# Remarks by Governor Mark W. Olson

**At the Second Financial Summit: Challenges and Emerging Risks Facing the Financial Industry, Madrid, Spain**
**July 8, 2002**

## Financial Markets Regulation in the United States

First, my thanks for being invited to participate in the Second International Financial Summit on Financial Regulation. Today I would like to share our experiences in the United States in dealing with this important issue. We are increasingly participating in a world economy, and our financial institutions are increasingly global in scope. Today's sharing of experiences and observations is therefore more than an interesting intellectual exercise. We, indeed, have a shared obligation to understand the evolving nature of our respective industries and to learn from each other's best practices. My opening comments will be brief as they are intended only to stimulate discussion among the panel members and audience.

In my remarks, I want first to identify the major trends driving change in the financial services industry. These trends will not be new to you, as they are global, but they will help define our current environment. I will then discuss briefly some issues that may be specific to the United States. As with every country, the financial services industry in the United States is a product of numerous influences. In my country, the most notable of those influences was our Founding Fathers' determination to decentralize authority and to limit the federal government's influence and to place the law and rule-making responsibility for commercial activities with the various states. I will move from there to the major trends in U.S. financial regulation and conclude with a brief description of the evolving regulatory role of the Federal Reserve.

**Drivers of Change**
Several common forces are influencing financial services industries around the world. Perhaps most dominant is the extraordinary leap forward in technology that has changed every facet of these industries. The first major technological changes, almost forty years ago, dramatically changed back-office processing. In recent years, technological improvements have changed the delivery of retail financial products to such an extent that our traditional definitions of deposit gathering and lending are in continual need of updating.

A second major driver of change is the growing complexity of our largest financial institutions. This complexity is a combination of increased size driven significantly by industry consolidation and by the creation of more-sophisticated financial instruments.

A third major change is the continued blurring of lines between financial products and financial industries. In the United States we have, in past years, devoted a great deal of regulatory and legal attention to sorting financial products by industry designation and attempting to confine products with certain characteristics to specific industries. For example, in the 1980s and 1990s we devoted considerable attention to the manner in which a money market fund account with third-party access offered by a securities firm differed

from a bank-sponsored interest-bearing checking account. Another cross-industry debate focused on whether fixed or variable rate annuities were fundamentally insurance products, bank products, or simply annuities. Consumers, not surprisingly, have indicated minimal interest in these legal and regulatory squabbles and have just made their own evaluation of how the product characteristics fit with their personal financial needs.

These three factors, the advanced technology, the move toward larger and more complex institutions, and the blurring of financial products--in turn have also substantially changed the manner in which institutions measure and manage risk. Those management innovations, themselves, are not only of great interest and importance to regulatory agencies, but they also are forces driving further change. Simply because institutions can measure and manage risk better, they are able to create products that make markets more efficient.

**Issues Peculiar to the United States**

In the United States, our tradition of separating the financial, securities, and insurance industries and, more broadly, separating banking and commerce has consumed a significant portion of our regulatory attention in a manner not required of European countries that have adopted the Universal Bank concept. In addition, we have a tradition of multiple chartering options for full-service banks. This tradition flows from the previously described dispersion of legal and regulatory authority. Therefore, not until the Abraham Lincoln Administration in 1864 was our national banking authority created, and only after the 1929 Wall Street panic, was a national securities regulator created. Today, although nationally chartered banks hold the majority of U.S. banking assets (55 percent), the states continue to charter most insured commercial banks (74 percent). We continue to have very active state bank chartering authorities in all fifty states. The insurance industry is the last bastion of a financial services industry without a federal regulator. To this day, insurance regulation continues under the direction of state insurance regulators.

**Fundamental Regulatory Changes**

In whatever form, financial services regulation is adapting to the fundamental changes under way in our respective industries. A dramatic change affecting all of the financial services industries is the shift from a paper-based to an electronic commerce environment. This change requires new definitions for certain basic business practices--for example, a redefinition of what constitutes finality of a sale when the entire transaction is conducted electronically. Other examples are determination of what constitutes a signature in a fully electronic transaction or of how state law applies to electronic business transactions, some of which are conducted by multiple parties in multiple states. Other regulatory issues arise when technological advances allow new entities to leapfrog traditional institutions and command major market positions. This phenomenon is most clearly defined in the securities industry, where the electronic communication networks (ECNs)--now only six years old--account for 50 percent of the transactions that take place on NASDAQ. These changes, in turn, have important regulatory implications for banking organizations. The definition of what is or should become a "banking business" can rapidly change and in many cases should change if banks are to remain competitive and innovative in financial markets.

A second fundamental change involves bank supervision--it is the shift from a transaction-based to a risk-based focus. As financial institutions increased in size and complexity, it became clear that examiners could not keep pace in the historic manner of examining transactions. Instead, examiners needed to evaluate large, complex institutions' ability to identify and manage risk. For example, in evaluating credit-risk exposures, examiners first determine how credit risk is managed. They look, for example, at such basic

elements of risk management as the way the institution establishes its risk parameters and more specific elements of credit administration and credit review. They evaluate risk-management models or tools that the institution uses and their suitability to the relative sophistication of the institution's loan portfolio. Determining the level of individual transaction testing depends, in part, on the results of the initial assessment. Banking regulators are still shifting from transaction-based to risk-based examination procedures, but our ability to keep pace with the increasing size and sophistication of our largest institutions necessitates that we successfully make that transition.

Besides looking at credit risk, the Federal Reserve also specifically evaluates banks for market risk, liquidity risk, operational risk, legal risk, and reputational risk. The potential exposure of reputational risk has become quite apparent after the recent experiences of Enron and Arthur Andersen.

**Current Role of the Federal Reserve**
Three years ago, the Congress concluded more than twenty years of negotiation and produced a major reform of financial services laws and regulations. In very brief summary, this new law allows banks, securities firms, and insurance underwriters to function using common ownership by a newly authorized entity called a financial holding company. The new law also provides a mechanism for determining prospectively which products or services fit the definition of "financial in nature" or "incidental to financial activity" and therefore qualify as appropriate for a financial holding company.

The Federal Reserve has been accorded a major role in deciding these issues and has also been assigned the role of umbrella supervisor of financial holding companies. As such, the Federal Reserve will rely as much as possible on the functional regulators of a company's subsidiary banks, securities firms, and insurance entities, but will oversee the financial soundness of the consolidated organization, including the activities that are otherwise unregulated. Our focus is the potential risk these nonbank activities can present to banks.

In addition, the Fed, in conjunction with the Treasury Department, will respond to requests for determination as to whether new products and services meet the test for "financial in nature" or "incidental to financial activity" to be approved for financial holding companies. This change has made our laws more consistent with changes that occurred in the marketplace and has provided a mechanism for allowing new products as the marketplace evolves.

**Conclusion**
The past decade has been a time of dynamic change in the financial services industry, and there are no signs that the pace of change will abate. An important component of this change is the growing global reach of many of our financial entities. Financial regulators throughout the world will need to continue responding to these marketplace changes and providing oversight consistent with our safety and soundness responsibilities. For that reason, I look forward to today's discussion of financial markets regulation.

▲ Return to top

2002 Speeches

---

**Last update: July 8, 2002, 8:00 AM**