

**Ms. Phillips examines whether national financial market regulatory systems should be harmonised in the light of international competition** Remarks by Ms. Susan M. Phillips, a member of the Board of Governors of the US Federal Reserve System, at the Seminar on Banking Soundness and Monetary Policy in a World of Global Capital Markets sponsored by the International Monetary Fund and held in Washington on 28/1/97.

It is a pleasure to be here today to discuss a topic that has become more important in a world of global financial markets -- the matter of coordinating and harmonizing our national regulatory systems. On the conference agenda, the topic was phrased as a question, that is, whether we should harmonize our systems. In a sense, the question is somewhat moot -- the globalization of the markets and the breadth of international conglomerate financial institutions is forcing us in that direction. But I would quickly add that one definition of "harmony" is "a pleasing combination of elements." We can sing compatible and pleasant-sounding notes, without singing the same note. It is in that sense that I believe harmonization of our regulatory systems will develop.

In my comments this afternoon, I will mention some of the efforts underway in which the United States is working with other countries to develop more consistent supervisory and regulatory systems, particularly for large financial conglomerates. That experience may provide others with ideas about how they might pursue similar efforts, either on a bilateral or multilateral basis. Perhaps more importantly, though, I will also offer my views on where our interests are likely to be most similar and why and how regulators around the world are likely to continue working toward compatible or "harmonized" systems. Let me begin with those thoughts.

#### The Importance of Compatible Regulatory Regimes

One cannot have dealt with U.S. and world financial markets during the past few decades without being thoroughly impressed with the rapid pace of change and the manner in which technology and financial innovation have affected market practice. The improvements in communications and transportation and, importantly, the gains from technology and the miniaturization of the goods we produce have fueled a growing volume of international trade. Our financial institutions, in turn, have sought constantly to find more effective and efficient ways to facilitate and finance these activities, and at the same time manage the related risks. As a result, we have seen dramatic growth in financial derivatives, strong support within the industry for new clearinghouses and netting procedures to reduce counterparty credit risk, a growing need to clarify our laws and regulations regarding financial contracts, and financial markets that are far more closely linked today than they were even a decade ago.

In the area of bank regulation and supervision, substantial progress has been made in developing capital standards that help to ensure the financial strength of internationally active banks and that promote greater competition. Simply put, firms in need of international financial services will utilize domestic or foreign financial institutions to the extent their prices are competitive and their financial stability can be assured. As a result, regulators are recognizing the need to harmonize laws and regulations in order to promote economic growth and to deal with important and oftentimes increasingly complex matters that are of common interest to us all.

We are recognizing also the need to enhance financial systems -- including supervision and regulation -- in the emerging market economies, primarily for the sake of those economies, themselves, but also because of their increasing importance in international financial

markets. Indeed, G-7 leaders at their summit meeting in Lyon last summer identified this goal as an important element in efforts to promote international financial stability.

That we need some level of conformity seems, I'm sure, quite clear. Otherwise, the inconsistency and incompatibility of rules and regulations across countries may make it difficult, if not impossible, for some firms to engage in global business activities. Such barriers are detrimental to the efficiency of international trade and finance, generally.

The difficulty, of course, is the precise nature and level of conformity that is necessary to maintain an efficient and equitable world financial system. Here I submit that it may be less important that we standardize particular banking laws and regulations, than it is for us to pursue similar goals, as we independently develop our domestic regulation and supervisory structures. Specifically, if we apply market-based incentives in our regulatory structures, that, alone, should keep our rules sufficiently similar and compatible.

We must also recognize that technology and financial innovation are permitting banks today to become ever-more adept at avoiding regulatory barriers and other restrictions that artificially constrain their activities. Moreover, to the extent they are effective, such restrictions can work against local institutions, businesses, or consumers by making banks less competitive internationally or by withholding from their customers the benefits that competition can bring. Regulatory regimes are likely to be more effective in the long run for financial institutions and for domestic economic growth if they are market-compatible.

#### Areas of Common Interests

In our roles as central bankers, bank supervisors, and regulators, what are the areas of greatest common interest to us for which we should develop compatible rules and regulations? To keep it simple, let me suggest two. First, to maintain a healthy, responsive, and financially strong banking and financial system will facilitate the growing needs of our domestic economies. Second, to build and maintain an adequate legal and regulatory structure will permit our institutions to compete safely on an equal and nondiscriminatory basis, both domestically and abroad. These thoughts may not sound original; they're not. They are essentially the two reasons the Basle Committee on Supervision exists, and they underpin most other international efforts to coordinate banking issues.

