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Banking Reforms

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Introduction

It is a pleasure for me to take this opportunity to share with you some reflections on a matter as important as banking system reforms.

I think that all of us agree that a major challenge for every country is to achieve and sustain high rates of economic growth that can improve the standards of living of their citizens. This is particularly important in the North African and Middle East countries participating in this Seminar, insofar as their past growth performance has proven insufficient both in absolute terms and relative to other comparable regions. What is more, in view of geopolitical risks, rapid growth and improved standards of living are very important to foster social and political stability.

In this context, why is the topic of this seminar relevant? Something that we also know, based both on economic theory and international experience, is that the contribution of financial development is very important to achieve economic growth and stability. And banking reform is a key element to promote financial development.

Indeed, a sound and smoothly functioning banking system that is capable of channelling saving to its most productive uses contributes to higher economic growth. It is also conducive to macroeconomic stability, for at least three reasons: it provides for the elimination of a direct factor of instability, it allows effective monetary policy transmission and it acts as a factor capable of absorbing both domestic and external shocks.

In this respect, experience not only shows that the consequences of a weak financial system may prove very serious for the economy as a whole in the event of a crisis; it also reveals that the inefficient workings of financial markets and of the institutions operating in them considerably stifle economic growth. The design of public policies has to include both elements. However, I shall not be focusing today on matters relating rather to crisis-resolution but on banking reforms conducive to their stable and efficient functioning.

One relevant question to be answered here is what have we learned in the past about banking reform from our international experience that may be useful for the developing countries and emerging markets attending this Seminar today?

To respond, I will structure my presentation around three major headings. First, I think that it is important to start by reveiwing the general economic context and the key features of the financial systems within which the banking system operates in these countries. Second, I will refer to past experience in banking reform in developed countries. Finally, I will try to identify some areas of consensus regarding banking reform.

General economic context and key features of the financial systems of North African and Middle East countries

Let me start with the first issue I referred to, namely the general economic context and key characteristics of these countries. My intention is not to be exhaustive, but to point out some elements that I consider relevant from the perspective of today's talk.

Regarding the general economic context, and taking into account that, obviously, there are differences from country to country, I would mention three basic features.

First, and in spite of recent progress towards an increase in the degree of openness of these countries, they are still relatively closed economies, both in terms of trade and in relation to their financial systems. Second, and also bearing in mind that we have witnessed significant improvements in this area in recent years, greater efforts are needed to strengthen their institutional framework. In this respect, in the past few years some countries have made tangible progress, but many aspects have still to be improved. Reinforcing their legal systems and institutions, property rights and economic institutions are just some examples of the direction in which to move. Finally, but importantly too, in many countries the size of the public sector in the economy remains large, despite progress having been made in some cases.

The financial systems of these countries also evidence particularities that should be taken into account when considering banking reforms.

The financial systems of these countries are bank-centered, that is to say, the size and the role of capital markets tend to be, in many cases, marginal. It should be noted that, in a number of these countries, the development of capital markets has received growing attention in the last few years, but in most cases they remain very underdeveloped. At the same time, there is a low degree of banking intermediation, in relation to GDP levels, and there is a high share of bank lending to the public sector. The banking system is often highly concentrated, which frequently entails entry restrictions for prospective new players.

All in all, these characteristics result in a financial system with low levels of competition and efficiency, and a wide use of cash as a means of exchange in financial transactions. All this is usually reflected in a scarcity of credit to the private sector, as well as in financial systems with a high level of segmentation, that is to say, where there is low or no access for certain groups of borrowers to the financial markets.

Some elements of the banking reform experience of developed countries

In short, the financial systems of many emerging economies and developing countries need to be reformed to make them more efficient and, thus, a more useful tool in providing economic growth. Can the international experience of banking reforms over recent decades be useful in this connection? In my view, the answer is yes, so let me briefly review the reform process since the 70s in the financial sectors, and particularly in the banking sectors, of a large number of developed countries.

Here, as in other fields, each country's experience is unquestionably unique. This is because of the numerous differences between countries both in the starting position of their economic and financial conditions and in the institutional and legal frameworks in place. Further, their financial markets and the institutions operating in them display different structural features.

Yet I believe the varied experiences over recent decades allow us to identify certain common factors in the different banking reforms enacted in different countries.

In many European countries, and as in the United States and Japan, among others, the banking system in the 70s was highly regulated. Such regulation affected many of banks' operating areas, curtailing their action notably. There were limits, for example, on the interest rates banks could set; there were obligatory investment ratios; the possibility of holding a stake in non-financial corporations was limited or prohibited; and there were restrictions on opening branch offices on the basis of the commercial criteria established by banks.

