Mr. Davies reviews current debates on regulatory structures governing the financial system Speech by the Deputy Governor of the Bank of England, Mr. Howard Davies, held on 22/2/97 at the Federal Reserve Bank of Atlanta's Financial Markets Conference entitled 'Market and Regulatory Structures in a Global Environment'.

It is conventional, and polite to say, at the beginning of a speech of this kind, that one is thrilled to have been asked to speak on the subject of the structure of financial regulation and that the topic is, of all the many preoccupations of human kind through the centuries, the one which generates the most enthusiasm and excitement in one's breast.

But I cannot bring myself to do it. You may think me ill-brought up to say this - if so blame my parents - but I find the question of the structure of regulation to be quite resistible. I know that there are those who like nothing better than to draw new organigrams and to explore the manifold interfaces between regulatory agencies. (There are also people who find self-fulfilment collecting airline sick bags, or watching synchronised swimming. That is a matter for them.)

But my lack of enthusiasm for the topic of regulatory structure is, I hope, not an emotional response. It is rationally based on two prior beliefs. First, that the relationship between structure and effectiveness is loose. I know of little evidence that structural reforms are quickly followed by an enhancement of the effectiveness of the activity in which those agencies are engaged. Secondly, my prejudice is to believe that regulatory structure should follow market structure, rather than the other way round. Regulators should seek to respond to changing markets which, in turn, respond to changing customer demand and new product availability, rather than seeking to dictate either. So we should always ask ourselves whether the regulatory framework we adopt makes sense to market participants, rather than requiring them to structure their business to fit in with some governmentally imposed view of the way product delivery should be organised.

But I recognise that, in practice, we cannot avoid constant attention to the maintenance of the regulatory framework. Firstly, because while good structure will not necessarily generate effectiveness, a faulty, out of date framework will certainly make it very hard for regulators to do their jobs well. And, of course, the market is not in an 'original condition'. The financial markets we have now are heavily conditioned by the legislative and regulatory framework within which they have grown up. That is particularly true in the United States. It is hard to imagine that, absent Glass-Steagall, regulation Q and all the rest, the financial landscape in North America would look as it does today.

So I conclude that the debate on regulatory structure should be a constant dialogue between the markets and the regulators, but with a prejudice in favour of the former. Our ultimate task as regulators is to ensure that markets work efficiently, and in the interests of consumers.

Against that background, how is this dialogue proceeding in the UK at present? For we too are addressing the questions which preoccupy you in the United States, in our quaint, olde worlde British fashion.

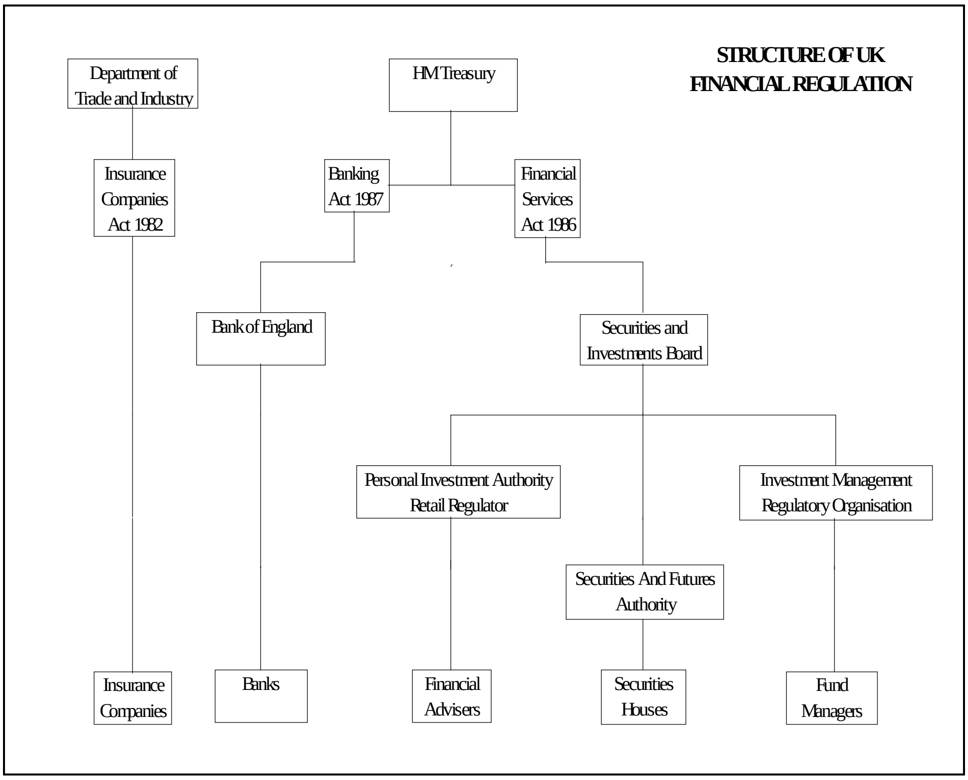
But before I review the current debate on regulatory structure in the UK, I should say a little about the way we define the objectives of financial regulation. We think of five: to protect the economy against systemic risk; to protect individual depositors, investors and insurance policy holders against loss from the failure of their intermediary; to protect customers against business misconduct; to assist society at large in the fight against crime (for instance by making sure firms have in place systems to detect and report laundered drug money and other proceeds of organised crime); and, last but not least, to create and sustain fair markets.

