GLOBAL BANKING: PARADIGM SHIFT

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Ladies and Gentlemen

Good morning

It gives me immense pleasure to be here in Mumbai for the Conference on "Global Banking: Paradigm Shift" organized jointly by the Federation of Indian Chambers of Commerce and Industry (FICCI) and the Indian Banks Association. I am also pleased to chair this morning's session on paradigm shifts in the financing of the services sector. In the last couple of days, several brilliant speakers have thrown up a wide range of issues that all of us here whether businessmen, commercial bankers, central bankers or regulators necessarily have to be familiar with. Admittedly, the discussions on the various topics have been very enriching. A Conference of this standard cannot but be constructive. May I extend my warm appreciation to the FICCI and IBA for hosting this Conference.

The main theme of this Conference compels me to succinctly look back into the evolution of multi-national banking or rather into the evolution of global banking as it is generally referred to in modern times. The move towards multi-national banking may be traced back to the euro-dollar market that stemmed from a number of conditions evolving simultaneously in the 1950s and 1960s – the establishment of the US dollar as the key currency in international finance, the return of European currencies to free convertibility in the post World War II years and the differentials among interest rates in money market centers.

However, in the two decades following the War banking and finance enjoyed a comfortably protected existence. Exchange control and stringent domestic regulation constrained the scope for competition or diversification. The incentive to and scope to innovate were indeed weak.

The internationalization of business, spearheaded by the big US companies that were going multi-national was, it will be recalled, a remarkable development in the 1960s. The expansion of transnational economic activity in the wake of the proliferation of multi-national companies in places other than in the US led to the rapid growth of international financial markets. It is difficult to put a precise starting date on the financial revolution, that is, on the beginning of sophisticated asset and liability management techniques and on the extraordinarily complex derivative and hedging products. But one can reasonably suspect that it did take-off sometime after the breakdown of the Bretton Woods System when the US dollar switched to a floating exchange rate regime.

Deregulation of the financial sectors at the micro level combined with the freeing up of capital movements at the macro level set the stage for global banking on a wider scale. Global banking then encompassed mostly the Western economies. The breakdown of the Bretton Woods System along with the unprecedented growth in liquidity resulting from the surge in world oil prices of the 1970s intensified global banking activities. The geographical coverage of global banking went beyond the Western economies. The debt crisis of the 1980s is a sad reminder of the mistake made by global bankers in risk calculation.

Meanwhile, the electronic data processing revolution began to open up avenues for financial engineering that could never have been thought of earlier. The ICT revolution has traveled a long distance. The ever-increasing speed of processing and communication has progressively redefined time-based competition. New vistas and extraordinary complexities in trading strategies never dreamt of before opened up.

Viewed from the perspective of history, the global banking paradigm has been changing all the time since the beginning of the 1970s. What makes the difference is the **speed** of the changes that have taken place since the 1980s as increasingly more and more smart players have been joining the game. Success in business today is **time-critical**. Speed has drastically shortened product life cycles. Worldwide electronic network over which financial institutions are said to transfer US$40 billion per minute has intensified time-based competition. Consumers, whether they are consumers of financial services or of tangible products, seek real-time responses. As is generally said, miss a day and the world moves on without you.

This brief overview of the evolution of global banking carries with it one message: banks have adjusted and re-adjusted to the shifts in paradigm over the years. They successfully developed their own business models focusing on niche markets and grew in size over time. I do not see any reason why should banks not succeed in coping with the speed of changes in paradigms in modern times so long as they are prepared to take pioneering initiatives.

Let me digress and make one brief observation. Most of today's advanced economies embraced capital account convertibility decades ago, which largely explains their leadership in international finance. By contrast, the vast majority of developing economies was still in the age of financial repression until the 1980s when financial sector liberalization gathered momentum. There exists solid evidence that the promotion of a strong financial system precedes and positively contributes to economic performance. Given the gap that exists between the advanced and developing countries, how can developing countries with their tiny financial markets expect to obtain high quality financial sectors that they need in order to promote growth? Of all the developing countries, Brazil and China have financial assets accounting for about 1 per cent of world total financial assets. The total assets in one third of all developing countries are less than US$ 1 billion - a very far cry from that of a small local bank in the United States. The total assets in another third of all developing countries are less than US$10 billion that compares miserably with the over US$80 billion assets of the world's fiftieth largest bank. It is almost impossible for developing countries with their tiny financial markets and poor quality financial services sectors to be meaningful players in global banking. The Financial Sector Assessment Programmes carried out jointly by the World Bank and the IMF for many of their member countries are careful not to make any specific prescription in favour of any paradigm. As I see it, the way out is to allow free entry of strong foreign banks into their domestic markets rather than being protective of local banks. Authorities and trade unions, too, in several developing countries tend to think along the line of the comedian Woody Allen who said: " More than any time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly." Either swim with the tide, or sink.

The increasing integration of economic activities, across national borders, through markets along with the phenomenal progress in banking technology has made banking systems across the world increasingly more vulnerable. Financial systems today are more prone to bank failures and systemic crises. During the post World War II period up to the end of the 1960s, that is generally referred to as the age of financial repression, the world financial system witnessed 38 crises.

Between 1973 and 1997, as many as 139 crises struck financial systems across the world. Evidently, the age of financial sector liberalization has also been the age of financial crises.

