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Remarks by

Susan M. Phillips, Member

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on

International Competition in Financial Services: Should National Regulatory Systems be Harmonized?

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I am delighted to have the opportunity to participate in this conference. It is always a pleasure for me to be able to come back to the Seventh Federal Reserve District and visit the Bank. The American Enterprise Institute and the Chicago Federal Reserve Bank are to be congratulated for encouraging serious research on the topic of harmonization of national regulatory systems. As someone who is in the trenches trying to address particular aspects of domestic (and sometimes international) regulatory harmonization in the financial services area, I can assure you that the questions are difficult. There are no easy answers. Moreover, even if it seems perfectly clear to all that something can and should be done in a certain area, you can rest assured that it will <u>seem</u> to take forever to effect appropriate regulatory adjustments.

Today I thought I would give you my observations as a practitioner on areas where regulatory harmonization in financial services appears to work and where it does not, both internationally and domestically. In this country, we have several types of very different regulatory schemes operating within the financial services area. We have State and federal securities and banking laws. At the federal level, we even have multiple regulators operating in the same regulatory scheme, sometimes with different approaches or emphases. However organized, both national and international regulatory systems are presenting financial market participants with major challenges as they compete in the rapidly changing global economy.

A fair amount of my work at the Federal Reserve -- and before coming to the Fed, for that matter -- has focused on financial derivatives. This is an area that naturally involves the very different regulatory regimes for securities, commodity futures and banking. So I apologize in advance if many of my examples come from the rather specialized, arcane area of derivatives. (I suspect that I can get away with this specialization in the City of Chicago.) Hopefully, at the end of this discussion, I can draw a few conclusions, or more importantly, the people doing research in this area, can test their theories and conclusions on international regulatory harmonization.

One major barrier to regulatory harmonization is the whole body of national regulations, guidelines, rules, interpretations, professional standards and industry practices which are built up in response to a particular law or oversight program. We do not even have to go outside the United States to find examples of conflicting regulatory regimes and industry traditions in financial services--at least three such structures are now operating:

1. Bank supervision with its focus on safety and soundness to protect the federal safety net relies heavily on on-site examinations. If problems are identified, banks are given an opportunity to take corrective action.

2. Securities regulation is built around the statutory charge of customer protection relying in large part on public

disclosure by issuers of financial instruments, external auditors, self-regulation and formal disciplinary and enforcement systems.

3. Commodities regulation, on the other hand, is built around the statutory charge of preserving market integrity, and utilizes non-public large trader reports, self-regulatory systems, and exchange and regulatory market surveillance programs.

Legal precedents and industry practices have developed within these three very different statutory and regulatory systems. Perhaps more important, there has been significant capital expended to set up corporations, holding companies, trading systems and exchanges to operate within the confines of these three regimes. Personnel have been trained; qualifying entry exams have been passed; accounting and back-office systems have been set up. When the traces of these three regulatory systems were jumped with the development of financial derivatives, the challenges of regulatory harmonization have became evident. So as not to inhibit the development of the markets, Congress, regulators and supervisors have accommodated with legislative amendments, no-action positions, safe harbors and specific exemptions.

Market participants have sometimes used the different regulatory systems as a way to exclude competitors, sometimes resorting to the judicial system. At other times, the existence of multiple regulatory regimes has facilitated the introduction of such new, innovative products as exchange-traded financial futures. I suspect that the strain on regulatory systems and market participants will remain because markets are not static. The ultimate challenge, of course, to legislators, regulators, supervisors and market participants is to determine when the structure has become so cumbersome that it must be overhauled. Changing regulatory programs and wiping away years of legal precedents obviously requires new legislation. Such drastic change is not costless and the benefits of status quo or even multiple regulatory regimes must be weighed against the cost.

Needless to say, if we have harmonization challenges at the national level, they are magnified at the international level. International harmonization often faces constraints, indeed barriers. If the regulated area is one where advances in technology and theory require major changes in supervisory approaches, the need to harmonize can make progress slow and difficult. Take, for example, capital adequacy and the minimum standards that are set out under the Basle Accord. In fact, I noted that this Accord was frequently cited in the papers for this conference. The original accord, set out in 1989, involved relatively simple rule-of-thumb minimum standards for capital adequacy to account for credit risk. When proposals were first made in 1993 to incorporate market risk into the standard for foreign exchange positions and trading activities in debt, equity and commodities, the rule-of-thumb approach expanded into a complicated matrix that made no one happy. The smaller banks said it was too complicated and the larger banks said it was too naive and simplistic, compared to their own sophisticated risk management systems. In the recent revised proposal published for comment by the Basle Supervisors Committee, supervisors are exploring means to use an institution's own calculations of Value at Risk as a platform for setting capital charges.