Described bluntly, these objectives make the job of regulators look impossibly daunting. But of course they are not absolute aims. Regulators cannot, and should not, offer blanket assurances to investors and depositors. They cannot, because the tools and resources to do so are simply not available. And they should not, because it would be quite wrong to remove from investors and firms the responsibility for assessing, taking and monitoring financial risks. This is a very important point, which Alan Greenspan has helpfully underlined on a number of occasions recently.

UK regulatory structure and proposals for change

Across the world we see a lively debate on how the regulatory cake should be cut. There has been change in France. The Australian Government has set up the Wallis Commission to look at the institutional arrangements there. Their first report has just been published. Reforms are in progress in Japan. In the US the new legislative season is about to open, with a number of runners and riders already saddled up in the financial regulation steeplechase. Similarly, in the UK, a variety of think tanks, and the opposition Labour Party, have produced proposals to amend, or in some cases fundamentally reorder, our regulatory structure. But, before describing these exciting proposals, perhaps a brief description of the British system would be in order.

Responsibility for financial regulation in the UK is divided between two Government Departments.



Most falls to the Treasury, but prudential supervision of insurance companies is the responsibility of the Department of Trade and Industry (DTI). The DTI carries out its supervisory responsibilities using its own staff; the Treasury, on the other hand, while setting the legal framework and policy directions for regulation, leaves most of the detailed regulatory functions to others. Under one piece of legislation - the 1987 Banking Act - the Bank of England carries out prudential supervision of banks. Under another, the 1986 Financial Services Act, the Treasury delegates its powers to the Securities and Investments Board, which in turn recognises a number of front-line regulators. These front-line regulators cover different sections of the market. One, the Securities and Futures Authority (SFA), is responsible for securities houses; another, the Investment Management Regulatory Organisation (IMRO), for fund managers. These two regulators undertake both prudential supervision and conduct of business regulation. The third, the Personal Investments Authority (PIA), is responsible for the retail sector, and has principally a conduct of business remit although it is responsible for the prudential supervision of independent financial advisers (IFAs). So, in effect, there is a layered approach to the regulation of financial services in the UK, with different powers held at each level.

(To complete the picture, the Building Societies Commission supervises building societies (Savings and Loans) - though the largest of them are now converting to bank status. And the Department of Social Security is responsible for the supervision of occupational pension schemes.)

This brief description of the legislative framework might lead one to suppose that the UK system is primarily statutory - yet the securities side is often described, at least by comparison with the US system, as one of self-regulation. Indeed, some argue that it is excessively self-regulating and, therefore, unreasonably lax.

We would reject that last charge. And, in practice, the distinction between statutory and self-regulation is not black and white. The UK system has elements of both. Prudential supervision of insurance firms is carried out directly by a government ministry, which is unambiguously Government regulation. Banking supervision is carried out by the Bank of England. Constitutionally, this is not ‘Government’ regulation, but rather regulation by a public body which is authorised by specific Act of Parliament. Certainly no one describes what we do as self-regulation, even though the Bank of England is a bank.

On the investment side, the picture is more complicated. The Government has delegated its powers to the Securities and Investments Board. The SIB’s governing board includes people who are active in financial services, but they are appointed by the Treasury and the Bank of England (indeed I am one of them) and are required to act in the public interest. Again, this does not look like self-regulation. However, the various front-line regulators are called, in the Act itself, ‘self regulating organisations’ (SROs). Their boards include a high proportion of active practitioners, elected by the industry to represent its views. Practitioners are also heavily involved in policy discussions, rule-making and enforcement functions. But, like the SIB, the SROs operate indirectly under statute, and have a duty to regulate in the public interest.

We therefore have no self-regulation in the strict sense, rather a variety of statutory and statute-backed bodies with practitioner involvement, each with different relationships with the industry and with Government. Effective regulation needs the input of all participants in the market if it is to offer appropriate protection without stifling innovation. Regulators can benefit greatly from effective practitioner input but to retain the confidence of the investing public they must persuade them that regulation puts their interests, and not those of the firms and their shareholders, first.

The system we now have is undoubtedly capable of achieving an appropriate balance between market sensitivity and consumer confidence; it has, in many respects, worked well. But it has been stress-tested in a number of difficult episodes: the Maxwell affair, the private pension mis-selling saga, the collapse of BCCI, Barings Bank and Sumitomo. These episodes have taught us something about the strengths and weaknesses of our system, just as the S&L crisis and the Daiwa New York problem have done in the US. Furthermore, markets themselves have moved on. The financial landscape of today is almost unrecognisable from the one which informed legislators' views in the early 1980s, before the Banking and Financial Services Acts were put on the statute book. It is therefore not surprising that over there, as well as over here, there is criticism of the existing structure, and pressure for change. Our own system, with its monopolistic approach to the origination of legislation, does not generate competing draft bills. But the marketplace for ideas on regulatory reform is, I can assure you, just as well contested.

