

**Banking and Financial Services  
A New Era**

**Remarks by  
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Good afternoon. It's certainly a pleasure to be here with you today, particularly to talk about the topic of financial supervision. What could be more timely? While our representatives in Congress have left us somewhat in the lurch with respect to action on H.R. 10 -- the Financial Services Modernization bill -- I may owe a debt of gratitude to Citicorp and Travelers -- not to mention Bank of America and NationsBank and NBD and Bank One -- for providing a perfect lead-in to a topic I had planned to address even before their announcements. And that is the rate of change in the financial services industry and how regulators might respond to the increased systemic risk presented by such change.

John Reed of Citicorp and Sandy Weill of Travelers have touted the creation of the proposed Citigroup as "a model for financial service companies of the future." And it may well become not THE model, but A model, if Travelers, a company engaged in insurance, investment services, asset management and consumer lending, becomes a bank holding company through the acquisition of Citicorp. While I don't intend to speculate on the outcome of an application that is still to be filed, I would like to make a couple of observations.

As you are well aware, the Federal Reserve is required by statute to evaluate the financial and managerial resources and future prospects of any organization that would be a bank holding company, along with its ability to meet the convenience and needs of the community to be served. We must also require the divestiture of nonexempt activities, which in the case of Travelers, could mean a number of its subsidiaries -- typically within a two year period. I believe these requirements will be met -- through a process that treats Citicorp and Travelers equitably as compared with all other bank holding company applicants. We at the Bank also recognize the need to modernize the legal and supervisory structure within which financial firms such as the prospective Citigroup operate. Yet even without such modernization, the Citigroup proposal represents a position toward which the financial services industry has been steadily moving, as a result of *de facto* and *de jure* changes in activities permitted banking and other organizations. The Citigroup proposal is not, however, a position the current U.S. financial supervisory structure was established to address, or that it can easily absorb.

Today, this country's financial supervisory structure is oriented around the traditional industries of banking, insurance, and securities. Supervisors and regulators of each industry are experts in the nuances of their regulated

businesses, but seldom are they asked to consider the ramifications of organizations fully engaged in two or more of these businesses. Even in the case of bank holding companies, where non-banking affiliates have begun to incorporate significant securities activities with the relaxation of the non-qualified income tests of Section 20, widespread integration with the whole banking system has not occurred.

Moreover, as the size and global reach of financial conglomerates increases, it is arguable that supervisory attention needs to focus on the implications of problems for the system as a whole, not on just the institution itself. Supervisors in most developed countries increasingly rely on financial transparency as a way to encourage markets to provide risk-reducing discipline, but I see this as a complement to, not a substitute for, more informed supervision. In that regard, I would argue that the evolution of the financial industry here and around the globe requires that supervision focus not just on the form or structure of the specific financial service entity -- i.e., is it a bank holding company or an insurance company or a conglomerate of the two. Supervision should also focus on the risks to the entire system if problems occur at that institution; that is, the systemic risks that could present themselves.

What do I mean when I talk about systemic risks? I mean the risk

that problems at one institution can affect others and cause a chain of difficulties that, at the extreme, can threaten the viability of national and international economies. This can occur as a result of the natural interconnectedness of financial institutions as they fund each other, process their customers' payments through national and international payments systems, and operate in identical markets. Size and global reach only increase this web of interrelationships to the point that problems in one firm in one country -- if sizeable and severe enough -- can migrate to others. Systemic risk may be small given current risk management techniques, but it is real, and, if realized, extremely costly. I would argue that the growing presence of large globally active and interactive players in the U.S. requires a new attitude toward supervision -- one that is both respectful of functional regulators, but focused on the entire system as well; systemic supervision, if you will.

A systemic supervisor, as I envision it, would be responsible for those firms posing risks to the stability of the financial system -- firms of significant size and impact relative to domestic and global markets, those extensively involved in the clearing of financial transactions, and those that could spread financial contagion. These organizations would include the largest banks and securities firms, as well as diversified financial firms that

include large banking organizations. Firms not likely to need systemic supervision would be the vast majority of banks, finance companies, securities and insurance firms whose activities are not of a scope and complexity to present undue systemic threat.

