Managing change in international banking: a central banker's view

*The **Deputy Governor** reviews[1] the evolution of international banking over the 1970s and the changes which are now taking place; and discusses the challenges these will pose, both for the banks and for the supervisory authorities. While welcoming the progress made in liberalising the financial services industry, he cautions that the strategic choices to be made by banks, the implementation of decisions to diversify, and the assessment and control of the new risks they may undertake, present problems and potential conflicts; supervisors too need to respond to the changes taking place and to modify their approach to deal with the new situation. He concludes that there can for banks be no substitute for a well-thought-out and carefully implemented strategy which takes full cognisance of the risks involved.*

Introductory remarks

During the last two or three years, international banking—and indeed financial activity more generally—has embarked upon changes which are probably as far-reaching as any in its long history. The rapid development of the euromarkets in the 1960s and the subsequent emergence during the 1970s of international banking as we now know it are the most recent examples of significant change. But these will, I think, be outstripped in the breadth of their impact, both on financial institutions and on the range of instruments available to borrowers and lenders, by what is going on now. So it seems, at least, to me as a central banker in London. The City of London is in the throes of a major transformation, and all of us involved in it are faced with a need to re-examine fundamental questions about the way in which financial institutions should carry out their business and about the regulatory framework within which they should do so.

Successful change in the financial sphere is rarely entirely the product of accident or the march of external events. While it may often appear with hindsight to be part of a natural evolution in which no other outcome was possible, the reality is that change calls upon management skills and efforts in a way that more stable times do not. It is, in short, a management challenge, both for banks and for the authorities. What is more, it is a challenge which will produce both winners and losers. We cannot all expect to respond successfully to it and emerge unscathed.

The evolution of international banking in the 1970s . . .

Before elaborating on the ways in which our management skills are to be tested, however, I will spend a little time on the past; for it may give us clues as to the probable outcome of current changes, and may provide lessons which will—if learnt—help us to avoid some of the hazards which accompany such periods of upheaval.

Until the end of the 1960s, international business was—except for trade finance—largely untapped by commercial banks. There was therefore much scope for rapid expansion. The euromarkets had been developing throughout the 1960s, but it was only at the end of that decade that banks began to explore the possibilities of applying techniques which they had developed in a domestic context—in particular, the provision of medium-term loans—to their international activities.

Several forces lay behind the transformation of international banking from an essentially short-term, trade-related, activity into one very largely based on the provision of substantial medium-term facilities. Perhaps the most fundamental was that many banks saw international activities as a promising way for them to achieve their corporate objectives. In the late 1960s, many of the large US money centre banks had adopted a conscious strategy of balance sheet expansion, funded predominantly by purchasing funds in the wholesale money markets. This fundamental change of approach spread to other banks around the world, and it soon found an outlet in international lending. The US banks in particular pursued international lending because it was not, as their domestic activities were, circumscribed by restrictions, and so had great potential as a direction in which rapid expansion could take place. Not only this, but international lending looked profitable and also held out the prospect of further diversification of risks and a degree of insulation from domestic cyclical factors.

This strategy of internationalisation paralleled, and was in part driven by, that of the banks' industrial customers, who frequently provided banks—through their demand for financial services to support their own international expansion—with the initial impetus to become involved in international business. At first it was only the largest banks which took advantage of the opportunities, led as I have said by US banks but followed in the early 1970s by their European and Japanese counterparts; latterly, the

(1) In a speech at the banking management conference of the Institut pour l'Etude des Méthodes de Direction de l'Entreprise (IMEDE) in Lausanne, Switzerland, on 17 September.

main Arab banks have made their presence felt. In their wake, many smaller banks—which in retrospect may seem ill-equipped to have become involved to the extent they did—became swept up in the process.

At about the time when banks first appreciated the possibilities of internationalisation, there was also a crucial adjustment in the pattern of financial surpluses and deficits around the world. The oil shocks in 1973 and again in the late 1970s had a significant impact on the international distribution of wealth. They also gave rise to substantial financing needs, as oil-importing countries struggled to accommodate themselves to the consequent changes in relative prices. Any alteration in the pattern of wealth holding necessarily has an impact on the pattern of financial flows; but this one was not only substantial in size, but carried important implications for the form of those flows. Not only did many of the oil-importing countries which had the greatest need for funds not have ready access to the securities markets; but the newly-emerged financial surpluses were held by investors—most notably, oil producers—with a relative preference for bank deposits as a medium in which to hold their wealth. This made it easier for banks to attract these (predominantly dollar-denominated) funds and so to meet the greater demands being made on them. It thus helped them to shift the balance of their portfolios towards international assets.