Critics of the existing British system object on three counts:

1 that the failures of the last decade demonstrate its inability to cope with strains and crises;

2 that it is unnecessarily complex, with overlapping and sometimes even conflicting responsibilities; and

3 that it has failed to keep pace with changes in institutional and market structures; the distinctions on which it was based no longer effectively apply.

It is not my aim today to give a comprehensive assessment of the validity of all these arguments. And, in any event, just as in the US, there is a heavy political dimension to this debate. But I would make a few observations on the arguments advanced for change.

The UK system <u>is</u> complex, although it is no more complicated than the equivalent arrangements in some other countries with similarly sophisticated financial markets. (Indeed, were I not a guest here, I might say that the US system was rather more labyrinthine than ours.) Those who argue for simplification point to duplication of function and cost, especially between the SIB and the front-line financial services regulators. There is undoubtedly a case to answer in that area, as both the SIB and the SROs would acknowledge. But the legislation we have explicitly dictates a two-tier structure.

It is also true that institutions now tend to be involved in a variety of different businesses. Banks own securities houses, fund managers, and insurance companies. Insurance companies are diversifying into banking, and so on. So that even though there should always be a lead regulator, looking at the overall position of the business, institutions still face the costs of complying with the requirements of several regulators.

But the question underlying these arguments about complexity and overlap is more fundamental. Should regulation be based around institutions (it is institutions which fail, after all) or around functions or types of business which call for specialist regulatory knowledge?

The UK system is organised neither along wholly functional nor wholly institutional lines. In today's markets, where firms are a mass of subsidiaries and business units, no major market participant deals with a single regulator across all its businesses. Similarly, no regulator has unique responsibility for regulating one function of each business. The insurance operation of a firm, for example, is covered by separate prudential and conduct of business regulators.

Most people involved in financial regulation would recognise this description of the problem. But determining how to resolve it is not straightforward, as evidenced by the wide variety of proposals for change which have been advanced.

Some proponents of reorganisation would like to begin by making all financial regulation the responsibility of a single Government Department - the Treasury. They suggest that this would clear up accountability for the legislative framework, and for the powers and sanctions in the regulatory regime and create consistency of regulatory approach across sectors. Straightforward administrative tidiness may also be a factor. While there may be merit in both these arguments, such machinery of Government questions are for the Government to determine, and I happily leave such matters to them.

Most of the discussion about regulatory structure in the UK has concentrated on the area covered by the SIB and the front-line financial services regulators. It is in this part of the system that the arguments about duplication of function, unnecessary cost and poor communication are most often heard. The various alternative models all feature some degree of consolidation, and some would go as far as to fold all the main financial services regulators into a single body. Others propose two bodies, each reporting directly to the Treasury, with one covering wholesale business and one covering retail, acknowledging the different regulatory imperatives, especially in the conduct of business field, of the two sectors. The aim would be to reduce the number of domestic regulators large institutions would have to deal with, and to improve the match of regulation to function.

Even more radical changes have been proposed, encompassing not only the SIB area, but the prudential supervision of banks and insurance companies as well. One model, colloquially known as 'Twin Peaks', would replace the whole of the present system with two Commissions: a Financial Stability Commission, with responsibility for systemic risk, the prudential supervision of all major institutions, and conduct of business regulation of wholesale activities, and a Consumer Protection Commission, which would be in charge of conduct of business regulation in retail markets, as well as detecting market manipulation and insider dealing. It would also carry out prudential supervision of those stock brokers and fund managers who deal with private clients, and of independent intermediaries.

The advocates of this model argue that it would better match regulation with both institutions and functions, in particular on the wholesale side. The underlying contention is that the traditional separation between banking, securities and insurance is breaking down, so that there is now a less meaningful difference between institutions and functions.

I am not persuaded of the merits of this case. Although the activities of banks and securities firms do overlap at the margin, this is not true of the core activities.

Banks in particular continue to have a number of distinctive characteristics. First, there are the risks associated with the maturity transformation seen in their balance sheets. Banks experiencing a drain in their liquidity, perhaps because of a classic ‘run’, could be driven into insolvency through the forced realisation of illiquid assets at ‘fire-sale’ prices. Second, there is the risk of contagion - problems at one bank can spread to others - not just through direct financial linkages but also because, in the absence of timely, transparent information on bank assets, depositors become concerned about other banks which they see as similar. Finally, banks play a central role in payments systems, including payment flows generated by FX trading.