In sum, the basis of regulation in the 70s was the setting of operating restrictions on existing banks, which posed sizeable obstacles to potential new entrants. These entry barriers were effective not only against foreign banks seeking to enter a particular country's market, but also prevented domestic competition arising. As a result, banking systems were at that time highly inefficient, although they generated high profits for the established banks.

Over-regulation had one aspect which we might, if you will allow me, declare as positive from the standpoint of the stability of the system; the exceptional profits obtained by banks acted as a buffer that allowed potential difficulties to be withstood. Yet the cost of the system was very high, for at least two reasons. First was the cost for consumers of financial services, since access to bank financing was very difficult and the latter was very expensive. Second, and stemming from the foregoing, a system less efficient in channelling saving to the most productive uses undoubtedly reins in the possibilities of higher economic growth. As you will recall, I referred to this matter at the beginning of my speech.

Accordingly, acknowledgement of the shortcomings of the system in terms of its inefficiencies led to deregulation being undertaken in many countries. However, I believe there are other powerful factors relating more closely to the very dynamics and development of financial markets which exerted pressure geared to freeing up the banking market.

On one hand, technological progress and the development of new computational techniques meant that the value added by providing a purely local banking service was lower. On the other, and this was a point of particular importance in countries such as the United States, the restrictions on banks led other financial institutions to emerge, institutions with a lesser regulatory burden and a greater capacity to compete in capturing saving. The growing pressure exerted by these institutions also acted as a stimulus for established banks to demand greater scope for action in taking commercial decisions, such as the opening of branch offices or the unrestricted setting of interest rates.

Be that as it may, the fact is that this broad set of factors drove a growing process of deregulation and freeing up of the banking sector in many countries.

Liberalisation, as is natural, occurred in different ways in different countries. This was due to the type of measures applied and to the pace at which the process was undertaken. However, the general tendency was to lift the restrictions referred to earlier.

As was to be expected, the freeing up of the banking sector entailed increasing competition based on the erosion of the market power of already-established banks. Consequently, the exceptional profits banks had enjoyed until then declined, leading many of them to pursue riskier lending policies. Heightened competitive pressure in the banking industry meant that more than a few banks reacted by taking on greater risks and, more importantly, they did so without extending in parallel their risk selection, control and management systems.

The shortcomings of banks' corporate governance mechanisms and their risk control and management systems were one of the main reasons behind the banking crises affecting many countries in the 80s. But other factors also contributed. I should like to highlight two of them.

Firstly, the macroeconomic situation. On most occasions, bank crises could be seen not to emerge in full until the country's economic situation deteriorated. This shows that if banks do not implement appropriate lending policies during the good times in the cycle, imbalances will build up, becoming manifest subsequently when the situation of the economy worsens.

Secondly, the shortcomings in the regulatory and prudential supervision fields. The elimination of the excessive regulation in place previously was not accompanied by additional measures, which meant, for instance, that there were no capital ratios set on the basis of assets at risk, or that on-site inspections were non-existent or insufficient. What is more, the liberalisation drive sometimes saw the authorities fail to be as scrupulous as they ought to have been in granting banking licences, which allowed entrepreneurs with no experience in banking - and who were occasionally only seeking a means of financing other activities - to gain access to the market.

In the wake of banking crises that proved costly to differing degrees in terms of GDP, there was a notable change in the banking sector. The regulatory reforms made prevented succumbing to the potential temptation of returning to a highly regulated system. On the contrary, the banking reforms marked a significant step towards what we know today as prudential regulation. Unquestionably, the "Core Principles for Effective Banking Supervision" adopted by the Basel Committee on Banking Supervision in 1997, and recently under reform, are an essential reference in this area.

Banking reform has also been driven by the sector itself, which has seen notable advances in risk management, control and measurement in the last 15 years. Indeed, banks themselves have understood that in an industry such as theirs, where risk is part and parcel of the business, success cannot be had without setting in place the management mechanisms for proper risk measurement and monitoring.

Some areas of consensus of potential relevance for banking reform processes

At this point I shall attempt to point out some areas of consensus of potential relevance for banking reform processes. Nevertheless, as regards advice on banking reforms, we must start with an exercise in humility.

The reason is that there in no 'one-size-fits-all' strategy, since different countries have different characteristics, meaning it is not possible to offer a valid set of recommendations brooking no exception or qualification. The best that we can thus hope for is to identify those areas where some consensus has emerged over the years and try to come up with some useful ideas. There is a need to adopt a pragmatic approach and recognise that banking reform is not an instant process and has to be very carefully designed. I shall now refer to some such areas of consensus which I consider relevant.