The systemic supervisor would focus on the consolidated risk management infrastructure of companies under its supervision, with emphasis on counter party relationships, arrangements within the payments system and securities clearing systems, concentration of assets, capital adequacy, and coordination with foreign supervisors. The supervisory approach could be implemented in a number of ways -- all of which present some obstacles -- but two models are worthy of discussion.

Under the more extreme and likely controversial model, a *systemic supervisor* would be solely responsible for the prudential supervision of all aspects of firms that are potential conduits of systemic crisis. The systemic supervisor alone would provide financial oversight oriented towards safety and soundness of all functional business lines as well as activities at the consolidated level. Traditional functional supervisors would retain supervisory responsibilities relating to issues other than safety and soundness, such as consumer and antitrust, but would have no role in the prudential supervision of these large firms.

In an alternate model, a *systemic coordinator* would assume ultimate responsibility for the prudential supervision of all designated firms, but the actual monitoring and supervision would be a collaborative effort between the systemic supervisor and current functional supervisors. The systemic supervisor would examine internal controls, risk management, and managerial activities at the conglomerate level, but it would rely upon functional supervisors to focus on the respective components of the business, including safety and soundness concerns.

Under any approach to supervisory reform, key issues must be resolved; under a regime of systemic supervision, there would be additional issues.

I see one of the primary issues as moral hazard; i.e., the risk that financial institutions overseen by the systemic supervisor might be viewed as "too big to fail." While this is clearly a concern, the fact is that moral hazard exists today. Supervisors must tread carefully when large, globally active institutions become troubled, and may need to take steps to stem crises. Such steps do not necessarily mean avoidance of failure, but rather an orderly winding down of business. In any poorly managed institution, moral hazard is mitigated by the knowledge that managers and shareholders will lose their jobs and investments, respectively, and uninsured creditors

will incur risk. While a systemic supervisor would not change the realities of moral hazard, it could arguably hasten supervisory intervention before a crisis and the response after the fact.

Comprehensive consolidated supervision in some form is essential, whether it be accomplished by a single systemic supervisor or by a systemic coordinator. The legal structure on which functional regulators tend to focus is no longer an adequate delineator of activity in organizations that manage businesses and market product lines across legal entities. Issues here arise in connection with both the systemic supervisor and systemic coordinator approach. The task of a systemic supervisor, solely responsible for the prudential supervision of all facets of the largest financial companies, could be very complex. It would require expertise in the risks involved in all financial service activities -- the range of which would be constantly evolving. Alternatively, a systemic coordinator working with functional regulators could rely on their respective areas of expertise. In doing so, however, it would be one step removed from the actual supervision of the entities for which it would hold ultimate supervisory responsibility; the issue could become one of responsibility absent authority.

Designating conduits of systemic risk would be a formidable task. It

would be virtually impossible to reach a consensus among market participants or their supervisors regarding the precise definition of systemic risk, or the specific institutions that would be overseen by a systemic supervisor. Therefore, guidelines would need to be determined legislatively -- a task that would also be difficult given the various interest groups involved. Lodging authority in a single systemic supervisor could exacerbate this problem, since major financial institutions would be faced with a move from one known supervisory environment to a new supervisor; however, a systemic coordinator might ease this problem.

Concentration of power would also be an issue, particularly in a scenario of a single systemic supervisor. Placing the authority to oversee the safety and soundness of all systemically sensitive organizations, whether banks, insurance companies or securities firms, in the hands of a single supervisory authority, is unprecedented in U.S. history.

Accountability could be maintained to some degree through watchdog-type agencies such as the GAO and Inspector General, but it would ultimately fall to the Congress to delineate the authority of a systemic supervisor.

