

Vanderbilt University

- I. Purpose of my talk today is to explore an area of Federal Reserve involvement you might not have focused on - supervision and regulation of the nation's banks specifically, and financial institutions more broadly
 - A. One of the three primary purposes for the formation of the Federal Reserve System – financial stability as well as monetary ^{or price} stability
 - B. *acute* Not the only federal banking regulator—OCC, FDIC, OTS—but the one given the responsibility through holding company oversight for the most complicated organizations and their internal organization
 - C. The nature of banking organizations has changed over the years, as has their importance to the financial world. We are not nearly so bank-centric we once were. Credit available, and deposit substitutes offered by a variety of financial service organizations, and many more financial services seem to be so closely related to banking as to be needed to be provided by banks in order to be competitive—examples 1968/69 and now FOMC
 - D. Beyond this technological change has had a profound effect as well, in what products are provided, how

products are delivered, what risks are predominant and how those risks are managed.

Examples:

- (1) ATM networks, telephone networks, on-line banking, trading (low cost of information processing allows for expanded retail network, 24 hour access, lower transaction costs)
- (2) Credit Scoring (low cost of information processing allowed for growth in consumer credit)
- (3) Derivatives (combination of advances in financial theory and computing power allowed for the development of these products)
- (4) Securitization (low cost of information processing allowed for growth in consumer credit, for example, the mortgage markets: now its not whether I can get a loan, but rather, at what price can I get a loan)
- (5) Risk Management Systems (combination of advances in financial theory and computing power allowed for the development of these products)
- (6) Internationalization of financial markets (instantaneous worldwide communications spurred financial activity)

(7) Consolidation (economies of scale, centralized risk monitoring and management)

(8) Conglomeration (economies of scope: advances in information processing may allow for efficient cross-selling – so says Citigroup: commercial bank, insurance company, securities firm)

- Developments allow capital to flow more efficiently worldwide
 - society has benefited
- However, not without creating new risks for our financial system and our economy

II. Financial Modernization brings many Challenges: Regulators' Responsibilities

- Financial modernization provides many challenges for the Fed and other agencies
- Consider what many of our financial institutions (FIs) now look like:

⇒ Many FIs have grown in size and scope - The top 100 institutions (commercial banks) controlled 49% of assets domestically in 1970. By the end of 1998 they held 70% of assets

⇒ Many FIs have commercial banks, with insured deposits, as subsidiaries

– these banks operate side-by-side with non-bank financial institutions

⇒ Many FIs have become increasingly global in nature

⇒ Some FIs have become the primary provider of sophisticated financial products -

*U.S. Bk
Jap 10 - 20% - '68
Jap 10 - 40% - '99*

*Bk of B - 25%
L.A.
Citigroup*

*major
major*

– many firms and individuals now rely on the products for risk management

⇒ Many FIs have become important, with some becoming dominant players, *state street* in domestic and international payment systems

- Result: FIs are becoming increasingly interconnected
- Result: A few very large FIs are becoming increasingly important in the functioning of our financial system, and in turn, our economy

III. Why do we regulate banks/financial institutions anyway?

⇒ protect the consumers

⇒ maintain the stability of the financial system

- Traditional Approach: *Tools are* ~~Focus is on~~ consumer regulation and deposit insurance

⇒ Consumer protection: much of the banking, insurance, and securities

regulation is in place to protect consumers from fraud

⇒ Depositor/bank protection: deposit insurance: protects

Traditional vs. newer approach

depositors' savings, and also protects banks from runs.

⇒ Source of risks:

- ◆ Financial transactions are plagued with informational asymmetries thus, making consumers susceptible to fraud
- ◆ Short-term nature of deposits vs. long-term nature of bank loans make banks susceptible to liquidity problems
- ◆ Informationally opaque nature of bank assets make solvent banks susceptible to bank runs – but the solution to consumer protection against an illiquid bank-deposit insurance brings with it problems
- ◆ Insured depositors do not have an incentive to monitor bank activities
- ◆ Bank managers, at times, have the incentive to take on more risk than they otherwise would – moral hazard argument

→
moral hazard

Need
regulation
as
well //

To minimize the exposure of the deposit insurance fund: regulate and supervise insured banking entities –

do as any private insurer would do, monitor and place restriction on permissible activities

- Systemic Approach: Focus Should be on Systemic Risk –
At least for the central bank