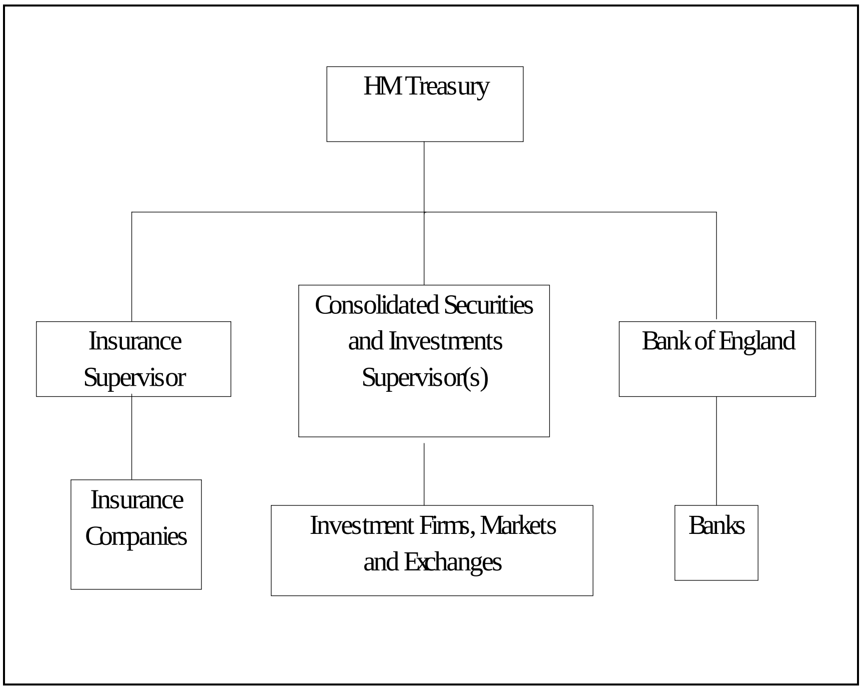
The conclusion I draw is that there is enough that is special about banks for their prudential supervision to be retained as a separate activity in any new regulatory structure, and that this argument at present outweighs the case for change.

Whether prudential supervision of banks should be a function of the central bank is a separate question. Some argue that other central banking responsibilities (such as the conduct of monetary policy) make for conflicts of interest and therefore that supervision should not be carried out by the central bank.

I am not persuaded by these arguments either. Nor am I aware of many examples where the suggested conflicts between a supervisory role for the central bank and its other responsibilities have arisen in practice. Indeed, there are important synergies between the supervisory function and other central bank responsibilities. It makes sense for the ‘micro’ supervision of individual banks in the system to be carried out by the same body that carries out the ‘macro’ function of maintaining the stability of the financial system as a whole, stability which is essential if monetary policy is to be executed effectively and efficiently.

It is no accident that in all major countries the central bank has a significant role in the supervision of banks, even if in some cases others have been given the legal powers to carry out the front-line tasks. Having as supervisors tried their best to limit the likelihood of failure, when faced with it central bankers are uniquely well placed to provide assistance, whether to the institution in trouble, to the market at large, or both. Those who wish to separate banking supervision from central banking must acknowledge that there are certain things that only the central bank can do, and that therefore there needs to be a strong link between the central bank and any new regulator. In Germany, for instance, the Bundesaufsichtsamt is the supervisor of commercial banks. But the Bundesbank has an important role in the day-to-day job of collecting prudential returns, and must be consulted on liquidity and capital requirements, which bear most directly on its role in an emergency.

The logic of these arguments might point instead to a ‘Holy Trinity’, rather than a ‘Twin Peaks’ model, based on three agencies, focused respectively on financial services, banking and insurance. That might allow the most sensible match - albeit not complete - of regulation to function and institution. It would also have the advantage of evolving fairly readily out of the present structure.



This last is not a trivial point, since the cost and disruption caused by reorganisation would be considerable, and higher in proportion to the degree of change. The process would inevitably generate uncertainty among firms and the public, and make the regulatory system more difficult to manage in the meantime. This argues for building on the present arrangements, if at all possible, rather than beginning again with an entirely new structure that could take years to settle down.

Furthermore, what matters to the financial system, and to the public, is that regulators are effective. Effectiveness necessitates good communication, consolidated supervision and close co-operation to maintain protection across the piece. Whether structural change (including bringing functions together under one umbrella) would improve communication and co-operation and so increase effectiveness, is a key question, and the answer is far from clear.

We have been making considerable efforts recently to enhance communication between different supervisors in the UK. That has involved, as you would expect, the usual paraphernalia of Memoranda of Understanding. But, in addition, we have sought to achieve cross-membership of some of our most important institutions. For example, Sir Andrew Large, the Chairman of the Securities and Investments Board, has become a member of the Bank of England’s Board of Banking Supervision and, reciprocally, I have joined the SIB. Of course one should not exaggerate the importance of individual appointments of this kind. But they do help to create a climate of co-operation, and give a signal to the respective staffs of the two institutions that they are expected to work together as closely as possible, and a signal to the outside that they can expect this to happen.

The Approach to Regulation in the UK

The discussion of regulatory approaches is often phrased in terms of rules versus judgement or, as academics tend to put it, rules versus discretion. Should supervisors simply set the rules, and shoot those who break them? Or does that create too rigid a framework, one which stifles initiative and imagination?