I might mention that this is a major leap for many supervisors to contemplate banks calculating their own capital levels, even if the banks' internal models meet specified parameters such as holding period, confidence interval and observation period for the calculation of value at risk. Supervisors must also find the magic formula or scaling factor to transform a VAR measure into a prudential capital charge.

In addition, U.S. bank supervisors are grappling with the additional task of incorporating interest rate risk into risk-based capital standards for areas outside the trading book. We could well end up with simple formulas for capital charges to accommodate credit risk, but more sophisticated models for market and interest rate risks. Layered on top of those capital charges is the general direction to U.S. banks to hold enough capital to account for other operating or legal risks and concentration risk. At some point, one has to wonder whether the whole regime -- internationally harmonized or not -- will collapse of its own weight.

Faced with the prospect of either an increasingly complicated, or an arbitrary simplistic, capital requirement in a rapidly changing financial system, researchers at the Federal Reserve have been exploring a fairly radical precommitment approach to capital determination. This proposal would not only rely on a firm's internal risk management model, but also the firm's commitment to manage its trading book to limit losses to the publicly precommitted level, with penalties for noncompliance. The Board has requested public comment on this approach and I look forward to a healthy debate. The precommitment capital proposal had already inspired international supervisors to build incentives for continued improvement in firm risk management systems into the proposed risk-based capital structure. International supervisors may be reluctant to leap to the precommitment approach but their willingness to embrace the internal models approach is a clean break with the past and offers hope of further progress.

International harmonization becomes even more complicated if national sovereignty or cultural issues are raised. National blocking and secrecy statutes are often cited as inhibiting international harmonization. But perhaps more subtle are international cultural differences with respect to such things as attitudes toward bankruptcy, market power or conflict of interest. I suspect that entire papers could and probably are being written somewhere on each of these issues, but let me just offer some cursory observations to give you a flavor of the influence of cultural differences. First, in the United States, we have several formalized routes to bankruptcy, but other countries even refer to the process as "reorganization," implying an aversion to firms going out of business. Different international legal structures present particular challenges if, for example, a multinational firm goes under, bankrupt or into forced reorganization. The prospect of unwinding such a firm with assets booked in multiple countries has forced international regulatory bodies to seek ways of at least facilitating orderly firm exit while minimizing market disruptions. The different legal approaches to firm dissolution remain at issue.

With respect to market power questions, the U.S. antitrust legislative and enforcement system often is at odds with other legal systems. Likewise, the "big-is-bad" notion permeating the U.S. legal system is not as prevalent in other industrialized countries. The conflict-of-interest notions underlying the Glass Steagall Act also are not common in other countries. I am hopeful that the time has come to dismantle the artificial barriers between commercial and investment banking in this country. But, as you know, the fate of Glass Steagall reform is far from certain.

Now that I have painted such a bleak picture of international regulatory harmonization, you might wonder if I have any positive war stories to tell from the trenches. I do think that if the harmonization efforts work in the direction of the underlying economics, there is a much better chance of success. Within "underlying economics," I include reinforcing the financial incentives of strong players in the relevant market or taking actions to remove barriers to entry thereby making the market more efficient or lowering transactions costs. Examples abound, but again I am going to resort to banking and the financial derivatives market.

In spite of all my comments about the challenges of harmonizing capital adequacy standards, the Basle Supervisors' Accord has made major progress in the last decade. The financial incentives of large internationally active banks are generally supportive of uniform capital standards. Since capital is the buffer which allows banks to ride out economic downturns, international capital standards assure the creditworthiness and financial stability of counterparties in cross-border transactions. In essence, the costs of a "credit check" or "due diligence" are reduced. In addition, bank entry into foreign countries has been eased by the establishment of international capital standards. The challenge for the international supervisory community going forward will be to accommodate the realities of a complicated world trading environment where technology is facilitating the application of financial risk management theory to an ever wider range of bank activities.

I might add, and it may be obvious to many of you in the room, that the U.S. has its own inconsistency in capital requirements between bank-style risk-based capital requirements and the generally higher SEC style capital requirements. But re-evaluation of this domestic capital disparity is being prompted by the common use of derivatives at both large banks and broker-dealers, the breakdown of Glass Steagall barriers and the international competition from universal banks. The pressure for this domestic harmonization is being exerted through such international channels as both the BIS and IOSCO and through large domestic broker-dealers who have set up derivatives subsidiaries outside of the reach of SEC capital standards. Those firms have developed a framework for voluntary oversight including a bank-style risk-based capital measure under pressure from the SEC and the U.S. Congress. This is a tentative step toward domestic capital harmonization.

