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Notes for Remarks by
John W. Crow
Governor of the Bank of Canada

At the Annual Meeting of the Association of Mexican Banks
Monterrey, Mexico
5 August 1988

Not for publication before 8 August 1988
at 9 a.m., eastern daylight saving time

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COMPETITION OF DOMESTIC BANKS WITH INTERNATIONAL BANKS

It is a special pleasure for me to be here today and to have been invited to contribute as a panelist on this interesting and complex topic.

First, two sets of introductory comments.

Let me emphasize that the issues reflected in the title are just one aspect of a much broader range of questions. Competition between so-called domestic banks, banks when they are operating on their home turf, and international banks, banks operating in a country other than their own, is only one of the significant areas for competition in the financial services industry within countries and around the world. Still, competition between domestic and international banks is itself a big enough and many-sided enough issue to fill easily the time allotted for my remarks.

My second comment by way of introduction is that I am of course not a commercial banker. I am sure that there are important business skills transferable between the two disciplines of commercial and central banking. Also, an understanding of financial markets will surely come in handy

in either profession. Some people have distinguished themselves in both kinds of roles. Nevertheless, I should warn you that as a central banker I am not called upon to decide on strategies for profitable commercial lending or how best to seek deposits. And these are strategies that traditionally lie at the heart of commercial banking.

But while I cannot claim inside knowledge of many of the points at issue, I can claim to be a deeply interested onlooker, albeit from a Canadian perspective. Furthermore, some spectators get an excellent view of the playing field and the game. Commercial bankers in the audience will judge whether the game I see is the same game as they are playing.

I have three main topics. First of all, I will review briefly the recent efforts to bring about a convergence of capital adequacy measurement and capital standards for banks operating internationally.

Secondly, I will share with you some thoughts on how these banks' activities outside their traditional home bases are evolving.

Finally, I will comment briefly on a set of questions that come up often in the context of the entry of international banks into domestic markets and with which I certainly have a very direct involvement. These are questions related to central banks' ability to conduct national monetary policy in financial markets that are considerably more international in scope than they were even a decade ago.

The capital convergence exercise, undertaken by banking supervisors and central bankers from the G-10 countries and Luxembourg, has had two main objectives.

The first objective has been to strengthen the international banking system. The erosion of the capital bases of banks through the 1970s and early 1980s, as they competed ever more aggressively for business in the world arena, had become a mounting concern for banking supervisory authorities. In light of the international character of the problem, the most effective response was to organize a common effort to promote the shoring up and improvement of the capital positions of banks operating internationally.

Another objective has been to manage this broad improvement in capital positions in such a way that was internationally equitable. Bothersome disparities had emerged in regard to the capital positions of international banks headquartered in the various G-10 countries. This planned levelling of the playing field means that some countries' internationally operating banks will have to work appreciably harder than those of others to meet the agreed minimum capital standards that come into full effect at the end of 1992.

It is worth noting that the new internationally comparable capital framework is intended to be applied to banks on a consolidated basis. This consolidation covers international banks' subsidiaries undertaking banking business throughout the world.

Naturally, one question that will preoccupy national supervisors in the G-10 countries is the extent to which this international comparability exercise should be

allowed to influence their approach to capital adequacy for purely domestic lending institutions. In this context, I can also note that it is the express hope of the G-10 group that the capital adequacy framework that has been devised will also find favour among supervisory authorities in countries outside the G-10.

Let me now turn to my second topic, an overview of some of the more important actual or potential areas of competition between domestic and international banks.

Given that every bank and every country is different, and given that the entire scene is continuing to change rapidly, generalizations do not come easily. However, one useful approach is to examine the scope for international banks to transfer expertise across borders in order to engage in various kinds of lending.

One area of lending that is generally viewed to be attractive from this standpoint is the banking business of transnational corporations. International banks, particularly if they have established banking relationships with parent corporations at home, may be well positioned to attract the business of the overseas operations of such enterprises. This advantage may be further enhanced if international banks offer a wider range of products, including securities products, than domestic bank competitors and are perceived to be more sophisticated.