There is no simple answer. The Bank of England imposes an increasing number of rules: it has, for example, implemented detailed regimes for capital adequacy introduced by the Basle Committee and the European Union. We set capital requirements to cover the more readily quantifiable risks; we enforce limits on banks' large exposures to individual counterparties; we have rules on banks' liquidity; and we seek to ensure that banks have robust systems and controls, as well as management with the skill and integrity to ensure, in that delightful US phrase, that the bank is 'safe and sound'.

But our judgmental approach - allowing supervisors the discretion to exercise informed judgement within approved guidelines - still contrasts with that of many other regulators. This flexibility allows us to be tough where appropriate, but to avoid inappropriate requirements - tailoring the requirements to the nature of the bank's activities. Most fundamentally, perhaps, we can ask questions, and attempt to take advantage of all the information at our disposal to form a judgement of the risks facing depositors and investors, as well as of the quality of a bank's management. So in addition to enforcing rules and looking for problems, we can help management. We can spread knowledge of best practice: asking banks about the full range of risks they face (including those - like reputational and settlement risk - that they would often rather ignore); and pointing out to complex groups the extent to which their managerial and organisational systems have moved away from their legal structure.

It is true that, in addition to being less rule-bound than most other supervisors, the Bank is commonly viewed as doing relatively little on-site supervision. Of course, this depends on how you define the term. Accountants are well aware that the Bank does, for example, make extensive use of reports prepared by auditors - who, of course, operate on-site - in order to assess the adequacy of internal controls. In particular, the Bank regularly instructs banks to appoint reporting accountants to report on systems and controls and on the accuracy of prudential returns.

The Bank's supervisors also spend a growing amount of time on-site. Since 1986, Review Teams have carried out focused visits to banks to evaluate the level of risk in an institution as well as the risk management systems in place to identify, monitor, and control these risks. And in 1995 we introduced a Traded Markets Team to focus on banks' pre-processing models which can be recognised under the CAD (Capital Adequacy Directive) as well as sophisticated risk modelling techniques used by the banks to manage treasury activities. These teams spend on average about three days on banks' premises, which may seem short, but the visits are highly focused, reflecting a great deal of work carried out in advance, not just between team members and the line supervisors of the bank in question but also by the bank itself in providing detailed answers to a series of questions.

At the same time, the Bank has recognised the need to be more systematic in its approach to risk assessment and has announced its intention to introduce a more formal approach based on a common approach, known as the RATE model, to identify - using a series of qualitative and quantitative measures - the risks faced by the bank. RATE is an acronym for the three stages of the process: **R**isk **A**ssessment, **T**ools of supervision and **E**valuation.

In the future, by performing periodic risk assessments, we aim to gain a better understanding of the quality of management, the characteristics of the business and the risks the banks face. The greater degree of consistency across banks embodied in the new approach will allow the Bank to be more focused in performing its supervision. The tools of supervision, such as Review Team Visits and Reporting Accountants Reports on internal controls, will be targeted at the areas of greater risk and concern in individual banks. We shall very shortly be issuing a consultation paper setting out how we plan to implement the model in practice. That paper will show that we have tried to model parts of our approach on best practice in the US. The City of London may not always have been a preferred habitat for camels, but you may well see some genetically modified examples on the streets there quite soon.

A better understanding of the risk profile of each supervised institution will assist the Bank in setting risk asset ratios. As you all know, Basle sets a <u>minimum</u> capital ratio of 8 percent of risk weighted assets. The 8 percent ratio is sometimes interpreted as a ‘one-size-fits-all’ standard. The Bank, however, sets the trigger capital ratio for each authorised bank at, or above, the 8 percent floor and considers an <u>adjustment to that trigger ratio</u> whenever we see a substantial change in that bank’s risk profile.

Where does this all leave us in comparison with other regulators? I suggested earlier that our flexible, judgmental approach is somewhat distinctive. But we are no longer, if indeed we ever were, outliers on the supervisory spectrum. While the Bank has decided to implement a more systematic approach to risk assessment, other supervisors - who traditionally operate a rule book - are (in a fast moving marketplace characterised by rapid product innovation) moving towards a regime that gives more scope for supervisory judgement.

But the fact that regulators internationally are converging in their approach does not necessarily mean that they are right. They may all be converging on an inappropriate model. Indeed some would argue that regulators do as much to create problems as to solve them: that regulators create perverse incentives - even as we speak bankers may be designing products whose whole rationale is to exploit anomalies in our rules. Perhaps we would all be far better employed elsewhere, leaving the market to regulate itself. Why should we not facilitate that process by concentrating on rules of disclosure, obliging banks to publish accurate information on their capital adequacy and risk profiles, and leaving the rest up to the market - perhaps with some safety net for small depositors and investors? As you know, the New Zealanders have made an interesting move in this direction in the last couple of years.