When I consider the past successes in coordinating international bank supervisory or regulatory policies, I think first of the Bank for International Settlements and the work of the supervisors' committee. After all, the BIS has been the principal forum for developing international supervisory standards for banks in industrialized countries and, by their voluntary adoption, for banks and bank supervisors in other countries throughout the world. Bilateral discussions can also serve useful functions either where particular issues are of concern or as a basis for subsequent broader dissemination.

Nearly a decade ago, such bilateral and -- through the BIS -- multilateral efforts produced the risk-based capital standard, known as the Basle Accord. Since then, we have produced numerous other policy statements dealing with sound risk management practices for banks. These statements related first to derivatives activities and most recently involve the management of interest rate risk. Dr. Padoa-Schioppa, chairman of the supervisors' committee, has probably already discussed these initiatives with you.

One of the Committee's most recent accomplishments, however, is the development of new capital standards for market risk in trading activities. That standard is notable because it reflects a new approach for constructing international banking standards. In particular, the internal models approach contained within that standard builds on leading industry practices and helps supervisors to promote risk management in banks.

Promoting sound risk management is a goal we should all pursue more aggressively in considering new banking policies and regulations. It is also the type of approach I had in mind when I said earlier that our laws and regulations should be compatible with underlying economics and market demands. To the extent we can continue building on "best" or sound banking practices in designing our rules and regulations, we will be working toward a common end. As we work together identifying those practices and deciding how to apply them as supervisory or regulatory standards, we will also be strengthening relations among ourselves that can prove invaluable in times of market stress.

Not to over-use the example of the market risk standard, but it illustrates another useful point, as well. Reliance on a bank's own risk measurement and modeling process in determining regulatory capital standards also acknowledges that no single or specific technique is best for everyone. Each institution should tailor its risk measurement and management process to its own needs. While adhering to basic principles, each institution must determine for itself the proper incentives and techniques for managing its affairs. No two banks or banking markets are identical in their operations, structure, or historical development. Permitting a range of compatible responses to similar situations encourages experimentation, innovation, and growth. Accommodating a certain level of flexibility is necessary for banks, and it is necessary for regulators, too.

Indeed, flexibility may be even more important for non-G-10 countries than it is for those of us with large, developed financial systems because of the greater range of capital market and economic infrastructures among developing countries. Materially different situations typically require different solutions. Accommodating differences, though, does not reduce the need for minimum regulatory or supervisory standards based upon well-known principles of sound banking. It is up to supervisors and, if necessary, legislators to craft regulations and laws consistent with internationally recognized standards, but accommodative to local customs and economic needs.

In developing sufficiently flexible, market-compatible regulations, I believe we should rely as much as prudently possible on market discipline and on banks' internal incentives to perform well. This approach requires that the public have information about the risk exposures of banks and about their procedures for managing those risks. As regulators, we can encourage this process by requiring or prodding banks to disclose information to the markets that is both relevant and comparable among institutions.

Whether such disclosures are imposed by official regulations or evolve through more subtle efforts, supervisors can help guide the process by considering carefully the kinds of information the private sector needs and that banks use -- or should use -- to manage risk. Even in the United States, where surveys show disclosure is relatively good, supervisors make available to the public data collected on Call Reports.

In countries where disclosure practices are minimal at best, bank regulators may be able to perform a particularly important role by publicly disclosing some, if not much, of the information banks report to them. By fueling market information in this way, regulators may

stimulate greater investor interest in banks and the growth of local capital markets. Improved disclosure practices by banks may, in turn, also spill over to other industries. One thing we know for sure is that investors dislike uncertainty. By shedding light on a bank's condition and future prospects, some of that uncertainty should disappear.

While it is important that key prudential standards be sufficiently robust and consistent among countries, certain variations in the details and applications of these standards can be useful. As with private markets, some level of competition among regulators can stimulate improvements and change. I will grant that the United States may take regulatory competition to an extreme, but it also demonstrates, I believe, the advantages that derive from accommodating different views and permitting financial institutions alternative ways to do business. In my view, and considering the political difficulties we have faced in trying to change U.S. banking laws, our current regulatory structure, offering some choice in charter that is administered by multiple regulators, has provided financial institutions with more freedom and expanded powers than they would likely have received with a single regulator.

