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Remarks by

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Good morning. It is wonderful to be in Japan once again and particularly to return to this beautiful historic city of Kyoto.

It is my distinct honor to be a keynote speaker for this conference of policymakers and senior officers concerned with strategic planning for some of the world's largest and most dynamic financial institutions. Having served in similar capacities I know how the planning process is affected by both regulatory and economic factors.

An international meeting on this subject is timely and appropriate, because, increasingly, banks and other financial institutions are competing in a global marketplace to provide financial services. Regulatory authorities in all countries, and particularly in industrial countries, should accept that it is important to coordinate policies. Otherwise, one nation's banks might be placed at a serious competitive disadvantage.

I will focus my remarks today on several important regulatory issues which will confront bank managers and policy officials over the next few years. In particular, I will discuss the scope of expansion by banks into securities activities; the implications for banks of the new risk-based capital guidelines announced by the Basle Committee of bank supervisors; the European Community proposal for a unified market in 1992; Federal Reserve responsibilities for designation of primary dealers in U.S. government securities; and, examine some of the issues associated with the financial restructuring of U.S. corporations and so-called leveraged buy-out debt.

These issues involve both opportunities and risks for banks as well as challenges for regulatory authorities. I hope solutions will evolve that improve the efficiency of financial markets, expand opportunities for all institutions in equitable competition, and yet avoid excessive risk for institutions which accept deposits from the public with either implicit or explicit protection of a government safety net.

Last month the Federal Reserve Board approved requests from several large U.S. banking organizations to expand their securities activities. They had applied for permission to underwrite and deal, within the United States, in both corporate debt and equity securities. The Board approved underwriting debt effective immediately. The Board, while approving in principle the underwriting of equity, deferred for one year approval to implement such activity to allow time for the banking organizations to demonstrate that they had the necessary managerial and operational skills to do so safely.

Those requests, and the Board's decision, reflect two important trends that have appeared in financial markets in recent years: the fading distinction between commercial and investment banking and the multiplying links among national markets. In order to be competitive, both Japanese and U.S. banks have been permitted to conduct securities activities outside their home country. In recent years these activities have grown substantially. Technological advances, product innovations, new competitive forces, and deregulation in several key markets -- including the "big bang" in London -- made securities activities much more interesting to banks as well as other financial institutions.

The Glass-Steagall Act prevents U.S. banking organizations from conducting most securities activities at home -- as Article 65 prohibits domestic securities activities of Japanese banks. Section 20 of the Glass-Steagall Act, however, permits holding company affiliates of U.S. commercial banks to engage in underwriting and dealing in a broad spectrum of securities, which would otherwise be ineligible for banks, so long as the affiliate is not "principally engaged" in such underwriting and dealing. In 1987, the Board gave several holding companies expanded authority under this Act. In doing so the Board determined that if revenues from those activities did not exceed 5 percent of the securities affiliate's revenues, it would not be deemed to be principally engaged in those activities. That same standard was applied in the more recent decision. It is my understanding that wider domestic securities powers for Japanese banks will require a legislative change as well as regulatory approval.

In addition to meeting legal limitations covered by the "principally engaged" test, the Board was concerned that banks be protected from the presumed added risk inherent to these securities activities. In this regard the restriction of the broader securities powers to separately organized and capitalized affiliates should protect the bank. In addition, the Board imposed two key restraints: first, commercial banks were prohibited from lending to any Section 20 securities affiliate under virtually all conditions, and second, capital investment by the parent holding company and loans by it to its securities affiliate were excluded from the parent's capital when calculating regulatory capital. These steps were taken not only to address the risks that may be associated with underwriting and dealing in securities, but also because of the possibility that conflicts of interest could emerge between the bank and the securities affiliate in the holding company.

When making its decision, the Board concluded that approving the activities would lead to increased competition in the securities markets and would provide bank customers with more convenient and efficient services. In each case approved, the request involved a new entity coming into the market, rather than the acquisition of an existing firm. This approach should reduce concentration in the securities industry and be important to small businesses, which often have few choices among underwriters due to the limited size of their transactions.

Potentially increased competition is an important consideration, but it carries increased risks, as well. We have already seen a number of institutions withdraw from certain segments of the British securities market because of inadequate profit margins and relatively low volume. Some firms that left the London market were established organizations that had participated in those markets for years. Some foreign-owned securities companies are also reassessing, and in some cases reducing, their operations in the U.S. market. As new firms enter the securities business worldwide, we can expect to see still further pressure on profit margins and additional financial problems for some participants. We must recognize that securities firms are not commercial banks and do not have the implied government support that banks often have. Therefore, a clear separation and insulation of banking subsidiaries will be needed.