Should we then get out of the business and leave it all to the markets? To answer that question, it may be helpful to go back to first principles. Back in 1958, Modigliani and Miller demonstrated that in a frictionless world a firm’s capital structure cannot affect its value. In the real world, however, departures from the M&M assumptions - such as taxes, bankruptcy costs and agency costs - may influence the capital decision of any firm; capital may after all be costly. But banks differ substantially from most other firms because their soundness and safety is crucial to maintaining systemic stability; without capital requirements some will exploit this fact by taking large risks with little of their money, in the hope that the taxpayer will bail them out. In other words, some may believe that they are (partially) insulated from potential market discipline. From a regulatory perspective, banks must therefore be required to have capital to absorb the possible losses that result from risk-taking and still remain solvent.

What is our position in this debate? It is tempting to conclude that the only problem is a perception of a government-funded safety net for large banks; remove that and our problems will be solved. But systemic risk cannot be wished away as easily as that, even though we in the UK have demonstrated by our actions that we do not rescue every bank which gets into problems. So, while we try to stay clear from ever more detailed rules, we do not believe everything can be left to the market; certain minimum 'regulatory' capital standards are in our view necessary. Of course, we must aim for a credible and comprehensible regime which does not require constant updating and elaboration, is not immensely costly, and is reasonably consistent. The value-at-risk approach is an attempt in that direction. It recognises that there is a crucial role for judgement in supervision, and that one size really will not fit all. It does not prescribe the key qualitative factors in legalistic detail. But it does set out the parameters so as to ensure that there is a framework in place which will deliver broad consistency and also some degree of prudence.

Some have argued that regulators should go further than the value-at-risk approach: rather than defining the key parameters and endorsing particular model types, why not leave it to the banks, and give them an incentive to improve their internal models as much as possible? Under this pre-commitment approach a bank would specify the maximum portfolio loss on its trading activities and this would become the institution's market risk capital requirement. Banks exceeding their pre-committed maximum loss (that is breaching their capital commitment) would be penalised in one way or another. Such penalties could be financial, or could entail corrective supervisory action.

In some ways pre-commitment can be seen as an extension of the model-approval approach we already adopt. The aim, which we endorse, is to ensure that supervisors work with the grain of the business, and monitor ratios which are seen as meaningful by those who run banks themselves. To that extent, we support it. But there are potential drawbacks. It could amplify the moral hazard problem: if the bank wins, its shareholders - as well as its traders under their bonus packages - pocket the profit, and if it loses, the regulator/tax-payer ends up with the bill. A penalty would not act as a deterrent to a bank prepared to gamble its capital because that bank would not be affected by such a penalty when it was 'down and out'. Furthermore, regulators could over time become less familiar with banks' risk management systems, which might make them less effective in a crisis. Early supervisory intervention is more difficult if supervisors only become aware of problems ex-post, after the limit has been breached.

It may be possible to devise an approach to pre-commitment which avoids these potential handicaps. But for the time being our attitude remains somewhat hesitant.

Finally, a discussion about rules is not complete without touching on the question of a 'level playing field'; an odd analogy, I think, since in field sports there is no such thing. If there were, why would teams change ends at half time? (In American football, of course, teams change ends three times - and in baseball they resolve the problem by running round in circles.)

When banks and securities houses do similar business it seems only fair to apply similar capital rules. But while this is true at the margin, when we look at the total business of banks and securities houses, the picture is still vastly different. A major part of a bank's regulatory capital is held against credit risk. By contrast, securities houses invest primarily in liquid, marketable assets which can be readily sold, with illiquid assets typically a small proportion of the total, generally 2% or so, and the bulk of a securities firm's regulatory capital tends to be maintained for market risk purposes. It is therefore not obvious that we need to set the same detailed rules for banks and securities houses. That is not to say that we should entirely ignore differences in supervisory regimes, but rather that we should focus on areas where those differences are on a scale which seriously distorts competition. In other words, we should spend rather less of our time discussing risk weights, and rather more discussing risks.

Globalisation and the Regulatory Response

How far do these general principles, which I have discussed so far in relation to the UK, apply to regulatory structures in a global environment?

One issue for supervisors is increasing globalisation. The biggest institutions now span 50 or more countries and may have 300 or more entities within the group. This is not new; globalisation in this sense has been a feature of banking certainly since the 1970s. What is rather newer is the way in which the firms are centralising the controls for all these far flung entities. With the recognition that similar risks are being run in different subsidiaries (for example a Japanese bank might have exposure to US interest rate risk from its activities both in London and New York), there has been a move to consolidate these homogeneous risks and manage them centrally within a group. This means control lines which transcend or cross the entity structures and a matrix management structure. It means that the head office can exercise much stronger control over the volume of a particular type of risk being run across the group. For example, for some UK banks, the management of their global foreign exchange book will be managed in London during London office hours, then it will switch to the US operation but under strict limits set by London; after the US close it will move again, to the Far East, but still under the control of limits set by London.

The increasing development of whole book value at risk models has also encouraged this centralisation of control. In the foreign exchange example, the value at risk model used by the group will be maintained and run in London. So the riskiness of positions across the world wide group will be assessed according to the London model.

But centralisation of controls goes even further. Oversight of credit and key credit risk decisions may well also be centralised. Oversight of FX settlement risk is sometimes centralised in London as well as control of the position risk. Likewise various aspects of the internal audit function may well be centralised.