These advantages may, however, be overstated. Experience in some countries, including Canada, has shown that price and service are generally more important considerations in the banking decisions of foreign subsidiaries than the banking relationships of their parent

corporations. Moreover, while international banks may offer initially a more attractive overall banking package, domestic banks have generally been quick to respond to the competitive challenge -- a development which improves market efficiency to the benefit of the domestic economy. As regards relative levels of sophistication, I can note for example that while Canadian banks are of course domestic banks in Canada, they also have the expertise that comes from being major players on the international scene.

Another area that at least from some technical points of view could be fertile ground for international competition is consumer financing and residential mortgage lending. Experience has shown that such lending can be managed rather effectively on a large scale basis, in terms of a few basic variables describing the client in question. Thus the specialized management skills involved can in principle be transferred and adapted across borders.

The international record in this regard has, however, been mixed. There is considerable evidence that international banks have not had any great success in penetrating host retail markets and instead have tended to concentrate their attention on the major commercial customers. In large part, this may be related to the considerable start-up costs of entry -- of establishing the minimum size network necessary to compete with already well-entrenched domestic banks in retail markets. In addition, international banks may not be familiar with local customs and attitudes of doing business.

The small and middle corporate market also does not appear to have been specially productive for international banks. This is the area where client knowledge, an ear kept

close to the ground, and a long standing relationship really seem to matter for doing good business, and the evidence would suggest that established domestic banks, being on home ground, have a built-in advantage over international banks. While I am of course most familiar with the Canadian case, I know that Canada is not the only country where results in this market for international banks as a broad group might be considered disappointing.

In sum, while the jury is still out and may indeed stay out for a long time, it would appear that international banks are unlikely to have an inherent advantage over domestic banks. Indeed, domestic banks have considerable strengths, not the least of which is their in-depth knowledge of the domestic economy and financial system and potential borrowers. While in Canada, and elsewhere, the entry of international banks has taken away some business from domestic banks through increased competition, the domestic players continue to compete successfully. Also, as I noted earlier, one result in any event has been a more competitive environment that itself has been beneficial.

This overview would be incomplete if I left the story at the technical level. There are also, it must be recognized, yet another series of considerations relating to where lending institutions are centred.

Let me note as an illustration in this regard that within Canada -- a regionally diverse country -- there have been longstanding forces continually pressing for regionally based, regionally controlled, lending institutions. The broad contention is that such institutions might be more responsive to regional aspirations and regional needs. Restrictions on nation-wide banks in the

United States, although clearly weakening, have originated in similar regional concerns.

To illustrate the national, as opposed to regional, interest, I can note a comment made several months ago by the Governor of the Bank of England. In considering the issue of foreign involvement in the British financial system he observed that while he welcomed foreign entry into the U.K. market, it would not be desirable for the control of the core financial system -- the payments system and the supply of credit -- to pass "into the hands of institutions whose business aims and national interests lie elsewhere". In other words, the world is changing, but not completely.

As a transition into my final comments, let me note that the observation I have just cited did not indicate that the entry of foreign institutions impeded monetary policy.

Indeed, the way we see this at the Bank of Canada, it is not likely that a strong case for exclusion of foreign institutions could be made on grounds that their presence interfered with the conduct of domestic monetary policy.

This is not the occasion to spend a great deal of time on this question, but let me emphasize what I am saying and what is not being said.

Broad monetary policy, the management of monetary conditions, has in every country now to take account of the interaction of domestic and international financial markets. Furthermore, the links between domestic and international markets are so numerous and so complete, at least for Canada, that it is unrealistic to suggest that changing the degree of foreign institutional financial presence on the domestic

scene would measurably alter the quality of the domestic-international transmission. Not every country is as fully plugged into international financial markets as is Canada, but I would suggest that the links are increasing everywhere.

In any event, to concede the reality of generally strong domestic-international links by no means implies that domestic monetary policy does not remain a powerful economic tool.

The important consideration in viewing national monetary policy as a powerful instrument in these circumstances of strong international linkages is to accept that the exchange rate is part of the mechanism by which monetary policy impulses are transmitted. Commercial bankers know well the strong links between developments in the domestic money market and developments in the exchange market. Indeed, because of those links, through expectations and the forward exchange market, many financial institutions have their money market and exchange market operations in the same large room.

My final thought is this. While strong international financial links are certainly a complicating factor in the management of national monetary policy, the fundamental ability to direct monetary policy at domestic monetary stability still remains.