The recently expanded securities activities are only one of the features that have transformed the business of banking in the past decade. Although the basic business of banking remains lending and investing, the host of new financial instruments and the internationalization of credit markets have materially altered bank balance sheets and the risks banks face. These developments have some positive aspects. Many of the new instruments and techniques permit banks to improve their management of credit and interest-rate risk, and to reduce or hedge their levels of exposure to certain risks. Customers from banks also benefit from a wider range of financial alternatives. But, what is important is that the risks as well as the opportunities of these new techniques are fully understood.

One of the unsettling patterns, at least among U.S. banks through much of the 1970s, was the low level of capital ratios. Capital ratios at the beginning of this decade had declined to unacceptable levels at many large U.S. banks. In response, in late 1981, U.S. authorities developed specific capital standards based on asset size. Congress also expressed concern about capital ratios and in

1983 the International Lending Supervision Act required U.S. bank regulators to impose uniform capital standards on U.S. banking organizations. In the 1980s considerable progress has been made in improving the capital-to-asset ratios for U.S. banks.

Although the simple measure of capital adequacy based just on total assets served its purpose, it became clear that a measure tailored to a bank's <u>risk</u> profile rather than asset size would be better. It was also clear that major nations throughout the world should adopt uniform or at least similar capital standards in order to maintain an acceptable level of competitive equality and bank safety. As you know, last summer members of the Basle Committee on Banking Regulation and Supervisory Practices reached an international agreement on a risk-based capital standard. Each participating country is now in the process of implementing that accord, which will be phased in over the next few years.

These international capital standards were difficult to design and are admittedly very complex. They represent years of international discussions and negotiations and required compromises by virtually all parties. However, they relate only to credit risks and do not yet cover interest-rate or exchange-rate risks.

When these standards are in place, and if they are vigorously enforced, they will strengthen the financial system against unexpected shocks, and should remove some competitive inequities created by different national standards. In the interim, when reviewing applications, the Federal Reserve will continue to enforce its current capital standards on U.S. banks, while considering in each case the progress the applicant is making toward the new benchmarks. I should note that these are <u>minimum</u> standards and higher capital ratios may be needed by banking organizations attempting to expand their activities significantly.

Preliminary estimates indicate that many large banking organizations throughout the world are well on their way toward meeting, or have already met, the final requirements set for the end of 1992. Some Japanese banks, for example, have raised substantial amounts of additional capital in the past year through various means including issuing stock and have significantly strengthened their capital ratios. Many U.S. banking organizations have also increased their capital ratios within the last year, primarily through strong earnings retention. Other banks with still-low capital positions will need to do likewise in the coming years or will need to slow the rate of risk-asset growth. In any event, it is clear that a new era of reasonably consistent international capital standards is upon us, and major banks throughout the world will be held to specific and more rigorous capital requirements. The standards, while complex, should increase the safety of the world financial system and relate capital needs to the level of risk an institution decides to take.

While new powers and revised capital ratios will affect banks' activities, changes in the treatment of banks in foreign markets will also be an important factor for the future. In particular, the plan of the European Community to establish an integrated internal market by 1992 represents an ambitious goal. It also presents a new set of challenges to banks and other financial institutions.

Given the scope of the undertaking in Europe, the <u>potential</u> benefits appear large. This is true for many economic sectors, including the financial sector. Two key concepts, if adopted, could create an entirely new structure. First, the single banking license will mean that a credit institution established in any EC country will be able to branch into all other EC countries, reducing banks administrative costs. Second, the principle of <u>mutual recognition</u> would mean that host authorities would permit any credit institution to exercise the same powers it has in its home country. As a result, pressures will develop over time for banking in each EC country, and in the community as a whole, to replicate the structure of the country that permits the broadest powers. That is, universal banking will become the pervasive pattern. Analogous changes are likely to occur in other economic sectors.

While the potential for gain is great, so are the risks. I know that decisionmakers in the European Community are well aware of the complexity of their task. They know the stresses likely to arise as firms are created, merged, or restructured to meet the increased competition and opportunities that will arise. Moreover, they sense the need to reconcile their definition of bank capital and their capital standards with the recent international agreement on capital standards.

I am less confident, however, that all of the decisionmakers fully understand the crucial need to permit institutions from non-European Community countries to operate in the EC on an equal basis with EC firms. For example, the notion of reciprocity, referred to in Article 7 of the proposed second banking directive, is a vague concept. No doubt all of us in Japan and the United States are deeply interested in the ultimate resolution of this issue. I was pleased to see some clarification last October that reciprocity would <u>not</u> be applied retroactively and would <u>not</u> mean that every country had to have a financial structure the same as Europe's if their firms were to be allowed entry into Europe. I remain concerned, however, that some form of reciprocity could be adopted. Such an action would jeopardize an open global system of entry to financial markets that benefits us all.

Public policy in the United States has generally followed the principle of national treatment: that is, relatively free entry and full participation in U.S. markets as any U.S. company could participate. That policy has served our interests well by allowing foreign financial firms to make important contributions to the depth and competitiveness of our financial markets. In recent years, however, there has been an increasing concern that U.S. financial institutions, both banks and securities companies, are not receiving national treatment in a number of host countries. In that context, official efforts have been made to improve U.S. banks' access to foreign markets with several <u>important</u> <u>successes</u>.

