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Fostering Strong Financial Markets through Prudential Supervision

Address by

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I am pleased to be here today, to meet with and exchange views with such a wide gathering of banking supervisors from Latin America, the Caribbean, and Canada, and I appreciate the opportunity to address this Conference. Our economies have made important progress in recent years on a number of fronts, both in terms of performance and in structural reforms. In the United States, efforts to contain the fiscal deficit are showing results. Here in Argentina, our host country, hyperinflation has been tamed. In a number of countries represented here, privatization has opened up new investment opportunities. Improved financial reporting and supervision of financial markets have given investors greater confidence and opened up sources of funds for local entrepreneurs. The recent turmoil in some of our financial markets must not be allowed to overshadow completely the basic, underlying improvements that have been made, nor the fact that this period of stress has been a time for consolidating, not abandoning, the economic reforms implemented during the past few years. This lays the foundation, I think, for a new era of prosperity and progress in this hemisphere.

The subject I will be discussing today -- strengthening financial markets through prudential supervision -- is of critical importance to our mutual economic interests. Financial markets play the central role in determining the allocation of real resources in our national economies and also

internationally, and the banking markets we supervise play a key role in the financial system. Notwithstanding the dramatic changes in finance that I will be discussing today, in the United States banks are still the principal repository for the public's liquid funds. The safety and ready availability of these funds are essential to the stability and efficiency of our financial system. Commercial banks are the backbone of the national payments system, an essential component of an industrial economy. A strong and adaptable banking system is also needed to transmit the impulses of monetary policy with the least amount of friction and delay to the rest of the financial system as a whole and to the whole economy.

For all of these reasons, depository institutions are generally afforded a measure of official protection, a so-called safety net, and are accorded a higher degree of official supervision than other financial institutions. I think all of us would agree that additional dimensions to our multiple responsibilities include not only maintaining the stability of the financial system and encouraging an effective and efficient banking sector, but also protecting taxpayers from losses associated with the safety net. Today bank supervisors face critical challenges in fulfilling these responsibilities.

Walter Bagehot stated in *Lombard Street*, his renowned book written in response to the banking problems of his day, "The

business of banking ought to be simple; if it is hard, it is wrong." (Emphasis is Bagehot's.) For perhaps a hundred years after the publication of *Lombard Street* in 1870, this statement remained generally true, but I think you will agree that "simple" would not be a term we would apply to banking today. It is not that the basic business of banking has changed in recent years; banks are still essentially engaged in measuring, managing, and accepting risk, as they were in Bagehot's time. But the rapid growth in telecommunications and information processing technology has revolutionized how banks conduct their basic business. The new financial products and means for delivering banking services precipitated by the new technology underlie a boom in productivity in banking, for good and ill. Today a single trader equipped with a modern work station can generate a volume of transactions and a level of exposure for his firm that would not have been conceivable by his predecessor a decade or two ago. These changes, however, have not altered the fundamentals of sound banking. On the contrary, they have made the need for strong, effective risk management systems more critical than ever.

Risk management now lies closer to the core of banking. Nowhere are these changes more clearly shown than in the financial derivatives market. Although some types of derivative instruments have existed for hundreds of years, the scale, diversity, and complexity of derivatives activities have greatly

expanded in the last fifteen years. And the present scale and complexity of these instruments could not exist without the use of computers and the rapid expansion of telecommunications. They could not be priced properly, the markets they involve could not be arbitraged properly, and the risks they give rise to could not be managed properly without such capabilities.

These changes are clearly seen in U.S. banks. During the period 1985-93, trading income of the seven largest money center banks almost tripled and accounted for 27 percent of their combined revenue from net interest and trading income in 1993, as compared with about 9 percent in 1985. Income from trading can be volatile, however, as was demonstrated in 1994, when trading income fell by 35 percent from the previous year. At year end 1994, the notional amount of interest rate and currency swaps held off balance sheet by these U.S. banks was about five times their balance sheet assets, and the replacement value of the interest rate and foreign exchange contracts held by these seven banks was about 2½ times their equity capital.

In addition to making possible the dramatic changes associated with derivatives, technological advances have accelerated the pace of financial globalization. Banking organizations that span the globe are now commonplace. Low cost information processing and communications technology has encouraged the rapid growth in cross-border banking, which has

improved the ability of customers to avail themselves of borrowing, deposit, trading, arbitrage, and risk management opportunities offered anywhere in the world on a real time basis. But while millions of consumers of such services have been made better off, we have also witnessed some spectacular failures, such as the collapse of Barings Bank and the financial crisis in Orange County, California, in which the new financial instruments played a highly visible role. We have seen the corrupt management of BCCI create a global structure to exploit weaknesses in supervisory systems to defraud depositors on an unprecedented scale.