⇒ Failure of one our largest FIs has the potential to disrupt financial markets quickly and on a large enough scale to impair economic activity

⇒ Likelihood of such a crisis is low, but the costs potentially are quite large

⇒ Source of risks: (four types)

- ◆ The payments system: Systems that clear and settle large-value transactions stemming from payment orders and the trading of financial instruments and their derivative products are used primarily by the largest financial institutions. Because the clearing and settlement of payment obligations are not always simultaneous, the inability of one participant to settle could cause other participants to default on their obligations. Isolated shocks could cascade into multiple defaults. Such a cascade could spill from the direct participants of a clearing system to

financial institutions that depend on one of the participants to settle their payment obligations.

◆ Financial institutions invest in similar types of assets, many of which are difficult for investors to value or monitor. The disclosure of problems at one such institution can have spillover effects on others. For example, if short-term debtholders have difficulty distinguishing financial institutions that are viable from those that are not, they may refuse to roll over the debt of any institution with asset holdings similar to those of the troubled firm. If this forces some firms to liquidate assets at fire-sale prices to satisfy debtholders' demands, initially solvent institutions may fail. This problem of "runs" is greatest for banks, because of the nature of their deposit contract as well as their assets. However, nonbank financial firms are not immune to runs.

◆ An important player can affect asset prices in particular markets. If a failure of a major player in a particular asset market depresses the asset's value, and other firms holding the same asset

suffer. The failure of Drexel Burnham Lambert in 1990 caused the junk bond market to become very illiquid. The recent LTCM is also an example where liquidation had the potential to result in steep declines in asset prices, thus causing additional failures. Moreover, if a market leader has developed an expertise that customers cannot easily find elsewhere, its failure can sever important relationships, and this in turn can impair economic activity.

◆ A widespread "macro" shock to asset prices, such as a dramatic decline in stock prices or commercial real estate values, can lead to the simultaneous failure of many financial institutions. In reality, most systemic crises develop from some combination of a macro shock and the interconnectedness of firms. Events typically proceed as follows: A decline in asset values heightens insolvency risk for all financial institutions. A few key financial institutions fail, exacerbating problems because of their extensive connections with other firms. Moreover, because many other firms are already weakened by the adverse shock, they lack the

capital base to protect against counterparty defaults.

So → bank would have Δ → much more integrated financially popl FI's
→ Bank / FI's did - large more interconnected Regulation must focus more on consumers to system

IV. Financial Modernization Brings Many Challenges: Congress Responds

- Congress faces the challenge: The Gramm-Leach-Bliley Act (1999)

⇒ Financial Services Modernization bill: Congress finally passes legislation, after nearly two decades of attempts, addressing concerns that antiquated laws were inhibiting financial modernization

⇒ Glass-Steagal Act of 1933 replaced, BHC Act of 1956 modernized

Banking regulations

begin when banks were now arguably U.S. banking system strongest, best cap, best managed in the world

- ^{Big} Issues

⇒ What activities should be permitted?

⇒ Where should these activities be conducted?

when in Bk when in H.C.

- Why?

meet the challenges I just noted -

⇒ FIs faced new competition from home and abroad

⇒ Margins on traditional business lines were squeezed; though hard to argue that U.S. banks had off

⇒ New financial products defied categorization

⇒ Existing legislation did not explicitly apply to new financial products

⇒ Regulatory agencies, for several years, had been relaxing restrictions

on permissible activities, although, major restrictions remained

⇒ Others: (not everyone agrees)

- ◆ Advances in computing allows for more efficient cross-selling of products, increasing the economic costs of restricting permissible activities of FIs
- ◆ Consumers benefit from one-stop shopping for financial services

• Major Provisions of GLB:

- very complex & detailed in some areas; very hard in others

⇒ Allows unfettered affiliations among commercial banking, investment ^(merchant) banking, and insurance companies

(including underwriters)

⇒ Via:

◆ "Financial Holding Companies" (FHCs)

- can engage in financial activities new & existing BHC's

◆ "Financial Subsidiaries"

- of the banks more restricted - ~~new~~ certain banks no merchant banking 5 years

*• well capitalized
• well managed
• CRA satisfactory
• notification provision*

*↳ list
↳ complementary*

Does not permit combinations of banking and commerce

- Regulatory Provisions of GLB:

⇒ Obstacle: Despite blurring of business lines across FIs for years, the regulation of