Supervisors must be careful, however, as they try new or different techniques, that they do not impair their oversight efforts or relax them beyond prudent bounds. In such global markets as we have today, weak or ineffective supervision in either large or small countries can have far reaching consequences. Those concerns were at the heart of early work of the Basle Committee and its efforts to identify the respective roles and responsibilities of home and host authorities for internationally active banks. It is important for supervisors to be able to rely on their counterparts in other countries to administer agreed-upon standards of financial institution safety and soundness.

Whether we conduct our own on-site examinations, rely on external auditors, or use combinations of other supervisory techniques, we need to assure ourselves that all banking offices are adequately managed and supervised. I would note here that among G-10 countries a more consistent approach may begin to emerge. We in the United States are making greater use of the findings of a bank's internal and external auditors to guide or supplement our on-site examinations, while some of our counterparts abroad are recognizing more the benefits of on-site exams.

### Financial Conglomerates

Some of the greatest challenges to bank supervisors may arise when organizations link banking activities with other financial or nonfinancial businesses. Such financial conglomerates, which often combine banking, insurance, and securities activities, are not currently allowed to provide a full array of financial services in the United States, but they may do so abroad.

The existence of such firms -- and the fact that some of them are headquartered in this country -- have required regulators and supervisors in the United States to work with counterparts abroad to discuss oversight arrangements and develop ways to deal with matters in times of crises. This very issue is one of our current challenges. I have to say that this is not a particularly quick or easy process and is further complicated by the diverse regulatory structures, both here and abroad, involving banking, securities, and sometimes insurance regulators.

These discussions often raise difficult issues, since they tend to break new ground in supervision. For example, what approach should be taken regarding nonbank -- or even nonfinancial -- activities of companies that own banks? In the context of these conglomerates,

what does or should “consolidated supervision” mean? Within the context of consolidated supervision, how can the traditional safety-and-soundness approach used by bank supervisors be reconciled with the disclosure/self-regulatory approach used by many securities regulators? Moreover, do the diverse operating structures of conglomerates imply an extension of the safety net that virtually all governments currently extend to banks? One thing is clear: as we address the challenges of promoting a more consistent bank supervisory and regulatory process worldwide, we cannot always take official descriptions of regulatory and oversight regimes at face value. We need to dig deeper to understand how laws are interpreted and how individual banking agencies monitor and enforce safe banking.

Different countries necessarily have different banking and financial systems that face unique combinations of exposures and business risks. Even within the United States, for example, we have a relatively uniform supervisory approach for all banks and a risk-based capital standard that applies to them all. In practice, however, the activities of our banks, their capital levels, and their operating practices are quite diverse, and our oversight efforts take those differences into account. Small banks, themselves, recognize the greater risks they face from their lack of size and diversity, and have consistently maintained higher capital ratios than do money center banks. But they also have less formal procedures and internal controls, simply because their staffing and operations are so much smaller. The point is that even a uniform set of rules within a given country can and should be implemented differently as conditions demand.

### Conclusion

It seems clear that as financial markets become more and more integrated, bank regulators around the world will be seeing more of each other than they have in the past. Even in countries that have no internationally active domestic banks, authorities need to ensure that the banks operating in their markets are sound and subject to adequate supervision, whether by home or host authorities. Banks operating imprudently and without proper supervision are the ones most likely to mismeasure their risks, misprice their products, and disrupt the markets. Detecting and deterring such institutions does not require us to have uniform regulatory or supervisory systems, but it does require a certain level of cooperation and coordination and a material level of consistency in our regulatory regimes. Our experience in the United States suggests that achieving an appropriate convergence takes time, not only to develop but to maintain. Progress we have seen through the European Union and the BIS goes far in coordinating, or harmonizing, banking laws, regulations, and operating standards, but that’s just a start. As managers of large financial institutions develop more sophisticated and more comprehensive risk management systems, they are paying less attention every day to the peculiar legal structure of their organizations. As regulators, we need to understand how banking organizations manage and control risks and the full implications of their practices for the financial safety of depository institutions. By doing so, we can do much to protect our own interests while still recognizing and accommodating the business needs of banks.

In developing our laws and regulations we need to work together, for sure. But perhaps more importantly, we need to understand the market forces and incentives that banks face. If we keep those factors in mind in developing our individual rules, we may go far in developing regulatory systems that are both compatible among countries and less intrusive to the institutions we oversee.