The higher and more volatile rates of price inflation and the sharp swings in exchange rates which coincided with the alteration of the pattern of flows may also have given banks an advantage as intermediaries. Certainly, banks showed themselves during this period to be more prepared than the securities industry to undertake floating-rate intermediation and to take on the maturity transformation involved. The recent development and widespread use of floating-rate paper in the euromarkets suggest, perhaps, that it was the banks' readiness to seize their opportunity, rather than any inherent inability of the securities markets to offer suitable floating-rate instruments, which was decisive. But the volatility of inflation and interest rates undoubtedly favoured floating-rate intermediation just at a time when banks were looking for expansion of their international activities and had a flexible floating-rate instrument—in the form of the syndicated credit—ready to hand.

The speed with which banks proved able and willing to respond to the increasing demands placed upon them may also have been decisive in their displacement of the official sources which were the more traditional suppliers of balance of payments finance. Though industrial countries' governments and multilateral agencies were aware of the dangers of undue reliance by oil importers on commercial flows for balance of payments purposes, there was nevertheless considerable relief that the strains posed by the very large volume of 'oil funds' were being dealt with smoothly by the world banking system. Longer-term problems were built up, of which we are all now only too aware. But it is important to remember that, by the same token, potentially very severe short-term problems were avoided. Borrowers, for their part, doubtless saw benefits in commercial, unconditional, loans—once they were available—and became reluctant to return to the discipline of borrowing from multilateral agencies and the limiting conditions frequently attached to bilateral, government to government, loans.

In assessing the relative importance of the forces I have described, it seems to me that the strategic decisions made by the large US money-centre banks in the late 1960s were crucial to the role they—and the banks which followed their lead—took on in the 1970s. But developments in the world economy at the time clearly had a decisive effect on both the speed and the extent of the transformation of their balance sheets. So too did the syndicated credit, which greatly facilitated the lending process and widened the range of banks which felt able to participate in cross-border lending.

. . . and more recently

When we turn to the more recent changes in international banking, the conclusions to be drawn are much less clear—not least because the changes are still in progress, and it is hard to determine yet what the eventual outcome will be. Nevertheless, some of the factors which have initiated the current changes in the role of international banks can already be identified.

First amongst them, in order if not in significance, is the difficulty banks have encountered in their international lending. A substantial proportion of the external assets of international banks is now caught up in a process of rescheduling and renegotiation which is proving both difficult and a considerable burden on management time. I hardly need to give a detailed account, so familiar has it all become, of how these difficulties arose, or of what is being done—by banks, by other creditors and by the borrowers themselves—to enable the debtor countries to meet their obligations. It is understandable that these problems should make banks consider very carefully whether they should continue to be involved, to the extent they are, in international lending. The profitability of international assets is now far less assured, and many banks—especially the small ones—regret the extent to which they have become involved in international lending. In time, it is to be hoped that a solid basis for international flows intermediated by commercial banks will be re-established; but, for the present, it is not surprising that banks' forward planning is increasingly focussed on other areas of business.

Second, and in part a consequence of these international debt problems, is the banks' response to a recognition, both by banks themselves and by their supervisors, that their capital resources had by the early 1980s become over-stretched. Their policy of rapid growth had meant that insufficient attention had been paid to profitability, and the overall return on assets had become increasingly meagre. This, and the worsening loan loss experience—on some areas of domestic business as well as on international lending—have encouraged international banks both to add to their capital resources and to adopt a strategy more focussed on rates of return and less geared to balance sheet expansion.

As far as capital is concerned, the supervisory authorities in a number of countries have taken a lead in encouraging their banks to improve their capital ratios. Some have set explicit targets which must be achieved by certain dates—the United States provides the most obvious example of this—while others have pursued a less formal, but nonetheless determined, approach. For their part, banks have started to search for new sources of profit and for business which does not expand the balance sheet unduly. This is being reflected in an enthusiasm for off-balance-sheet activities, and a greater preparedness to undertake an agency—rather than an intermediary—role in certain transactions.