Recent financial innovations have also further blurred the distinctions between traditional types of financial institutions. Commercial banks, investment banks, mutual funds, insurance companies, and specialized finance companies offer new, broader, and frequently overlapping product lines. In the United States, competition with banks from new, unregulated companies has, in my view, caused considerations of efficiency and economic viability to rank with concerns for safety and soundness in the supervision of banks.

These financial market developments have caused bank supervisors to reevaluate some of their basic policies and procedures. I would emphasize, first of all, that the overriding goal of the bank supervisor cannot be to eliminate risks in the

banking system. If risk taking by banks' customers cannot and should not be eliminated, customer financing by banks implies, indeed necessitates, risk taking by banks. Keeping in mind then the fine line supervisors need to walk between encouraging prudent risk taking but deterring excesses, I will discuss a few of our current supervisory concerns in the broad areas of capital adequacy, risk management, disclosure, and, finally, international supervisory coordination.

Capital adequacy is foremost among bank supervisor's prudential policies. Prudential capital policy has become increasingly important for U.S. supervisors as the functional distinctions between banks and nonbanks have become progressively blurred. U.S. regulators have sought higher capital standards for banks in order to allay concerns about the participation of banks in the ongoing evolution of the financial system -- concerns about the risks to banks from new financial instruments and strategies and the potential extension of the safety net to nontraditional banking activities. Higher bank capital and the "early closure" of troubled banks based on their capital ratios were implemented in the Federal Deposit Insurance Improvement Act of 1991, in part, to help bank supervisors deal with the implications of rapidly evolving financial institutions as well as to set the stage for the repeal, in due course, of the legislative barriers to firms entering both the commercial and investment banking business.

The development of workable supervisory standards for capital adequacy has been a long, evolutionary process. Today, U.S. regulatory agencies are wrestling with the complexities of how best to devise capital standards for interest rate risk and trading activity risk. Some observers question how long we can continue to go down this road toward ever more intricate capital policy. No matter how complex capital rules become, it is doubtful they can ever satisfactorily address the problem of how much capital is needed for the overall set of risk positions in one of today's evolving financial institutions.

The Basle Supervisors Committee has proposed a new approach to determining the appropriate amount of regulatory capital that would be based on the banks' own internal risk-management systems. This approach has the advantage of giving banks an incentive to improve their risk management systems. The smaller the bank's so called value at risk, the smaller its regulatory capital requirement. A disadvantage is that different banks may arrive at different capital requirements for the same portfolio, even after controlling for the choice of confidence level and holding period. The feasibility of this approach will depend critically on the ability of supervisors to evaluate banks' risk management models.

The current state-of-the-art capital policy highlights an element of prudential supervision that has long played an

important role in the United States -- the on-site examination. The task of assessing risk management systems and internal controls has made the examination process even more critical today. With derivatives and highly liquid securities, risk positions can change drastically, not only day to day, but hour to hour, and minute to minute. Regulators have little choice but to devote increasing attention to the process by which banks manage their portfolios and risk profiles, as compared to the individual instruments that are held at any point in time.

The Federal Reserve has made a major effort to enhance the guidance it gives examiners on risk management and internal controls for derivatives activities and other trading activities. The Board's staff has highlighted the key considerations in letters to examiners. These issues are also addressed in detail in a Capital Markets and Trading Activities Manual. The Federal Reserve is developing an enhanced capital markets training program that will cover risk assessment, trading exposure management, and advanced derivative products.

This guidance to examiners is broadly consistent with the risk management practices recommended by the Group of Thirty, a body drawn from the financial industry itself. In the end, supervisors will have to stay abreast of industry "best practices" in the measurement of risk and the assessment of sufficient capital to cover that risk. At a minimum, we must be

able to distinguish between adequate practices and unacceptably crude risk measurement and management techniques. An increasingly important part of a supervisor's job is to determine that adequate practices are being followed and that internal capital allocation rules consistent with such practices are being enforced by bank management.

In order for supervisors to do their job they not only need to send examiners, or their proxies (that is, auditors), into the banks periodically, but they also need on a more frequent basis statistical reports that accurately show the banks' activities so that they can oversee their operations between on-site visits. In the United States, regulatory reporting is but one element in the general area of transparency, which includes accounting practices and public disclosure. U.S. prudential policies promote public disclosure to permit market participants to assess the creditworthiness of their counterparties, and there is considerable support within the financial industry for standardized accounting and disclosure, in spite of the costs.

