume of orders; price quotes became unreliable and spreads increased erratically, creating doubts about fundamental market liquidity. There were also strains in clearing and settlement systems, and delays in confirming payment of margin calls. In response, several major markets are taking steps to increase the capacity of their systems to handle substantially larger volumes of transactions as well as to clarify and adapt rules governing the behavior of market makers and other market participants.

The suddenness of the fall in equity prices and the volume of sell orders also led to fears about the adequacy of the capital base of some brokers. In general, fears about the solvency of counterparties were probably less in countries where brokers usually form part of financial conglomerates or universal banks. In some countries, however, a tendency toward tiering emerged on interbroker/dealer markets, which had hitherto relied on anonymity, as market participants sought information about the credit ratings of their counterparties. In New York and Hong Kong, minimum capital requirements for brokers were raised substantially in light of October's experience and supervisors generally have been reassessing capital requirements in view of the higher volatility now apparent on equity markets. Resulting fears of counterparty failure have been another stimulant to efforts aimed at shortening settlement periods within equity markets. The stock market break also brought to light the need for better coordination between cash and derivative product markets. The rules and clearing procedures established for the submarkets, such as price limits and margin requirements in futures markets, were sometimes inadequately integrated with the market for shares. This has led to discussions on mechanisms for ensuring greater uniformity of regulatory approach.

The full extent and nature of official intervention during the market break is unclear. In the United States, the authorities provided liquidity to the financial system through open market operations and counseled banks on the need to meet the large but legitimate funding needs of major market participants. Rules on collateralization were also eased. In Japan, regulations on margin requirements were relaxed, while in Hong Kong, emergency assistance was arranged to allow some participants to meet their liabilities. It is likely that analogous interventions occurred in other countries.

4. Deregulation, reregulation, and the risks in guarantees

Supervisory authorities face the problem of establishing a level of regulation that maximizes competition in financial systems without jeopardizing safety, soundness, and effectiveness. The processes described in this paper have promoted, and continue to promote, a more competitive financial system throughout the world. However, they have also allowed institutions to take on new kinds of risks to which some supervisory structures are not yet adapted, and further possibilities for the international transmission of disturbances have been created.

Thus, regulators across the world are reconsidering whether changes in the nature and scope of their activities are required to ensure the soundness of their national financial systems and the emerging international system. The issue is not one of regulation or deregulation, but of the appropriate amount of prudential regulation in a liberalized environment.

There is evidence that, as a result of recent developments, regulation of some activities in the financial sector in some countries may be tightened. In the United Kingdom, the liberalization of permitted activities involved in the Financial Services Act has been complemented by the establishment of a new, more comprehensive regulatory framework primarily for investor protection under the auspices of the Securities and Investment Bureau. Within the European Communities, the movement to a single market in financial services has been associated with the requirement for Community-wide standards if mutual recognition of regulations is to be acceptable. In the United States, the market break has led to a reassessment of the roles and need for coordination among the various bodies supervising financial markets. The role of explicit and implicit governmental guarantees is also under reconsideration in a number of countries, most prominently in the United States in the wake of widespread failures of intermediary institutions. If government guarantees on the funding side encourage participants to take on more risk in the belief that its cost could ultimately be shifted to the general public, then the system's effectiveness and soundness could suffer.

While the guarantees given by deposit insurance organizations are explicit, and may therefore be taken relatively easily into account, implicit guarantees are more difficult to assess. Even in payments to depositors of bankrupt banks and thrifts in the United States, actual guarantees have extended beyond the statutory protection of domestic depositors to cover foreign depositors as well. There seems an increasing likelihood that no industrial country is prepared to let a major bank fail outright, leaving the loss to fall to some extent on shareholders but mainly on uninsured creditors. In the light of actions and expectations of market participants during the stock market break, questions have been raised as to whether such guarantees effectively extend to the major securities houses, since the failure of any of these could have a systemic impact similar to the failure of a major bank. This, again, may lead some market participants to undertake excessively risky behavior, since they may not perceive themselves to be bearing the full cost of the risk. To the extent that such guarantees have spread, an efficient market would seem to call for closer surveillance over the risks entered into by such implicitly insured organizations.