The systemic coordinator approach, where supervisory powers are shared more broadly with functional supervisors, could mitigate concern in this regard. However, it could also impose a second level of supervisory

authority for those organizations not currently managed through a holding company structure. In sum, there is no question that implementing systemic supervision, while ultimately desirable, would not be accomplished without complications and challenge.

Now what qualities should be sought in a systemic supervisor?

Beginning with the most basic, a systemic supervisor must have supervisory experience in the financial arena. More specifically, it should have a professional supervisory staff highly trained in issues affecting the safety and soundness of financial institutions. Ideally, that staff should have experience in overseeing a broad range of financial activities.

The systemic supervisory authority itself should be insulated from short term political pressures. While ultimately answerable to Congress, it should not be a vehicle for partisan initiatives. The systemic supervisor must have the ability to engage in a high degree of international coordination, and must have an international perspective on supervisory matters. It should possess the stature to deal on an equal footing with the highest level of financial industry supervisors and the central banks of any country. Because systemic risk arises to such a great extent through payments system linkages, the systemic supervisor must have expertise in the intricacies of payment system issues. It must also be sensitive to the

affects on the financial system of economic shock and monetary policy and should have access to liquidity when necessary to avert a crisis situation.

At the risk of inflicting my biases on you, in my view, the qualities that are essential and many that are desirable in the make-up of a systemic supervisor are present in the Federal Reserve System. As the central bank of the United States, the Federal Reserve has an independence from political influence that is critical in making difficult decisions. It also has a long and respected tradition in working with other central banks and in shaping international perspectives on supervisory and payments matters. Monetary policy is a key priority that is closely linked with the stability of the financial system in both a cause and effect relationship, and that cements the natural affinity of central banking and systemic oversight. Further, more knowledge of international funds flows and market response would be essential to a systemic supervisor. The ability to provide liquidity as lender-of-last-resort also protects the financial system from undue disruption. Finally, the Federal Reserve's oversight of and participation in this country's payments system ensures that, as a systemic supervisor, it would possess the necessary expertise to understand the complex linkages that so often underlie systemic risk.

You might reflect at this point that the Federal Reserve already has the job of ensuring financial stability, and, arguably, has done so capably over the years. That has involved an implicit form of systemic supervision, carried out largely through the System's proximity to the large banks at the center of the system and counterpart central banks throughout the world. You might also question whether change is necessary given the fact that even the Citigroup proposal envisions a bank holding company structure that would, of necessity, include the Federal Reserve as a key regulator. Finally, even H.R.10 would have placed new activities under the holding company, not as bank subsidiaries, again giving the Federal Reserve regulatory authority. So why talk about change?

I talk about change for several reasons. First, I believe the supervisor of financial conglomerates that present systemic risk should not be determined by their structure -- for example, the Federal Reserve if a bank holding company, the OCC in most cases, if a unitary bank with subsidiaries. The job should relate to systemic concerns, not to the structure of the organization involved. Second, current bank holding company supervision may not be adequate to address systemic concerns as they arise from non-banking affiliates or subsidiaries. Supervisory techniques and information flows need to be reviewed and rethought to

ensure complicated interactions and risks among the various services in a financial conglomerate are understood and addressed. Finally, I believe systemic concerns should be an important part of discussions about regulatory restructuring. To date, they have not been.

In closing, let me emphasize that the need for systemic supervision is becoming more widely recognized as global financial intermediaries increase their penetration in many countries, increasing the speed and severity of the transmission of financial shocks. The potential for heightened systemic risk calls for a supervisor that crosses traditional institutional lines, and whose primary focus is the stability of the financial system as a whole. Problems within certain financial intermediaries can cause substantial damage to the entire economy, whether they result from failure at an individual institution or from changes in asset values. These developments suggest consideration of a new design for ensuring financial stability, with a supervisor specifically responsible for containing risk. In my view, the Federal Reserve would be well suited to the role of systemic supervisor. But whether the systemic supervisor is the Federal Reserve or some other entity -- either preexisting or newly created -- is not so important as that it have the means to carry out its mission.