One initial element for achieving a sound financial system is the need to develop an appropriate institutional framework, building up a set of mercantile and civil laws capable of ensuring agents' property rights, developing institutions that foster monetary and fiscal discipline, improving mechanisms to appropriately disclose information and a set of adequate accounting standards, among others. The idea of the need for an appropriate institutional framework is in fact reflected in the preconditions of the Core Principles which, among other considerations, also point to appropriate macroeconomic policies as a necessary element for the proper functioning of financial markets. In fact, unless there is a sound macro-policy framework, there will be imbalances building up which, sooner or later will lead to banking crises, with very disruptive economic and social consequences. In countries whose economies are subject to a greater degree of volatility, it is particularly important to have an institutional framework and to secure economic fundamentals that are sound and stable.

A second issue to be considered when reforming the banking system is that there is a need for appropriately setting priorities and finding the correct sequencing of reforms. The specific path of banking reforms may differ from country to country, but often a gradual step-by-step process may in the long run be useful.

I have said before that in these economies banks are most relevant in the financial system. In fact, regarding financial development, there is no clear evidence as to whether a model based on banks is better than one based on markets, or vice versa. In my view, the important thing is that whatever the mix, the overall system performs efficiently and in a sound manner.

Nevertheless, if we are pragmatic, given that banks are central to the financial systems of developing countries and emerging markets, I think that a good strategy would be to give priority to developing a sound and effective banking system. What is more, the development of the banking sector is expected to strengthen the performance of the financial system.

A third idea regarding banking reforms is the need to liberalise banking activities. As indicated, in many countries there has been a progressive lifting of regulations that had comprised the imposition of various restrictions on banks' business decision-making capacity. That has allowed progress towards a more competitive and efficient system, and one capable, therefore, of boosting economic growth to a greater extent.

Nevertheless, and this is very relevant given the numerous bank crises I referred to earlier, it would seem necessary for financial liberalisation to be accompanied by the application of appropriate measures from the standpoint of prudential regulation and supervision. This could be said to be an accompaniment condition of an internal nature, without which the process of banking reform would be seriously affected.

These prudential regulation and supervision elements are included in the Core Principles. In fact, these principles, which have become the pivotal reference for progress towards effective banking supervision, include a broad set of factors. These cover, inter alia, the relevance of the independence of the supervisory authority; the need to establish entry requirements based on the suitability of bank managers; the setting of capital ratios relating risks incurred by banks to the minimum capital requirements they must maintain; the need to introduce appropriate risk control systems and to establish suitable supervisory methods combining on-site inspections with remote monitoring; and the need for banks to provide sufficient information and to set in place both appropriate disciplinary measures and the co-operation mechanisms needed for cross-border supervision.

In short, the banking reform process should unfold, from my viewpoint, avoiding financial repression but introducing the appropriate mechanisms so as to avoid the opposite extreme. In this respect, the third reflection I would like to make on this matter is that in our present-day capacity as banking supervisors we must work to introduce the appropriate incentives so that banks can function correctly. The action of markets, and of the agents participating in them, must be an essential complement to banking supervision. Furthermore, banks' senior officers have a responsibility for the correct functioning of their institutions. Indeed, the chief responsibility for the sound functioning of banks lies with them. In fact, banks themselves have to make a continuous effort to improve their risk management and control systems, along with their corporate governance structures.

In other words, supervision is not confined solely to bank supervisors and regulators. Recent reforms, such as Basel II with the joint operation of its three pillars, are geared in this direction. In my view, Basel II is an important step in the right direction: as it is based on the correct principles, I think that it will help countries to promote financial stability and growth. Regarding the adoption of Basel II by developing countries, this is a widely discussed and relevant topic. I am not going to go into details now, but I think that for many developing countries and emerging markets the adoption of Basel II, even in its simplified approaches, must be a target to be achieved through a gradual process over time.

There is a fourth element regarding banking reforms which, in fact, I consider as another accompaniment condition in this process. I refer here to the need to step up the degree of external openness, insofar as liberalisation of the capital account entails significant benefits. Indeed, financial globalisation offers benefits in terms of greater growth potential. Moreover, the financial systems of many emerging economies are small, and this gives rise to negative factors such as those derived from an excessive concentration of risks or from the fewer investment opportunities that such systems offer.