For an example, we can again focus on derivatives. Existing financial accounting and reporting systems have lagged in providing comprehensive, useful information on institutions' derivatives activities, and intensive efforts are underway to improve them. The challenges to producing uniform, meaningful

reporting on derivatives are formidable. A particular instrument can be risk reducing in one firm's portfolio and risk increasing in another's. Market positions can change in minutes rather than days. Significant changes in accounting standards have already been put into effect in the United States. One feature of the new standards is that OTC derivative positions will be treated differently if they are traded than if they are used solely for hedging purposes. The new standards also call for the disclosure of more information about the value of, and the gains and losses from, traded OTC derivatives.

Differences in national accounting practices are posing problems in cross-border counterparty risk assessment, and improvement of accounting standards is a high priority of the Basle Supervisors Committee. One of the reports of the Basle Committee, the so-called Fisher Report, named after Peter Fisher of the New York Federal Reserve Bank, recognized the lack of consensus in this area, but called for more public disclosure drawn from firms' own internal risk measurement systems, such as summary statistics on their value at risk over different holding periods. It also recommends that ex-ante estimates of value at risk be compared to actual outcomes in order to show the historical performance of an institution's risk-management system. Disclosure that focuses more on the processes by which risks are assumed and managed rather than on the instruments themselves is compatible with our supervisory approach toward

these activities and should be strongly encouraged. A framework of accurate, useful, and understandable public information would not only bring the discipline of the market to bear on fostering sound practices in this area, but also might correct some observers' highly exaggerated views of the risks these activities involve.

I will conclude with a few remarks on consolidated supervision and international cooperation, topics that are the subject of separate sessions of this conference. The dramatic collapse of Barings Bank is the most recent reminder that there is room for improvement in these areas.

Most industrial countries and many of the countries represented at this conference subscribe to the principle of consolidated home country supervision. The Barings case is the latest illustration of why comprehensive supervision on a consolidated basis is crucial. Although the Barings collapse was resolved without systemic effects, should it have occurred in unfavorable circumstances, when the markets were already disturbed, the consequences might have been otherwise.

Certainly one of the most important lessons of the recent past is that international supervision is only as strong as its weakest link. The United States adopted the principle of comprehensive, consolidated supervision in the Foreign Bank

Supervision Enhancement Act of 1991, following some well-publicized scandals. In judging the fitness of a foreign bank to enter the U.S. market, the Federal Reserve must conclude that it is subject to effective consolidated supervision. This statute has not been easy to implement because banking structures and techniques of bank supervision vary greatly among countries, but we have found through cooperation with various supervisors that most bank supervisory systems incorporate at least some elements of comprehensive, consolidated supervision. I also note that since the enactment of this statute a number of countries have adopted a system of banking supervision grounded on the principles of comprehensive, consolidated supervision, or moved in a significant way toward adopting such a system.

Nevertheless, going on four years after enactment, the comprehensive, consolidated supervision standard in the Foreign Bank Supervision Enhancement Act remains somewhat in advance of on-going international efforts to strengthen the supervision of internationally active banks. Supervision on this basis is not the current norm around the world, particularly in countries with less developed financial systems. The U.S. standard is stricter than the Basle minimum standards, which also emphasize the need for supervision on a consolidated basis of the worldwide operations of internationally active banks. It has proved a significant barrier to entry for banks from jurisdictions that have not yet fully implemented a policy of consolidated

supervision. On the basis of our experience, the Board believes that this provision of the Foreign Bank Supervision Enhancement Act should be reevaluated. The Board would support the incorporation of some additional flexibility such as is embodied in the Basle minimum standards. Any such change would, of course, require amendment of the legislation.

Implementation of the standard on consolidated supervision has required the Federal Reserve to work with foreign supervisors on a greatly expanded scale, on both a bilateral and multilateral basis. International supervisory cooperation is also needed in other areas, however. Global markets, such as the foreign exchange market, may be concentrated in a few locations, but all supervisors need to be aware of developments in these markets to monitor potential risks to participants. In the past, cooperative efforts in this hemisphere have included supervisory meetings of the Center for Latin American Monetary Studies and conferences such as this one. Looking ahead, I see the need for bank supervisors from our countries to cooperate further. A little later this afternoon, my colleague Richard Spillenkothen will put forward some suggestions for achieving this. I am sure we all agree that ways to improve coordination among bank supervisors of this hemisphere merit a thorough consideration.

The world and each of our economies have a multitude of challenges, but also enormous promise. Meeting the challenges

and realizing the promise of a better economy for all our citizens will require the presence of strong financial systems in all countries, which in turn requires strong financial institutions. If we bank supervisors play a constructive role in ensuring a sound and vigorous banking system, we will have contributed significantly to the realization of the promise.