So for global groups, the control of the activities in the various legal entities scattered across the planet will hinge on the adequacy of controls located not in those particular countries but centrally. In a way it is simply an extension of the vulnerability of banking entities to problems arising elsewhere in the group. But in this case solvency of the individual entities will depend on the adequacy of systems and controls located in another part of the group. Massive intra-group transactions to move risk between entities will also affect the position of the various subsidiaries.

One obvious question is why firms do not dispense with such a plethora of legal entities and operate a simpler branch structure. The answer seems to be that differences in tax structures and even regulatory requirements in some countries still encourage the use of legal entities in different jurisdictions. In that case should regulators try to lean against this centralisation? Here I think the answer must be that the regulators should not try to discourage greater central control of risk. Where a firm is running one type of risk in different locations it must make sense for the total risk to be controlled centrally. But this does create a problem for supervisors because supervision has to be structured along legal entity lines (given that it is legal entities which fail). Responsibility for legal entities cannot be transferred between supervisors. Each supervisor must therefore take a view about the soundness of the entity in its jurisdiction, even where this hinges on controls located elsewhere.

How have regulators responded to these trends? In summary, they have increasingly sought ways of increasing co-operation amongst themselves, including agreeing their respective responsibilities and setting up arrangements for information sharing. In the banking sector, at least, they have also supplemented solo supervision of individual entities with consolidated supervision of groups as a whole.

When the Basle Committee on Banking Supervision was established by the central bank governors of the G10 countries at the end of 1974, its initial focus was to define the role and responsibilities of home and host supervisors of internationally active banks. These were set out in the 1975 Concordat which established how supervisory responsibility for banks' foreign branches and subsidiaries should be shared between host and parent supervisors, and which has been updated on a number of occasions since.

Securities supervisors too have a long tradition of international co-operation, including arrangements for information sharing and mutual assistance in enforcement, with IOSCO playing a key role in facilitating such co-operation internationally. There is also a long history of discussion <u>between</u> Basle and IOSCO.

Individual supervisors in both the banking and securities industries have chosen to reinforce co-operation arrangements with formal bilateral agreements with their overseas counterparts. Partly as a consequence, there have been an increasing number of informal meetings between line supervisors with operational responsibility for different parts of financial groups.

The importance of international regulatory co-operation is now widely acknowledged and is on the agenda of inter-governmental meetings. At last June's G7 summit in Lyon, the heads of state called for maximum progress preceding the Denver summit in June 1997 on "enhancing co-operation among the authorities responsible for supervision of internationally active institutions, importantly by clarifying their roles and responsibilities." Ahead of the Lyon Summit, Basle and IOSCO had announced a joint initiative to strengthen co-operation in this area, referring to the work of the Joint Forum of banking, securities and insurance supervisors, which was set up to promote information exchange on international financial conglomerates, and consider establishing for each a lead regulator.

The need for the international regulatory community to address successfully the challenge of supervising multi-functional global financial conglomerates is an issue of particular significance to the UK. This is because of the international nature of the London markets - uniquely so amongst the world's major financial centres. The failure of one or more major overseas firms may cause systemic problems in London where at the end of last year, overseas banks accounted for 57% of the total assets of the UK monetary sector, with US banks contributing 8%. Furthermore, almost three quarters of the 478 banks which take deposits in the

UK are branches or subsidiaries of overseas financial institutions, including 37 from the US. US firms have, of course, particular importance in certain markets. Our April 1995 derivatives survey showed US firms (including securities houses) accounting for around 40% of turnover in both foreign exchange and interest rate derivatives.

We therefore attach particular importance to international regulatory co-operation; and as the trend towards globalisation and multi-functionality continues it is becoming increasingly necessary. The Barings and Daiwa cases have highlighted the difficulty that banks can experience in controlling operations which are far from their head offices.

Barings, in particular, demonstrated that losses in a subsidiary in a remote location, in a unit which was not thought to be assuming any significant market risk, can be big enough to bring about the failure of the parent. So home and host supervisors have a mutual interest in the health of the subsidiaries. Regulators will rightly be blamed if any reluctance on their part to work together either exacerbates a crisis or fails to prevent one that could otherwise have been avoided.

It is possible to argue that an individual regulator can successfully meet his own objectives, by seeking to build firewalls between his entity and the rest of the group to which it belongs. These might include restrictions or even prohibitions on both financial exposures and operational interlinkages. In addition capital adequacy and other requirements might be set at a more onerous level than if the potential for parental support was taken into account.

Such measures may be the best that can be achieved at present; they certainly provide host supervisors with a measure of comfort. But they are, and always will be, a second best. There will always, for example, be a risk of reputational contagion. Counterparties might refuse to deal with a member of a failed group because they are unwilling to take the risk that the firewalls may be flawed, or that cultural or control weaknesses which led to the failure are repeated in that entity also. This, of course, is a hypothetical risk but one which does concern supervisors. Secondly, as the firm will incur additional costs in order to comply with these ring-fencing arrangements, while possibly at the same time being denied the risk reducing benefits of group wide controls, it is unlikely to provide the most efficient solution. Concern about these deficiencies has heightened as we have learned more about the way in which many global financial groups are managed. The lack of overlap between legal entities and the management of business lines means that the amount of true ring-fencing which is possible for a globally managed institution is open to debate.