The United States Congress has shown considerable interest in the treatment of U.S. financial institutions in foreign markets. The International Banking Act of 1978 called for a study of foreign government treatment of U.S. banks. That initial study has been updated twice, and the most recent update in 1986 covered securities activities in eight major industrial countries. More recently Congress enacted the Primary Dealers Act of 1988 which prohibits the Federal Reserve from designating a foreign-owned firm as a primary dealer in U.S. government securities if its home country does not afford U.S. firms the same opportunities in underwriting government debt instruments as are enjoyed by domestic firms in that country.

To implement the provisions in that Act the Federal Reserve has announced its intention to study the government debt markets in the United Kingdom, Japan, Switzerland, and Germany. As many of you know, a Federal Reserve team was recently in Japan as part of that effort. It would be premature for me to comment on the outcome of that study, However, the announced proposal to increase the share of 10-year Japanese bonds sold by competitive auction from 20 percent to 40 percent and to increase the foreign firms' share of the bonds distributed through the syndicate from 2-1/2 percent to 8 percent are evidence of good faith and big steps in the right direction.

Finally, because it is currently a hot topic in finance, I would like to turn to the process of corporate financial restructuring underway in the United States. Restructuring often occurs when an outside investor (or group of investors) has acquired control of a company by paying a price well in excess of the historic market price for a company's shares. The outside investors, and their financial backers, believe "value" can be created by giving management a greater ownership interest or by breaking up a company into pieces and selling the pieces for more than the equity markets had valued them as part of the consolidated company. These kinds of acquisitions are often financed by loans from banks and the issuance of large amounts of less-than-investment-grade securities. The result is frequently a very highly leveraged company.

Now, financial restructuring is not terribly new. Indeed, in a dynamic economy, one would expect some firms to be restructured to take advantage of changing opportunities. The corporate restructuring taking place in the United States in some ways reverses the trend toward conglomerate mergers and acquisitions in the late 1960s and early 1970s, in many of which the expected result was elusive. What is new about the current round of restructurings is innovation in financial techniques, including the development of a market for low-grade debt or so-called "junk bonds" and the enhanced ability of banks to syndicate their loans to other investors and institutions

To date the evidence from a limited historical record suggests that these financial restructurings have been successful on balance. Estimates of value created for shareholders range from 200 to 500 billion dollars with negligible losses so far to bondholders. Some studies have shown gains in operational efficiency and overall employment in firms that have been restructured. Moreover, there is no legal record of significant insider trading abuses in spite of the huge sums involved.

Then, why should the Federal Reserve, or any other bank regulatory agency, be concerned with bank exposure in cases of leveraged buyouts or other forms of corporate financial restructuring, or the possible effects of these deals on the economy? While the realized losses to date on these transactions have been negligible, the ability of U.S. corporations to cover debt service from their corporate cash flow has declined. That trend is uncharacteristic of a period of high profitability. In addition, the increase in the number of cases where bond ratings have been downgraded is of real concern. While most of the restructurings to date have taken place in stable noncyclical industries, the fact remains that the ability of these firms to service very high debt burdens has not been tested in an economic downturn. Many of the deals depend upon the ability to sell assets for high prices relative to earnings. It may be that holders of some of these debt instruments will find that there is a larger equity component in the instruments they hold than they originally estimated.

Mindful of these potential problems, I believe it is premature to embark on a policy of tax reform or other regulations that might deprive companies of important opportunities to improve their efficiency by financial restructuring. Tax factors favoring debt over equity finance have existed for decades, so I do not think tax reform, particularly one that might increase the United States' fiscal deficit, is an appropriate policy response. And regulations directed at U.S. banks alone would put them at a disadvantage vis-a-vis foreign banks. Rather, we at the Federal Reserve Board want to ensure that banking institutions are well diversified against potential risks that could arise in highly leveraged financings if interest rates rose or the economy declined or both happened at the same time. Each bank participating in a restructuring loan, whether a U.S. or non-U.S. bank, should do its analysis to assure itself that the credit is well-structured and that the interest rate charged justifies the expected risk. Participation based solely on the perceived skill of the lead bank is not a wise or prudent practice. At the Federal Reserve we have instructed our examiners to review these loans carefully and make certain that the lending banks fully understand the risks involved, are using credit approval procedures consistent with that risk, and are keeping directors informed on a regular basis of potential risk to the institution.

In closing I want to say that protectionism is the long-term enemy of economic growth and mutual prosperity among the industrialized countries. Certainly Japan and the United States have an unusual opportunity for a mutually advantageous future relationship if we can share opportunity and tear down barriers. Cooperation toward economic competitiveness between ourselves and with the rest of the world should be a policy we mutually embrace.

Thank you for giving me the opportunity to be with you at this conference and share my views.