Ms. Phillips discusses recent developments in supervision and regulation and how they affect the debate on financial modernization Remarks by Ms. Susan M. Phillips, a member of the Board of Governors of the US Federal Reserve System, at the Annual Washington Conference of the Institute of International Bankers on 3/3/97.

I am pleased to have the opportunity to address this group at a time when developments in global financial markets are presenting particular challenges for market participants and market regulators alike.

I was asked to talk with you today about both developments in Federal Reserve supervision and regulation, as well as the approaches to financial modernization being debated in the Congress. I won't try to cover the full waterfront on these topics, but would like to share with you some of the Board's considerable rethinking about the way we supervise and regulate bank holding companies. I will also describe how I believe the recent Board initiatives coming out of this process may well alter the debate about the structure and supervision of financial services in the United States -- a topic I believe has received insufficient attention in the legislative debate so far.

I will focus my discussion of recent Board actions on the supervisory process and on three regulatory changes made or proposed by the Board: changes to the application and nonbanking provisions of Regulation Y, changes and proposed changes to the Board-imposed "firewalls" between a bank and a securities affiliate, and changes to the Board's anti-tying rules. I stress these three not necessarily because they are the most important undertaken by the Board, but because I believe that they most directly affect the debate about how financial services should be supervised.

Supervisory Changes

The cornerstone of the bank supervisory process is the verification of prudent practices and financial condition through on-site examinations, coupled with off-site surveillance. Traditionally, on-site examinations of bank holding companies and their nonbank subsidiaries have focused on verifying compliance and determining the financial condition of an institution at the time of the examination by reviewing their loans and by testing other transactions. This process is changing.

The Federal Reserve's supervisory oversight at the bank holding company level is increasingly directed at evaluating risk management, internal controls, and decision making processes that are shared between a bank and its parent, rather than focusing on transactions and positions at nonbank affiliates. This focus is necessary given the continuing trend toward integrated management of financial activities on a consolidated basis. Testing the adequacy of risk management and internal control helps us understand the financial condition of the consolidated organization and the potential impact of consolidated risk management policies and internal controls on the operations of the insured depository institution. To implement this approach, the Federal Reserve last year began assigning a formal rating to risk management in our holding company and bank examination reports.

Changes have come not just in what we examine, but also in how we examine. We are making greater use of internal risk management reports, the results of internal risk models, and the work of internal and external auditors. For example, the Federal Reserve is now collecting internal loan classification reports prepared by most of our larger banks, as well as

other information generated by their internal risk management systems. This approach has a further advantage in that it can generally be conducted off-site, at less burden to the firm.

Our examinations are also becoming more efficient through pre-visitation planning that better identifies those areas of a company's activities that pose the greatest risk. We are also making greater use of computer technology in the examination process and using automated systems that permit examiners to analyze data on their personal computers. And, of course, whenever possible we rely upon examination and inspection reports prepared by regulators of the individual entities within the bank holding company.

Like examinations, disclosure practices of the past also focused narrowly on the financial condition of an institution at a point in time, using conventional accounting and regulatory measures. Today, however, disclosures are expanding to reveal not only the current risks of the balance sheet, but also management's philosophy for managing and controlling risk. Disclosure is an important aid to us as supervisors and, we hope, to market analysts. Improved disclosure has already been put into practice for derivatives and market risks, and we will continue to urge better and more broadly based disclosure of all major activities and exposures.

The Effect of Supervisory Changes on Legislation

As the issue of consolidated or "umbrella" supervision is debated in the legislative process, I believe it is important to examine how these supervisory developments alter that debate. There are those who argue that umbrella supervision of a diverse financial services holding company would either be an impossible task or an intolerable burden. But the risk-analysis and surveillance techniques that we have decided are the most effective for bank holding companies should also be adaptable to more diverse financial organizations that include banking operations. Clearly, we must all give additional thought to how such an adaptation would work so that we minimize the intrusion into new activities. Perhaps there should be some kind of carve-out for firms whose banking operations are a small part of the organization or if the firm is otherwise regulated. Nevertheless, to be successful, a financial services company should reap synergy gains not only by marketing a variety of products to customers but also by pooling and jointly managing diverse financial risks. Thus, the movement toward use of one treasury, one risk management policy, and one set of exposure limits would continue. It is those policies and risks that an umbrella supervisor must understand in order to gauge the risks to the insured institution.