Banks' abilities to adjust the shape of their business in this way have been greatly enhanced by the deregulation taking place in several important financial markets, and by the new instruments and innovatory financing techniques which have recently been introduced, both by the banks themselves and by other intermediaries. These changes in the regulatory framework of the financial services industry are breaking down both geographical and institutional barriers. In the United States, for example, banks are becoming able to spread their deposit-taking activities across some state boundaries; their previous inability to do this had been one of the stimuli to their international expansion. Many countries are relaxing restrictions on foreign banks wishing to operate in their domestic markets, so the scope for international banks to expand their overseas domestic activities—which are in many ways distinct from their cross-border lending business—is undoubtedly increasing. And the opportunities opening up to banks in areas of the financial services industry not previously accessible to them—for example, securities business and insurance activities—present further possible routes for diversification away from the international business they have relied on throughout the 1970s.

The continuing development of computers and telecommunications is a further influence on the services banks can offer. As well as being used much more imaginatively in developing and delivering banking services to customers in a purely domestic context, they are also making feasible international operations of a complexity and speed of response which could not previously have been contemplated. Dealing rooms and the systems they depend on are a vital part of all this, and are becoming increasingly central to many banks' activities. The sophistication which can now be achieved is staggering—as is, of course, the risk of fraud should levels of security in computer systems and communications networks not be kept under constant scrutiny.

Behind all these familiar developments is one which may, in the long run, prove to be at least as important to international banks as the debt difficulties and regulatory changes. I mentioned earlier that, in the 1970s, banks had been greatly assisted in their success in international intermediation by the macroeconomic background against which their lending developed. The oil shocks, the variability of interest and exchange rates, and the changes in the pattern of wealth holding around the world were, I think, very important. What we are seeing now, however, is a reversal of many of the adjustments brought about by the oil shocks. OPEC countries are no longer accumulating financial assets; indeed, in some cases, they are running down the substantial reserves they built up following the oil price hikes. In addition, they have become more sophisticated in their investment strategies and no longer show so marked a preference for bank deposits as a form in which to hold their wealth. This, together with the new pattern of surpluses and deficits—in which the US balance of payments deficit and the Japanese surplus are particularly marked—is restoring a pattern of wealth holding and borrowing needs which again favours securities rather than bank lending.

The volatility of interest and exchange rates unfortunately remains a feature of the financial environment. But here, too, the advantage this once gave banks is no longer so marked: many of the new instruments, which have been so noticeable a feature of the changes in the financial services industry, offer borrowers medium-term funds with the advantages of the syndicated credit but with the added bonus to lenders of marketability. It is perhaps significant that banks have found it necessary to add an element of marketability to syndicated loans, by introducing the transferable loan facility. This is a direct response to the renewed ability of the securities industry to attract business previously done by banks. As yet, however, banks' international lending shows little sign of reviving, despite this competitive innovation.

Current position of international banks

It is still difficult to predict the eventual outcome of the current wave of changes. Competition in the financial services industry is intense, and many important regulatory and institutional developments have yet to make themselves felt. In London alone, for example, the new market dealing arrangements will not come into force for another year; and the new regulatory framework too will still not be fully operational by then. In the United States, important deregulatory measures are still under discussion.

For international banks, there are, I suppose, two crucial questions. First, will bank lending be able to retain its place amongst the variety of channels for international intermediation? One must be wary of making predictions in this field in view of the speed and extent of the switches that we have already seen in forms of financial flow. But the evidence so far suggests that bank lending is unlikely to regain the dominant role it played in the 1970s, at least over the next few years, with economic circumstances now tending to favour securitised flows and the securities industry itself becoming increasingly competitive. In any case, the keenness with which large banks are seeking involvement in areas which have not traditionally formed part of what one thinks of as the banking industry might suggest that bankers themselves see financial conglomerates—of which banking will only be a part—as the way forward. But it will be some time before the effectiveness of such groupings is definitely established.

Second, will banks as institutions—whether or not bank lending as such retains a dominant role—in fact be able to compete successfully against other financial institutions in the new market environment? Might they be unable to make inroads into areas of business new to them and find themselves consigned to a shrinking sector? Again, the answer is far from clear.

Challenges facing banks' managements . . .

These questions give an indication of the nature of the challenge facing the managers of international banks as they plan for the years ahead. In some respects, for example in their contribution to the pressure for institutional deregulation, they are seeking—as they were in the 1970s—to put into effect a new strategy. But this change of strategy has itself partly been prompted not simply by management choices but by other events. An accurate analysis of which developments are significant to banks' business, and which innovations will survive, is therefore important if a coherent strategy is to be developed. Once this is done, the means must be found to implement that strategy successfully; and the new risks, which are increasingly evident as what were once simply innovations cease to be novelties and become the staples of the new industry, must be carefully controlled, monitored and accurately assessed.

