
It is a pleasure to be here today at the Exchequer Club. I thank you for the opportunity to discuss the changing financial landscape and offer my own perspectives on what the future might bring. During the next few months, there will be significant debates on various aspects of financial modernization, both within and without the halls of Congress. These debates may well set the stage for how financial service companies will operate as we enter the twenty-first century.

As we can all plainly see, the world is changing across many dimensions, posing new and ever-increasing challenges for both financial services firms and their supervisors. To succeed in this new world, I believe it is important for the industry and supervisors to find common ground for coping with these challenges. By working together to find solutions, we can both accomplish our goals, while retaining the core principles and values that have contributed to the industry’s success.

So today I would like to discuss briefly the changes underway affecting the financial services industry, as well as the individual and collective responses by the industry and supervisors to those changes. Then lastly, I will offer some thoughts on what the role of an umbrella supervisor might look like in this changing environment for financial services. All of these changes must be considered in the context of possible legislative reform.

The Changing World

As widely noted, dramatic advances in information and telecommunication technologies have allowed banks to develop new and more customized products and services and deliver them over a broader geographic area with greater efficiency. Such innovations by the banking industry, and by financial markets in general, have increased the sophistication and complexity of bank lending, investing, trading, and funding. They have propelled growth in less traditional or newer banking activities such as investment banking, mutual fund management, insurance and securitization. In the process, the risk profiles of many banking organizations have been altered in fundamental ways, placing greater pressure on management to monitor and manage underlying risks.

To meet this challenge, a growing number of institutions are employing modern financial theory for measuring and analyzing the trade-off between risk and returns. The availability of dramatically more powerful computers at ever more affordable prices has allowed institutions to process vast data bases of rates, prices, defaults, and recoveries. As a result, techniques for portfolio management and risk measurement that not long ago were possible only in theory are now becoming integral parts of daily operating practice. By applying these theories and techniques, institutions today are more effectively pricing and hedging risk, allocating capital, evaluating risk-adjusted returns and identifying the optimum mix of financial products or services. I believe these enhanced management practices have contributed importantly to the economic growth and market gains seen in recent years.

As competition has intensified, we have seen a growing overlap in the activities and product lines provided by both banks and other financial service providers that has diminished the past distinction between banks and many nonbank firms. That trend has raised
public policy questions regarding bank powers and the appropriate organizational structure through which banking organizations should gain new powers. Proposals recently introduced in Congress to address those issues would fundamentally redefine the relationship of banks to other financial services companies and in some instances their relationship to commercial firms as well.

Banks have not only expanded their products and activities, but have also expanded their geographic reach, both domestically and globally. Within the United States, banks have expanded nationwide as barriers to interstate banking have been removed. This expansion should continue as banks exercise their new power to branch across state lines. A related domestic trend is the rapid consolidation within and between banking organizations. Although some consolidation is undoubtedly related to the removal of barriers to interstate branching, it is also spurred by improved technology, strong competition in banking markets, and the drive by banks to reduce costs.

Internationally, the globalization of banking has accelerated, driven by improved technology and the opening of economies in eastern Europe, Asia, Latin America, and other regions. In particular, U.S. and other international financial institutions are forging a growing presence in lending, trading, and underwriting in these emerging markets. These efforts have created closer links among the world’s financial markets and have improved the efficiency and availability of capital. However, market integration has also increased the potential for systemic problems to transcend national borders, as the volume of international financial transactions has grown. Last year, for example, an estimated $1.5 trillion of foreign exchange contracts were settled daily in New York City alone. A default by a major U.S. or foreign participant in that market could disrupt financial markets worldwide.

Competitive pressures are intense to reduce the cost of financial services to the public. This is occurring against the need to improve the financial strength and competitiveness of the banking industry from the levels at the beginning of this decade. These factors have, in turn, also placed pressure on the banking agencies to remove unnecessary burdens on the industry without threatening safety and soundness.

Regulatory and Supervisory Responses to Change

What have been the regulatory and supervisory responses to these changes? Let me first discuss how we addressed the issue of regulatory burden. Although the poor bank profitability of the 1980s and early 1990s was mostly related to industry asset quality problems, regulators and Congress alike recognized that improvements could be made in bank regulations and in supervisory processes to improve credit availability and bank competitiveness without sacrificing safety and soundness.

Both legislative and regulatory efforts undertaken in the decade of the 1990’s have simplified regulatory reporting requirements, expedited the application process, eliminated duplicate regulatory filings, and have led to more streamlined and uniform banking agency guidelines and regulations. Taken individually, these and other refinements may not appear material, but taken as a whole they have put a meaningful dent in regulatory costs. In fact, the industry on several occasions has reminded us that it is not necessarily any particular individual regulatory requirement that is problematic, but rather, their cumulative effect, much like the straw that broke the camel’s back. We have taken that point to heart when considering new guidelines and regulations.
Efforts to reduce regulatory burden apply not only to banks, but to holding companies as well. Earlier this year, for example, the Board streamlined Regulation Y and reduced application requirements. These changes recognize that regulatory burden arises not only from the direct operational costs of compliance, but also from the indirect costs of delayed or lost opportunities to enter new activities.