In fact, as I am sure this group will recall in the wake of BCCI, the Congress also became convinced of the importance of consolidated supervision of any banking organization. Through the Foreign Bank Supervision Enhancement Act, the United States not only recognized the importance of consolidated supervision, but strongly encouraged it as an international principle of banking supervision by requiring that any foreign bank seeking to enter the United States be subject to consolidated home country supervision.

Subsequent history has confirmed that judgment. As I've noted, virtually all of the large holding companies now operate as integrated units and are managed as such. Thus, the Federal Reserve remains convinced that one supervisor must have the task of evaluating the organization as a whole.

This view is now commonly accepted around the world. The idea has for some time been endorsed by the Basle Committee on Banking Supervision, and many countries are adopting similar approaches.

Still, I can certainly understand why some advocates of a more diversified financial services holding company would wish to abandon consolidated supervision. Consolidated supervision raises hard questions -- the kind of questions that can bog down legislation and splinter coalitions -- and questions that engage us even now. What authority should a consolidated supervisor have over non-financial activities, if they are allowed? How should the consolidated supervisor work with the primary supervisor of a bank, or a broker-dealer, or an insurance company? How much burden must consolidated supervision entail?

As we all pursue the answers to these questions, perhaps the Federal Reserve's risk-based approach to supervision can provide insights into how umbrella supervision of an expanded organization could work.

Regulatory Changes

Just as with supervision, the regulatory side of the Federal Reserve has undergone profound changes of late.

Just a few weeks ago, the Board approved a comprehensive streamlining of Regulation Y that should substantially diminish the regulatory burden on bank holding companies and foreign banks wishing to expand or innovate in the United States.

First, the Board concluded that review of an application should focus on how the proposed acquisition or activity would affect the organization. The application should not become a vehicle for comprehensively evaluating and addressing supervisory and compliance issues at the applicant organization. This principle is also the basis for recent Congressional action to eliminate the prior approval requirement for engaging in Board-approved nonbanking activities under section 4 of the Bank Holding Company Act, provided the company meets specified standards for capital and management at the time of its last examination. As a result, the Board has significantly streamlined the process for well-capitalized, well-run companies to acquire a bank or nonbank and eliminated the prior approval process for such companies to engage de novo in Board-approved nonbanking activities.

Second, the Board concluded that bank holding companies should be permitted to conduct nonbanking activities to the fullest extent permissible under the Bank Holding Company Act, and that Regulation Y should be sufficiently flexible to allow for industry changes in permissible activities without requiring additional regulatory filings. Accordingly, the Board removed restrictions on investment advisory activities, derivatives trading activities, leasing, and other activities whenever those restrictions impeded efficiency or imposed costs without conferring corresponding benefits to safety and soundness. The Board also permitted a data processing or management consulting subsidiary to derive up to 30 percent of its revenue from nonfinancial data processing or nonfinancial management consulting. And the Board has indicated that it will be pro-active in approving new activities.

The next area where the Board has been particularly active concerns firewalls between a bank and an affiliated securities firm, better known as a section 20 affiliate.

Experience with these section 20 affiliates, and other affiliates engaging in similar activities without such restrictions, led the Board to conduct a comprehensive review of the firewalls. Much of the potential for conflicts of interest between a bank and a securities firm is addressed by other laws such as the registration and disclosure requirements and the anti-fraud provisions of the securities laws. Legislative and regulatory enactments, many adopted since the Board's initial 1987 section 20 order, also provide important insulation between a bank and a section 20 affiliate by imposing qualitative and quantitative limits on inter-affiliate transactions and requiring that a customer receive disclosures detailing the identity of its counterparty and the product being purchased.

Accordingly, the Board has repealed its restriction on cross-marketing between a bank and a section 20 affiliate, eliminated a blanket restriction on employee interlocks, and scaled back a blanket restriction on officer interlocks to include only a chief executive officer. The Board has also proposed to eliminate a firewall prohibiting a bank from providing any funding to a section 20 affiliate and three restrictions on a bank's extending credit or offering credit enhancements in support of securities being underwritten by its section 20 affiliate.