The creation of ring-fenced islands of activity seems to me contrary both to the trend in markets and second-best in terms of regulatory efficiency. The Bank of England has always believed that effective supervision of financial groups must involve consolidated supervision. As Alan Greenspan said last week in his testimony to the Congressional Sub-Committee on Financial Institutions and Consumer Credit, “Risks managed on a consolidated basis cannot be reviewed on an individual legal entity basis by different supervisors”.

It is important to define the term “consolidated supervision”. The underlying philosophy is that for, say, a bank operating in a large financial group, it is necessary to look not only at the soundness of the bank itself but also of the group as a whole. This will require both a quantitative and a qualitative assessment. The quantitative element involves examining the financial strength of the whole group. The basic measures here are capital adequacy and large exposures. In the Bank of England, we look at these against the minimum standards set out in the EU Directives and against the more stringent criteria which we have developed ourselves and apply to individual banking groups in ways that take account of their particular circumstances. It is worth noting that both the EU Directives and the Basle Capital Accord set these minimum standards on a consolidated basis only.

The qualitative element involves assessing factors such as the group's risk management process, internal systems and controls, capability of key personnel, culture and business strategy. Any supervisor will hardly need reminding that, in the Barings case, weaknesses in a subsidiary in just these areas brought about the collapse of the parent.

As the need for consolidated supervision is written into the Basle Concordat we can be confident that all regulators of internationally active commercial banks, including of course those in the US, subscribe to its principles.

Consolidated supervision is a relatively widely understood concept involving the range of activities set out above. Alan Greenspan last week talked of "umbrella supervision", which he described as a "realistic necessity for the protection of our financial system". (Of course we are not experts on umbrellas: it rarely rains in London, as you know.)

But I also referred earlier to a "lead regulator" - though the term 'co-ordinating supervisor' is gaining currency in some quarters. As noted, one of the tasks of the Joint Forum is to define the role of such a person. So far there have been extensive discussions of the role. Among the possibilities suggested have been:

Carrying out a quantitative and qualitative assessment of the group as a whole. (This is the consolidated supervisor's role and, where there is already a consolidated supervisor, the lead regulator would normally be the same body);

b) Taking a primary role in managing emergencies should they arise;

c) Acting to facilitate the exchange of information between the relevant regulators in a group;

d) (In the longer term) considering ways in which supervisors' efforts could be better co-ordinated when looking at (e.g.) controls.

It should be stressed that the existence of either a lead regulator or a consolidated supervisor in no way affects the legal responsibilities of the individual regulatory authorities which are responsible for regulating the different entities within the group. The objective is not to shift the balance of supervisory responsibility from host to home supervisors. Rather, the intention is that each host authority should be able to carry out these responsibilities more effectively by relying to some extent on the work of others. It cannot possibly make sense for, say, 30 different supervisors to crawl over the controls centralised and concentrated in one location?

We are keen to examine the practicability of allowing one co-ordinator to carry out the role defined above. Enthusiasm from the US has been more muted, although commercial banks are, of course, already subjected to consolidated supervision. Here I know there are political issues at stake too, and any foreigner is well advised to tread carefully. I would hope, nevertheless, that these important issues can be considered carefully.

More problematic is the position of the US investment banking groups who, uniquely amongst the banking and securities industries in major countries, are not subject to legislation requiring consolidated supervision. Some have banking subsidiaries in the UK, owned by companies established under Article XII of the New York State Banking Act. Accordingly these companies and their UK subsidiaries are subject to consolidated supervision by the New York State Banking Department. The involvement of a home country supervisor in this way gives us a degree of comfort which allows the ring-fencing to be less stringent than it would otherwise be. However this clearly falls a long way short of comprehensive consolidated supervision of the entire investment banking group.

There is a lively debate in the US at the moment about the most appropriate regulatory structure for all financial institutions, and particularly for investment banks. This tends to be regarded in the US largely as an internal matter. But the fact that the large US financial institutions have a global reach inevitably makes that debate a matter of great interest and concern to the international financial community. We are optimistic that legislation will soon be enacted to address these concerns. It would certainly be disappointing if it is not.

Conclusions

Though I have attempted this morning to identify some features of regulation on which we might well agree, I doubt whether there is such a thing as an ‘optimal’ regulatory structure. Each country has its own legacy of supervisory structures and approaches. But an appropriate international structure is one which works as seamlessly as possible and has clear lines of responsibility (at least, that is what we expect from international banking groups’ controls). One co-ordinating regulator for each institution could play a crucial role in such a structure. The question of the number of regulators is, in my view, less important; no one has yet suggested we set up one body world-wide to carry out all supervision, so whatever our own vision of an optimal regulatory structure, it will have at its centre a requirement for supervisors from different disciplines and in different countries to communicate effectively with one another. This weekend’s conference is a good opportunity to do that.