To reduce impediments, the Board has decided that the application process should focus on the analysis of the effects of a specific proposal, and should not generally become a vehicle for comprehensively evaluating and addressing supervisory and compliance issues. Rather, the latter can more effectively be addressed in the supervisory process. The Board also recently completed a lengthy review of its policies and procedures for assessing the competitive implications of bank mergers and acquisitions. Modifications have been made to that process to make it more efficient and address the potential benefits of scale economies for small bank mergers.

Another improvement in our regulations is the ability of well-capitalized, well-run companies to apply to acquire banks and nonbanks in a faster more streamlined fashion and to commence nonbanking activities approved by regulation without obtaining prior approval. To allow bank holding companies greater opportunities to innovate, the Board has also indicated that it will be pro-active in approving new activities.

Further efforts to provide flexibility and help modernize bank holding company regulations have been directed toward securities firms known as section 20 affiliates. Last year the Board raised the Section 20 ineligible revenue limit on underwriting and dealing in securities from 10 to 25 percent. This appears to be allowing greater flexibility for these operations.

The Board has also eliminated certain firewalls between banks and their securities affiliates and for other firewalls has proposed to eliminate or scale back even more, recognizing that other laws, regulations, and improved disclosures provide adequate protections against conflicts of interest. These and other refinements should allow holding companies to move closer toward their goal of operating as a one-stop financial service firm for customers, while operating safely and soundly.

The Comptroller of the Currency has also taken steps to widen the breadth of activities undertaken by banking organizations. For example, the expansion of insurance sales activities has opened new opportunities for national banks.

Beyond efforts to reduce burden and modernize banking powers, regulators are also redesigning their supervisory practices to address more effectively the changing nature of the industry. These efforts are leading to a more risk-focused approach to supervision. That approach is more responsive to the industry’s rapidly evolving activities and risk profiles and places emphasis on the institution’s own ongoing system for managing risk, rather than point-in-time transaction testing. By focusing resources on the areas of highest risk, and eliminating unnecessary procedures, this approach is not only more effective, but also less intrusive and costly to all parties. I should note, however, that successfully implementing this approach requires that supervisors attract, train, and retain qualified staff while also upgrading training, automation, and other resources. This is a continuing challenge indeed!

Regulators are also trying to build on private sector initiatives that promote safety, soundness and systemic stability. For example, at the height of Congressional concern...
about financial derivatives, the Group of Thirty sponsored a study to identify principles of sound practice for managing risks in derivatives for both dealers and end-users.

By providing guidance on this issue, that study served as a catalyst for industry participants to analyze and evaluate their own practices. Subsequent guidance from the Federal Reserve and the Comptroller benefited from the insights provided by the study, while adding a supervisor’s perspective.

The study’s emphasis on education and sound practices spurred greater understanding and acceptance by the industry of supervisory recommendations for sound risk management systems. I think it is safe to say that this cooperative approach between the private sector and regulators resulted in stronger industry practices and better supervisory oversight, not only for derivatives, but also for bank risk management more generally. Together, the industry and agency response helped stave off potentially restrictive legislation.

Another example of how supervisors are trying to build on bank management practices is their use of internal value-at-risk models in the calculation of capital requirements for market risk. By relying on internal models already used by the institutions for their trading and risk management activities, regulators can reduce burden while vastly improving the accuracy of the capital calculation. In addition, by embracing internal models for regulatory purposes, supervisors are encouraging organizations to incorporate sophisticated risk models more fully and formally into their risk management systems and to continue to upgrade and improve the models.

As these two examples illustrate, supervisors recognize that they do not have all the answers and that rigid regulatory solutions may often do more harm than good. A supervisory approach that promotes continued improvements in private sector practices provides the right incentives to industry and, in the case of banking, also reduces risks to the federal safety net.

In these ways, supervisors are placing greater reliance on a bank’s own risk management system as the first line of defense for ensuring safety and soundness. We also want to rely more on market discipline as another line of defense. This requires increased, improved disclosure of a bank’s activities, risk exposures, and philosophy for managing and controlling risk. We have made significant gains for derivatives and market risks. Hopefully we will see further gains in other areas in the years ahead.