Nevertheless, external openness is not free from difficulty, which is why I believe that in this case there is a need to be prepared. Consequently, the process should be gradual and, if it is to be successful, it will first need a sound banking system.

A fifth element of this process is related to the bank ownership structure. In this regard allow me just a couple of reflections regarding public-sector banks as well as foreign banks.

In relation to the opening-up process, a phenomenon seen in many emerging economies is the entry of foreign banks into local markets. Occasionally, it is believed this can cause a measure of uncertainty and instability in the banking sector of the host country. However, the benefits are very significant, as highlighted by Spain's own experience, to which I shall refer shortly. Foreign banks thus tend to heighten competition and efficiency, contributing to the transfer of technology and of human capital, which increases local banks' capacity. In fact, in certain circumstances the entry of foreign banks can be a means of strengthening the ownership structure of the banking system, for instance if privatisation processes are undertaken.

At this juncture I would like briefly to reflect on the role of public-sector banks, whose presence is still very significant in quite a few countries. Firstly, I think a distinction needs to be drawn between public-sector development banks and public-sector commercial banks. Development banks are considered useful if there are market imperfections warranting government action and if they complement private banks, not competing with them. But the growth of public-sector commercial banks, though there is no absolutely conclusive evidence, is usually associated with a lesser degree of financial development, with less protection of borrowers' rights and with bigger spreads. All of this reduces the efficiency of the financial intermediation process and ultimately economic growth.

Among other considerations, public-sector commercial banks tend to finance governments more, especially where the budget deficit is greater and the alternatives for seeking alternative sources of financing are fewer. The adverse effects are most considerable, and include most notably crowding out or, what is of substantial relevance for developing countries and emerging economies, greater country-risk exposure, increasing the vulnerability of the financial system.

I talked earlier of privatisation via foreign banks. But this is just one of the many existing alternatives with regard to how to pursue this process if it is deemed necessary. I do not intend now to tackle this question, which itself merits a deep analysis. But I would like to point out that the option chosen depends on the particularities of the country involved and that it should be the result of a gradual and progressive process.

In any case, regarding foreign and public-sector banks, and other topics, the relevant question is how much and how fast. But often - and in my view this is the major risk - the result is “too little, too late”. This leads me to the sixth issue I wish to discuss, namely the need to be pro-active in the approach to banking reforms. In that vein, it is preferable not to wait until a major crisis occurs, which is very costly. Practical experience, however, shows that a major crisis has often been a catalyst for reforms.

Finally, I would also like to make a reference to the role of central banks.

This role concerns the promotion, stemming from the pursuit of its responsibilities, of macroeconomic stability -and of price stability in particular- which, as I indicated, is a necessary condition for achieving a sound and stable financial system. But at the same time, the central bank can and should contribute to strengthening the financial system, assisting in the development of infrastructures, for example, through the development of efficient payment systems. Undoubtedly, a payment system capable of increasing the security with which banks relate to one another, while reducing costs, is of paramount importance for obtaining a sound and stable financial system.

The central bank can also contribute to the promotion of a more efficient banking system, and particularly to the development of money markets, by adopting market-orientated monetary policy instruments and procedures. And finally, in those cases where the central bank is entrusted with responsibility for banking regulation and supervision, it is of paramount importance that it should do its job efficiently and in an operationally independent manner.

Conclusion

Allow me to conclude with a brief reference to the Spanish case. Although I realise the subsequent panels will be discussing different national experiences in detail, I could not omit a few brief remarks on the Spanish financial system, as I consider its development over the past thirty years is most illustrative of a banking reform process.

From a system in which the operations of private banks, existing alongside public-sector banks, was very restricted, we have moved to a highly efficient, solvent and competitive system compared with our peer countries. As can be inferred from the deep-seated banking crisis in the late 70s, the process has perforce been gradual and not free from difficulty. Briefly, and following the progressive elimination of restrictive regulations, it involved the privatisation of public-sector banks, allowing entry to foreign banks, opening up the system to foreign competition and fostering domestic competition. In recent years, as in other countries, we have witnessed a process of banking consolidation along with the sector’s growing internationalisation. This entire process of transformation has been accompanied by changes in the regulatory and supervisory framework, geared to making it more effective and robust.

To conclude, a final idea by way of summary. The financial system is the engine of economic growth, and financial crises entail very high costs. There are usually three common elements behind these crises: a strong deterioration in macroeconomic conditions; shortcomings in regulation and banking supervision; and deficiencies in corporate governance and in banks' risk management systems. From my viewpoint, pushing through bank reforms involves making headway in these three areas.

Thank you.