It would be presumptuous of me to offer answers to these questions. There are many other speakers at this conference better qualified than I to discuss with you the substance of the many possible solutions to your management dilemmas. But from a central banker's viewpoint, I can perhaps offer you some general thoughts and alert you to some of the conflicts which may develop as you wrestle with the problems. I will then conclude, if I may, with some of the difficult decisions which we as supervisors face: for we too are caught up in the process of change, and must make decisions which may prove crucial to the success with which it is accomplished.

. . . in their strategic choices . . .

Let me begin with strategic choices. I have already mentioned that the overriding preoccupation with balance sheet expansion has been increasingly tempered with a concern about rates of return. This must be right. If banks are to be able to continue to attract the resources needed to support their activities, they must employ their capital at least as profitably as its alternative uses elsewhere in the financial services industry. If they do not, the banking sector will in the longer run shrink in relation to those parts of the industry better placed to meet the needs of the ultimate users of financial services. The ineluctable pressures of competition will eventually ensure that those sectors which are no longer adequately profitable will decline in size and importance; banking cannot expect to be an exception.

That said, the implications for management strategies are far from clear. It does appear that, for the present at least, international lending *per se* is not notably profitable. With the changes in the distribution of wealth holding noted earlier, which seem once again to be favouring securities as the medium for the deployment of investors' funds to their ultimate users, the attractions to banks of diversifying their activities into securitised lending and into securities business more generally are obvious and understandable.

Until recently, there had in many countries been a clear and strong separation of function in the provision of financial services, with banks in particular severely restricted in the activities they could undertake. It had, however, become increasingly clear that these demarcations inhibited the industry from providing a broad range of services efficiently and competitively. The many barriers produced a lack of responsiveness to customers' requirements and a lack of dynamism quite at variance with the competitive environment being fostered elsewhere in the economies of the industrialised countries. These obstacles had to be removed, and I welcome the fact that so much progress has now been made in freeing up the financial services industry. Many banks are widening their horizons, and profiting—both literally and figuratively—from doing so. I applaud their efforts. But does diversification always confer the benefits so widely expected of it? In the rush to take advantage of the new freedoms, are all those involved—and not just the major participants, many of whom are undoubtedly well placed to benefit from diversification—taking sufficient care over the direction in which they are heading?

I have two queries about the very widespread desire to diversify not just the risks to which a bank is exposed—a wholly laudable objective—but also the distinct activities undertaken. I have in mind not the natural extension of existing banking functions but the departure into completely different fields. My first query is simply whether widely diversified banking operations will in every case prove to be more competitive than specialist providers of the same services. International banking has indeed been carried out most effectively by large institutions able to benefit from economies of scale, and it is tempting to extend this thinking to current circumstances. I suspect, however, that diversification to any substantial degree may carry with it some important penalties if the individual parts are to be of a sufficient scale to compete effectively in their sector of the market. A large organisation is, from a management point of view, a difficult one to control. Its speed of response to changing market conditions may not be as rapid as its smaller but more specialised competitors. To add to the already major task of keeping up with the changes in the market the burden of managing an ever-wider range of activities, when it is still far from clear which will ultimately be of value, could weaken banks' effectiveness in competing against other institutions.

In the manufacturing field, it is often felt that firms with too many different product lines are put at a disadvantage. Industrial conglomerates are much less favoured than they once were—indeed it is not uncommon for them now to be separated into their component parts. In the same way, while a certain amount of diversification may be beneficial in the provision of financial services, to take it to too great an extent may be self-defeating: a degree of restraint and conscious choice may be more profitable in the longer run.

The second point which gives me pause is the oft-made claim that there are benefits not just from the different activities themselves but also from the fact that they are all provided in-house and so indirectly benefit each other. This is the so-called 'synergy' of a diversified business, where the whole may be greater than the sum of the parts. Of course, some of the new activities will be able to share overheads with the existing business. But for those which do not—and many of the novelties on which banks are now embarking may fall into this category—the claim that there will be spin-off benefits deserves to be examined particularly carefully. I am reminded of those bankers in the 1970s who, while admitting that their international lending was being done at excessively fine margins which did not justify the risk, claimed that it would generate further business on which there would be ample margins to compensate for this. All too often, I suspect, no such related business materialised.