Another area where I have been a bit surprised that there has been significant progress toward international regulatory harmonization is the general area of transparency of derivatives transactions. I am including accounting practices, regulatory reporting and public disclosure in the transparency area. Each has different issues and each is in a different state of development with respect to international harmonization, but they are clearly related and can be quite costly. There appear to be significant differences in international attitudes about public disclosure. I hasten to point out that the United States has much longer and stronger traditions of public disclosure. The U.S. regulatory systems and accounting standards promote such disclosure to provide public investors with adequate information to make investment decisions. This in turn has resulted in broad public participation in the capital formation process and efficient secondary capital markets. Such a system of public disclosure also permits firms to assess the creditworthiness of their counterparties in business transactions and again lowers transactions costs.

Thus there is considerable support within the business community for standardized accounting and disclosure, in spite of the costs. This is no less the case with financial derivatives. Due to the very complexity of the transactions, the road to regulatory harmonization has been difficult and I admit has a ways to go. I can report to you that significant resources are being devoted to the effort. The BIS has at least four working groups of two committees addressing various aspects of transparency. In some cases, papers have been issued or surveys undertaken.

There seems to be substantial agreement in the area of minimum standards for reporting to supervisors, but considerably less in the area of public disclosure or accounting standards. This may be partly explained by the recognition that there is not yet consensus within the derivatives industry as to what constitutes meaningful, understandable public disclosure. In many cases, the instrument valuation models as well as firm risk management models are still under development. The fact that a particular instrument in one firm's portfolio can be risk reducing and, in another, risk increasing clearly complicates the whole notion of uniform or meaningful reporting.

One of the BIS reports, the so-called Fisher Report, named after Peter Fisher of the New York Federal Reserve Bank, was issued late last year as a discussion paper explicitly recognizing a lack of consensus on disclosure, but calling for more quantitative disclosure drawn from firms own internal risk measurement systems. Work is continuing both in the public and private sectors to improve public disclosure of derivatives transactions. There may well have to be adjustments to the regulatory reporting schemes as consensus develops on appropriate public disclosures.

Accounting oversight bodies appear to be further behind in developing final standards for reporting derivatives activities. I know that the Federal Reserve Board staff have participated in discussions of hedge accounting and other derivatives accounting issues with the senior staff of the FASB. The International Accounting Standards Committee just issued standards for financial instruments (IASC Standard No. 32; June 21, 1995). They are seeking endorsement from domestic professional accounting groups; e.g., FASB in the U.S. So we may expect additional work in this area in coming months both at the national and international levels.

A final area I would like to mention briefly as realizing considerable success with respect to international harmonization is payments and settlement systems. The incentives for such harmonization seem obvious and require little elaboration, but the issues are technical and complicated. I think we take the integrity of the payments system in this country for granted, but international payments mechanisms occupy much discussion and attention among central bankers. If there are national or international financial problems of such intensity that they can be called "systemic," we could well see the payments system infected. Disruption of payment and settlement systems would in turn affect the liquidity in financial and credit markets -- the proverbial "gridlock" situation. Financial market supervisors and participants have a number of initiatives under way to improve the financial infrastructure which includes international harmonization to assure the integrity of payment and settlement. I will spare you the details of these efforts.

In closing, I am delighted to see serious academic work being undertaken in the area of financial regulatory system harmonization. I was pleased to see some of my practitioner observations echoed in today's papers; for example:

- More harmonization is not always the answer -- there are costs involved; in fact, some competition among regulatory systems may be healthy.

- The road to harmonization has many stumbling blocks, many of them quite intractable.

- Harmonization is more likely to occur when the underlying economics or incentives are supportive or when market processes are made more efficient.

Supervisors and regulators have set up and invested significantly in a number of mechanisms in recent years to facilitate regulatory harmonization. One might even observe that both national and international committees and coordinating groups have proliferated and in some cases become quite formal. This process may have been helped along by energetic regulators and by the European Union initiatives and also by such incidents (or accidents) as Herstatt, BCCI, Barings or the S&L crisis. But I rather believe that it is the developments in the marketplace -- economic, technological and theoretical -- that are driving the harmonization process.

Thank you.