The Board's proposal recognized that as financial intermediation has evolved, corporate customers frequently seek to obtain a variety of funding mechanisms from one source. By prohibiting banks from providing routine credit enhancements in tandem with a section 20 affiliate, the existing firewalls hamper the ability of bank holding companies to operate as one-stop financial services providers, thereby reducing options for customers. Instead, the Board has proposed to require that internal controls and operating standards ensure that a bank use independent credit judgment whenever it is acting in tandem with its section 20 affiliate.

Finally, the Board has taken action to allow greater packaging of products by bank holding companies. Since the 1970s, banks and bank holding companies have been prohibited from packaging their products unless the arrangement involved a traditional bank product. While this exception softened the impact of the statute, bank holding companies were nonetheless at a considerable disadvantage to their competitors, particularly as bundling of services has become a marketing imperative on both the retail and wholesale side of the business.

After reviewing its experience with the statute, the Board recently repealed a regulation that had extended to bank holding companies and their nonbank subsidiaries the statutory prohibition on tying arrangements by banks. Experience taught us that these non-banks did not have the type of market power that Congress presumed banks possessed when it enacted an anti-tying statute. The Board has also created exceptions to the statute to allow package arrangements between bank holding company affiliates to the same extent as the statute allows them within the bank.

Lastly, and perhaps of greatest interest to you, the Board created a safe harbor to clarify that any transaction with a foreign customer was not covered by the statute. Thus, for example, a U.S. branch of a foreign bank can participate in a syndicated loan to a European firm, even if the loan is offered only as part of a package of services that would otherwise run afoul of the anti-tying law.

The Effect of the Regulatory Climate on Legislation

I think it worth noting how all these reforms may affect the debate about the

corporate structure of bank holding companies -- specifically whether bank holding companies should be granted the option of moving activities prohibited to the bank into a subsidiary of the bank, and thereby funding those activities with subsidized funds.

Descriptions of how the subsidy works and examples of the funding advantages it confers are plentiful. But I believe that it is so ingrained in our thinking that we sometimes take it for granted. Think how obvious the subsidy would be if it involved another industry -- for example, if the government guaranteed that commercial paper holders of the automobile industry would be repaid in full. To complete the other strands of the safety net -- the discount window and the payment system -- let us assume that automobile companies experiencing liquidity problems could borrow from the Federal Reserve for the purpose of repaying commercial paper, and that they are able to achieve risk-free settlement. The effects of extending such a subsidy are not difficult to imagine. Automakers would find it very easy to place their commercial paper, and would be able to pay a below-market yield. And, to the extent the hypothetical allowed, I would not be surprised to see automakers use this funding advantage to enter other businesses.

So it is with banks -- and with subsidiaries of banks. Regulators can limit a bank's ability to subsidize its subsidiary through loans by capping their amount or regulating the rates the subsidiary must pay. But although one can limit the aggregate investment a bank can make in its subsidiary by requiring that such injections be deducted from the capital of the bank, the equity investment in the subsidiary is still funded from subsidized resources, and that subsidy transfer cannot be eliminated.

Thus, both analytically and practically, I think it difficult to deny that banks and their subsidiaries benefit from a federal subsidy, and benefit in ways that an affiliate of the bank does not. Nevertheless, some argue that a parent-subsidiary structure is more efficient than a sibling structure, and must be allowed for a broader range of activities. But in light of the recent regulatory changes that I have described, I believe that this argument is now questionable. A bank and an affiliate can now avoid a redundant work force and duplication of effort by having employees serve in a dual capacity, or by allowing reporting lines to cross. For example, a common back office or treasury can be maintained. Furthermore, the two companies can market their products jointly to both retail and corporate customers. With these regulatory changes, banks and bank holding companies have opportunities to make considerable adjustments to their organizational structures and operating procedures as well as to offer new products to customers in new ways.

Conclusion

Let me conclude by pointing out that the legislative debate has only just begun. Opinions are still developing, new ideas are still being presented, and positions are not yet cast in concrete. But even as new legislation is being debated, those of us who must try to interpret and administer existing laws recognize that we must do so in a developing global marketplace. I believe that the steps the Board has taken to make its regulatory and supervisory systems less burdensome and more risk focused will stand us in good stead in this changing financial environment. Nevertheless, comprehensive financial reform legislation is still needed to allow banking and other financial institutions to compete internationally and to offer the full range of financial services needed and demanded by their customers.