A strategy of diversification, then, while it may seem an obvious way to compensate for a shrinking demand for the 'core' business of lending, needs to be weighed carefully against its possible costs. A well-thought-out decision to diversify away from lending into other clearly defined areas of business may indeed be a sensible way forward for some international banks—but perhaps not for all. Certainly it is no guarantee of higher returns simply to imitate those who have for many years been making their living by providing these different financial services, or to adopt a haphazard approach to diversification in the hope that the various activities will somehow be mutually reinforcing.

... in the implementation of strategic decisions ...

What of actually carrying out a decision to diversify? Here too there is a management challenge. Broadly speaking, diversification can be achieved either by the acquisition of existing companies engaged in the chosen fields or by internal diversification, assisted perhaps by recruitment of qualified staff from other firms. Neither of these is straightforward. Growth and diversification by absorption, for example, is not just a matter of acquiring the control of the other business: it takes time for it to be properly integrated into the parent company. Appropriate management structures need to be devised so that proper integration takes place; adequate controls must be incorporated; necessary channels of communication must be established to facilitate appropriate cross-fertilisation; Chinese Walls may need to be erected to prevent inappropriate cross-fertilisation; and an awareness of any regulatory or supervisory requirements which the new acquisition brings with it must be cultivated.

Growth by internal diversification is not easy either. Expertise must be acquired, either by recruiting qualified and experienced staff or by gaining experience gradually in the market place. There are all too many precedents for banks getting into difficulties by internal diversification at too rapid a pace, failing to appreciate the hazards of the new activity. The unfortunate experiences of both Continental Illinois and JMB should be a salutary warning here: part at least of both these banks' difficulties can be traced to imprudently rapid expansion of activities for which the institution did not have adequate expertise or controls. There is also the danger of diluting management skills, to the detriment of the existing business. In today's competitive atmosphere, that could leave any bank dangerously exposed.

One of the means by which any company can strengthen its management or introduce new skills is, as I have just said, to seek out staff and attract them from their existing employers. This is certainly a much-used technique in the City at present and, while it may not be inherently undesirable when used in moderation, the scale it now seems to be assuming has important implications not only for the individual firms—at both the losing and receiving ends of particular high-cost transfers—but also much more widely. There is, after all, only a limited pool of talent available in the short term and if it is being sought out by too many firms the consequences are inevitable: a significant escalation of salaries generally and a lack of stability in staffing.

Both of these developments are worrying, even though higher remuneration in the short term may well be necessary to stimulate greater market availability of the required skills in the slightly longer term. If key staff—and even, on occasion, whole teams—can be offered inducements to move suddenly from one institution to another, it becomes very difficult for any bank to rely on the commitment individuals will give to implementing its plans and adds a further dimension of risk to any bank which is building its strategy largely around a few individuals' skills. This is also, I might add, potentially of concern to us as supervisors and regulators. The ability of a firm to carry out its business soundly and to retain its reputation in the market is increasingly determined by the individuals who occupy key positions in it, and not simply by that firm's historical associations and record. It is worrying that a firm authorised to carry out a financial business on the basis of a prospectus in which certain individuals are a key component can quite rapidly lose those individuals to its competitors.

There has long been a differential between salaries paid in the financial sector in the United Kingdom and those paid in industry; but international banking is an obvious sector through which foreign salary levels can be transmitted to the domestic economy. Both the fact that abnormally high salaries are being offered to key groups of staff and the publicity it has attracted are unwelcome; the more so, because the insecurity which one might expect to accompany such salary levels does not yet seem to be much in evidence. More thought, I suggest, needs to be given to what it is that these salaries are being paid for and whether they are justified. I am sure I am not alone in wondering whether things have already gone too far in the City transfer market; and in thinking that the pressure for quick success may be creating incentives just as false as those which encouraged loan officers to disregard many traditional banking virtues in the 1970s in their single-minded pursuit of balance-sheet expansion.

. . . and in the risks of the business itself

A final area in which I believe managers will face great challenges is in the assessment and control of the new risks they are taking, both on and off their balance sheets. The same pressures that have reduced the attractions of traditional lending are, as I mentioned earlier, encouraging banks to move risks off their balance sheets and to involve themselves in many of the new instruments and techniques which have proliferated over the past two or three years. Properly controlled, these new techniques should enable banks to select and manage their risks more flexibly: many of the new instruments make it possible to separate risks which previously were bundled together, and the increasing use of marketable instruments by banks enables them—in principle at least—to manage their balance sheets by trading existing assets and not just by acquiring new ones.