While it is important for supervisors to identify risk at individual banks, as the central bank the Federal Reserve must also be watchful for conditions and trends external to the banking system that could place the financial system and the economy at risk. This broader perspective has become especially important with the globalization of banking and integration of markets. That is why the Federal Reserve has worked closely with financial regulators around the world to reduce systemic risk and promote sound banking practices and improved disclosures among both developed and emerging countries. These efforts have led to the advancement by the BIS of core principles of bank supervision for authorities world-wide and, significantly, promotion of consolidated supervision of banking organizations by home country authorities. The issue of consolidated supervision is particularly relevant in revisiting the question of the modernization of the banking system. I will come to that in a moment.
Financial Modernization and Umbrella Supervision

First I would like to point out that whether legislative agreement is reached or not, market forces will continue the modernization of the financial services industry and will further blur the lines between banks and nonbanks. For example, we can expect mutual funds to refine their offerings to compete with bank checking and savings accounts, albeit without deposit insurance. Banks will undoubtedly make further inroads in mutual fund management and investment banking through internal growth and through acquisitions of securities firms. Investment banks may also supplement their services by making commercial loans and participating in loan syndications.

With such things happening, why do we need a legislative solution? The answer is that a well thought out proposal addressing the appropriate structure for the industry would allow for a more rapid and efficient integration of financial services. Moreover, by clearly defining the boundaries and structure of financial conglomerates, a well-considered supervisory program could adequately protect banks without undue intrusion to other parts of the conglomerate.

Because financial conglomerates generally operate as integrated entities and manage risks on a global basis across business lines, their true operating structure superimposes a risk management and internal control process that extends across legal-entity-based corporate structures. In this light, supervision by legal entity can create important supervisory gaps that may expose the insured depository institution to unnecessary risk. That is to say, someone should look at the risk management of the organization as an organic whole, rather than as separate pieces that are simply added together. In fact, comprehensive, consolidated supervision by the home country supervisor is a legal requirement for foreign banks operating in the U.S. Some foreign supervisors are now beginning to question the consolidated supervision of U.S. firms operating in their countries.

Now, I suspect some nonbank firms may feel apprehension at having an umbrella supervisor evaluate their operations. But let me emphasize that such oversight need not be overly onerous or intrusive. In fact, regulators are probably better prepared than ever before to implement an umbrella supervisory approach as a result of the supervisory techniques and approaches I just discussed. By applying risk-focused supervision, and promoting sound practices, and improved market disclosures, an umbrella supervisor should be able to implement an effective, unintrusive oversight process for conglomerates. Moreover, an umbrella supervisor may be able to provide assurances and information to other regulators and individual supervisors which may minimize their need to extend their reviews beyond the legal supervised entity and into the conglomerate’s other operations, creating duplication and burden.

I believe that the umbrella supervisor, whether it is the central bank or another agency, should not attempt to duplicate efforts of other regulators. Rather, the umbrella supervisor should evaluate the financial conglomerate from a more comprehensive perspective, bridging the gap between an organization’s legal structure and its structure for taking and managing risk. Similarly, the umbrella supervisor need not attempt to extend bank-like safety and soundness regulations to nonbank entities. Those standards were never intended to apply to the nonbank entities of a conglomerate and would insert unnecessary competitive barriers without achieving the desired benefits.
How exactly should an umbrella supervisor meet its responsibilities? First by focusing its supervisory efforts on the adequacy of the risk management and internal control process of the parent company and of the group as a whole, and determining how well those systems protect the safety and soundness of affiliated banks. That evaluation could be performed in a manner similar to that of a securities analyst, albeit from a different viewpoint. This assessment might involve analysis of public financial statements, rating agencies and Wall Street analyst reports, internal management reports, internal and external audit reports, meetings with management, and only limited, if any, on-site inspections of nonbank affiliates. Any visits that are made could be limited to testing the adequacy of management and operating systems, to protect the insured depository institution.

While various approaches could be taken to address capital adequacy and to avoid the unnecessary or inappropriate use of double leverage, I believe such approaches should be measured against the goal of assuring the safety and soundness of the affiliated banks. And finally, the umbrella supervisor should have appropriate enforcement authority, including the authority to require the sale of the bank in extreme situations.

Conclusion

It is clear that the financial services industry is changing and that banking powers must also change if banks are to remain competitive. The Board has long supported reforms and strongly urges them today. However, changes such as these carry risks. It is important, therefore, that change be introduced properly through legislative debate and by adopting proper safeguards to ensure that nonbank activities do not unduly expose banks and taxpayers.

The Federal Reserve is mindful of regulatory burden and of the need to accommodate change. Nevertheless, we also believe that some type of umbrella supervision will be necessary to protect insured depository institutions and address systemic risk concerns. Whoever plays that role should take a broad perspective in evaluating risks not only to specific depository institutions but also to the payment system and to the broad financial industry as well. Simply put, I believe that in an economy as complicated and integrated as we have in the United States, it is important for the nation’s central bank to have a significant role in comprehensive financial institution supervision.