A characteristic feature of financial systems is the inherent deep-seated difficulties. As such, financial sector liberalization and the resulting globalization of financial markets are tricky in that it has created greater opportunities not for mistakes but for blunders. Malfeasance by both the suppliers and recipients of capital has been quite common. We have witnessed how banks have generated feasts and famines in emerging markets since the beginning of the 1970s. Yet we need to embrace financial sector liberalization and make do with the globalization of financial markets because of the benefits associated with it.

Banks are the epicenters of financial sector vulnerability. If the financially integrated world markets have to be well managed, then banks necessarily have to be adequately caged in the more so when the services sector across the world has expanded tremendously in recent times. This sector appears to have benefited the most from deregulation and hence its fast expansion. Banks have been losing some of their traditional businesses to other intermediaries, both non-bank financial institutions and other commercial enterprises. New competitors, emerging from businesses ranging from supermarkets, wholesalers, retailers, car manufacturers and a host of others, are now offering an endless array of financial instruments, including equities, assorted derivatives and seductively packaged and repackaged risk. These services were once exclusively in the domain of commercial banking. But banks do possess long-standing core competencies in the provision of financial services. To compete and reassert themselves banks need to make the most out of their core competencies through the development of new skills and capabilities.

The growth in the relative importance of the services sector in the national accounts has been phenomenal in several emerging market economies. Domestic banks can only have a share in the cake by extending credit to consumers for the distribution and purchase of the products. It goes to say that in vast domestic markets banks, given their long-standing core competencies, are well positioned to take advantage of emerging opportunities. However, the economics of or the business case for sustained financial innovation and the quest for new efficiencies depend largely on successful exploitation of opportunities that can be seized only and only if banks are willing and able to respond to consumer demand with lightning speed.

But lending to consumers of services in most systems is made on the basis of cash flows of individual households. This does involve risk of default by consumers. In Mauritius banks carry out some sort of credit ratings for individual borrowers before any credit for purposes of consumption expenditure is extended. We are about to launch the Mauritius Credit Information Bureau that will be accessible to all commercial banks operating in the country. Commercial banks will be able to electronically consult the bureau and assess the creditworthiness of borrowers, be they corporate bodies or individual households. Such a bureau would definitely go a long way towards assisting bankers in rating individual borrowers more effectively. And, of course, it would in the same vein, help improve and strengthen banks' balance sheets – a consideration so endearing to central bankers from the standpoint of financial stability.

One area that is still relatively unexplored is the provision of trade finance facilities for the services sector more so at a time when outsourcing has gathered momentum the world over. Banks have indeed played a key role in the expansion of international trade. Hitherto, they have focused on trade of tangibles. They do have potential to establish systems and develop techniques with a view to providing similar services to enable the expansion of trade in services.

Advanced countries have attained their present level of economic development largely due to investment in R&D and innovation. This is seriously lacking in emerging market economies, which leads them to always follow others. I believe banks should create the future and take control of the markets they themselves develop. Genetics and biotechnology are likely to transform medicine and nutrition to become the new engine for growth in the future. This may sound fanciful at the moment, but is not impossible at some stage. Are banks ready to help its expansion and eventually reap the benefits? Why not go for equity funding? In Mauritius we have set up equity funds for financing enterprises in the tourism industry, the ICT sector and small and medium enterprises.

As I just stated lending to the services sector is mostly made on cash flow basis. As a central banker I cannot but reiterate that it involves risk that necessarily requires the creation of very robust risk-management architecture and of well-integrated risk-management teams within banks. International risk-architecture standards together with in-house expertise should allow banks to develop new business models, help understand the market and, most importantly, help understand the business of the customer as well as the behaviour of the customer.

The loss by banks of some of the traditional businesses, particularly to other intermediaries and other commercial enterprises makes it imperative that banks own their respective business models. Reinvention is not changing what is, but creating what is not. A butterfly is no more a caterpillar or a better caterpillar; a butterfly is a different creature altogether. There does exist scope for competing effectively by concentrating on specific geographic locations and product areas or by delivering services to specific customer segments. The big banks at the international level are rewarded for their scale of operations. Arguably, they are too big to fail. They consistently operate in the knowledge that their profits are private and losses, if they happen to be large, are public. Small banks have to be more imaginative than ever.

No doubt, the revolution that has swept through the financial landscape in the past twenty years or so has been beneficial to both financial institutions and consumers. Stiff competition between financial institutions has brought about a narrowing of basic margins in the business of finance and even in other business areas. Temptations to grow fat are strong. Pressures to move faster are intense. Risks are certainly greater in today’s challenging time. Technology driven sectors, in particular the expanding services sector, is not likely to stand still and wait for the laggards to catch up. As I said earlier, financial institutions need to re-invent themselves. Reengineering requires hard decisions. Success awaits institutions willing to make those decisions. Banks, in particular, should not ultimately find themselves in the corporate graveyard.

New expectations and new priorities are unsettling. This audience of august members, I am sure, is aware that we need to think outside the box, not inside the box. We need to get out of the old moulds of running businesses. Change is inevitable. We hate change. Yet it is the only thing that has brought progress and uplifted our living standards.

May I conclude with an observation of the former British Prime Minister, Harold Wilson, “ He who rejects change is the architect of decay. The only human institution which rejects progress is the cemetery.”

Thank you for your attention.

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