The ability of banks to benefit from these advantages will, however, depend very much on the care with which they use the new instruments. The penalty for all this flexibility is that banks will need to be aware that risks may present themselves in an unfamiliar form. Credit risk, for example, cannot be ignored simply because the claim is marketable, for any decline in credit quality will be reflected either in difficulty in trading the asset (which would affect its liquidity) or in a change in its value: so that the loss could appear in the balance sheet much more quickly than it would have done with normal lending. Assessing precisely how much of the risk of certain off-balance-sheet items should be allowed for by banks, and how much ultimately resides with the other parties to the transaction, is a further difficult problem posed by the ease with which risks can now be separately packaged and transferred to other intermediaries.

Interest rate and currency swaps, as well as options and futures, present banks with a whole new range of difficulties: complex techniques need to be employed to determine the extent of banks' exposure, and conceptual problems often need to be resolved. It is important, too, that managers themselves fully understand what is going on and do not rely on others to assess what is involved. We already know of cases where not even those in daily contact with the new instruments have grasped fully what it is that they are taking on.

Banking supervisors are, of course, taking a close interest in all these new techniques and are integrating them into their assessments of banks. But this supervisory concern does not relieve banks of the need to establish their own proper systems of control. Whether or not a particular risk is regarded as off balance sheet, a prudent banker should still ensure that there are adequate resources available to absorb any losses which might arise. Perhaps more difficult, he should ensure that what risk there is is correctly priced. I suspect that, in some instances, the new instruments are being issued on terms which do not fully reflect the risks involved. As with all new instruments, there is a honeymoon period when nobody has lost any money. That can, unfortunately, lead to complacency and eventually to hard lessons for those who do not take sufficient precautions against the risks which will inevitably materialise. Moreover, the honeymoon period of no losses may turn out to be surprisingly short. Instances are already known, for example, of experienced banks making sizable losses on options business.

There is one final aspect of risk which banks' plans for diversification into new sectors of the financial industry may create: that of links between risks in different areas of business. It is well recognised that, in a portfolio of similar instruments, close attention needs to be paid not just to the individual risks in the portfolio but also to their relationship to one another. On a grander scale, banks will now need to think about whether there are any correlations between possible losses on the many different forms their exposure to risk now takes, or in different areas of their business.

There are two slightly different aspects to this. The first is that some disturbance in the economy—say, a sharp appreciation of the exchange rate—may create problems in several areas of a bank's business at the same time, and appear in different guises depending on the form of the exposure. For example, it might cause problems in a particular industrial sector; this might affect a bank both through worsened loan loss experience and through an inability to place paper in the market as part of an issuance facility to which it was also committed. It could also lead to losses on options contracts the bank had written. The danger that distinct activities might simultaneously present problems in this sort of way is one that bank managements should take very seriously.

The second is that a problem in another part of a conglomerate may, through its effects on confidence, affect the banking side of the business. However well insulated the banking activities may be from other parts of the conglomerate, by separate capitalisation or by other means, the danger remains that confidence in a bank could be damaged simply because its name is used in, or associated with, other activities which may not prove successful. It is this worry which has been an important part of banking regulators' traditional reluctance to allow banks to depart too far from the essentials of lending. Confidence of depositors is crucial to banking. Banks' managements must therefore be particularly careful to consider the risks they may be running by taking on unrelated financial activities.

Challenges facing banks' supervisors

By no means all the problems of managing change in international banking fall to banks themselves: banking supervisors too need to respond to the changes taking place, and to modify their approach to deal with the new situation. Perhaps the most complex problems we face on the supervisory front, because of the fundamental issues they raise, are those created by the blurring of distinctions between intermediaries traditionally supervised or regulated by distinct agencies who, in the past, needed to have little contact with each other. As banks start to encroach on those non-banking areas, and as other specialists begin to take on some banking functions, the straightforward distinctions which could previously be used to delineate the areas of responsibility of different supervisory bodies no longer exist.

Financial conglomerates pose these problems in their acutest form: how can one best supervise a business spanning, for example, banking; dealing in securities as principal and agent; investment management; and insurance activities? Who should it be done by? What standards should they adopt? The general thrust of much current legislative change in financial markets is that traditional barriers to competition be removed, to improve the efficiency of the financial system. It is important that supervisors do not frustrate this objective by creating barriers of their own, but they must nevertheless safeguard the interests of depositors and investors. There are two distinct concerns: first, that all those active in the industry are in fact subject to supervision but not overburdened by an excess of it; second, that the standards applied by different supervisors do not introduce unreasonable barriers to competition, or confer on particular types of institution an unfair competitive advantage. As banks often remind us, there need to be level playing fields.

To banking supervisors, these sorts of problems are not entirely new. The rapid expansion of international banking in the 1970s, with banks increasingly conducting their international business in a variety of foreign centres, is an earlier example of developments in market practices to which banking supervisors had to adapt. It has proved a considerable task to ensure that the division of supervisory responsibilities for international banks between national supervisory authorities is both clearly understood and effectively operated, and that no bank or part of its operations should escape the supervisory net.

Much valuable work in this area has been carried out by the Basle supervisors committee, which first met in 1975. All the banking supervisors of the G10 countries, together with those of Luxembourg and Switzerland, are represented on this committee, and they have done much to ensure that banking supervision keeps pace with the activities of international banks. They have not only laid down principles which assign responsibility between host and parent supervisory authorities for internationally represented banks but have also worked on the standards which should be applied. Their work has resulted in clear understandings on the division of supervisory responsibility for various aspects of banks' international operations and on the adoption of the principle of consolidated supervision. These were set down most recently in the revised Concordat published in 1983. This lead is one which other banking supervisors are increasingly following: the Concordat, for example, was endorsed by participants from some ninety-five countries at a conference of international banking supervisors held in Rome last year.

It has proved harder to agree on the way in which common supervisory principles should be applied to the detailed supervision of different nationalities of bank: differences in supervisory powers, in legal requirements and—most fundamentally—in the structure of banking in different countries pose formidable obstacles. Nonetheless, discussions in Basle have contributed to improved understanding of the issues involved and there are indications that some convergence of supervisory standards is being achieved.

Because of banks' unique role in the financial system, the correct supervisory treatment of banks which form part of financial conglomerates is of special interest. Banking supervisors are confronted here with challenges which have both a domestic and an international dimension. Financial conglomerates raise in a domestic context some of the issues which the Basle committee addressed in the 1970s: for example, that differing supervisory demands might create distortions in the way conglomerates carry out their business. Co-operation between those who may be responsible for different parts of the financial services industry will be even more essential if conflicts between the regulators are to be avoided, because their concerns may be different in some important respects. The nature of the regulatory bodies too may differ: in London, for example, they will include government departments, the central bank, practitioner-based private sector bodies administering statutory powers, and self-regulatory organisations. Harmonising their aims in their approach to areas of business which several feel a need to look at is therefore a challenge.

Banking supervisors will always, and rightly, want to keep a close watch on any conglomerate encompassing a banking business. But, when such banking activities form only a small part of some much larger business, this will not be easy. Separate and adequate capitalisation of distinct activities is one safeguard, because it can limit the severity of shocks which one part of the business can transmit to the others. But it may not be wholly satisfactory: separate capitalisation does not rule out the possibility that trouble could spread to the banking entity simply through loss of confidence in other aspects of the business.

When it comes to the international dimension of these supervisory issues, the complexities multiply. I will give you just one example. One of the issues we have needed to address in London has been that of how to treat non-banks from abroad seeking to conduct banking businesses in London. The approach we have chosen to adopt is that the banking operations of such conglomerates should be supervised by the competent banking authority in the parent's domestic market. This ensures that such operations are supervised by the same body and in the same manner as banks originating from that country and so will be subject to the same supervisory criteria.

Conclusion

I have, in the course of my remarks to you tonight, highlighted a number of issues which may present international banks and their supervisors with difficult choices. I would not, however, wish to leave you with the impression that I am pessimistic about the future. Banks now have a wide range of opportunities opening up to them in the financial services industry, and we can be sure that they will seek to turn them to advantage. My caution to you would simply be that there can be no substitute for a well-thought-out and carefully implemented strategy, fully cognisant of the risks involved and not just of the benefits to be gained. If that is the spirit in which the challenges are faced, banks could emerge from the transformation of the financial services industry better placed to meet the needs of their customers and with a role in financial affairs at least as important as they have played hitherto.