FIs pre-GLB differed dramatically depending on the charter of the institution

(Fed, FDIC, OCC, SEC, state insurance regulators, etc.)

different purposes of regulation

⇒ GLB Solution:

- ◆ "Functional" regulation of subsidiaries of FHC

- ◆ "Umbrella" regulation of newly formed FHCs

⇒ Functional Regulation" – the financial subsidiaries of a FHC will continue to ~~be~~ be regulated by their pre-GLB regulatory authority

Examples:

(1) a national bank regulated by the OCC

(2) a broker-dealer or investment adviser regulated by the SEC

(3) an insurance company regulated by a state insurance regulator

⇒ "Umbrella Supervisor" – GLB establishes the Federal Reserve as the regulator of the consolidated FHC – big issue – what does an umbrella supervisor do?

⇒ Conditions for Umbrella Supervision:

◆ "Fed Lite" provisions: GLB limits, to some extent, the Fed's authority over entities that are functionally regulated by other regulators. Specifically, the Act directs the Fed, in discharging its function as umbrella supervisor, to rely to the maximum extent possible on examinations and reports prepared by functional regulators, publicly reported information, and reports filed with other regulators (e.g., the SEC or state insurance regulators). The Fed ^{arguably} currently uses this model ^{now} in the supervision of BHCs, where they rely heavily on information provided by the OCC and the FDIC.

◆ The Federal Reserve is also prohibited from applying any capital standard directly to any functionally regulated affiliate that is already in compliance with the capital requirements of its functional regulator (such as a securities broker-dealer affiliate that satisfies the SEC's "net capital" rule).

◆ The Federal Reserve retains broad regulatory authority to examine and require reports from any affiliate of an FHC. In addition, with limited exceptions, the Act does not affect the Federal Reserve's authority to establish consolidated capital requirements for an FHC, which would take into account at the holding company level the assets held by functionally regulated subsidiaries of the FHC. Currently, the issue of FHC capital requirements is being debated. It looks like FHC capital requirements will exclude consideration of non-bank subsidiaries of a FHC, although there has been no final decision on this matter.

In my view this is vital. Large and sophisticated financial services companies manage risks on a consolidated basis, cutting across legal bank and non-bank entity affiliates. The market tends to link closely its assessment of the various entities with its view of the consolidated entity. Thus assessing risk of the entire whole is critical. Information flow between functional and umbrella regulators has to be continual & two-way. Can't duplicate under GLB, but at the same time can't ignore the interrelationships either.

V. Interpreting Regulatory Provisions in GLB – the Fed's Responsibility

- **Supervisory efforts will focus on two aspects of FHCs**
 - ⇒ **the financial soundness of a FHC as a whole**
 - ⇒ **particular emphasis will be on the impact that non-bank subsidiaries have on the financial soundness of the insured depository institutions**

- **Procedures for fulfilling obligations**
 - ⇒ **Focus will be on assessing consolidated risk-management systems of the FHC**
 - ⇒ **Validation of risk-management systems is the primary challenge for regulators**
 - ⇒ **Possible action plan when concerns arise at a functionally regulated subsidiary**
 - ◆ **interaction with FIs management**
 - ◆ **interaction with FIs functional regulator**
 - ◆ **if necessary, transaction testing by Fed examiners**

- GLB

- fgr banks have U.S. presence thro^{sub} Bks →
process of being a FHE same as for domestic
bank - well managed, well capitalized,
CRA satisfactory → self certification -

~~Do~~ HKSB

- if operates thru branches & agencies more complicated → Bd is to designate requirements "comparable" to domestic → but how to determine well cap (Basle & no), well managed etc.
- proposed rule - FR foreign bank → same risk based cap std, lower leverage, FR must find capital comparable, appeal process - well managed → depends on U.S. operations & views of home Country supervision

• CRA - substantial

- difficult to implement - public disclosure of all written agreements in fulfillment of CRA involving payments > 10,000 or loans > 50,000 - must report annual amount & use of funds post 5/12/2000 -
- ambiguous, sensitive - what determines an agreement who is involved - CRA wants investment in CRA → if bank publicly commits → is this an agreement -

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• Privacy -

state rules

- consumer must have right to "opt out" of disclosure of personal info to unrelated third parties -
- institution must have privacy policy & make consumer aware of this at time opt out ability is provided
- involves not just bank regulators but SEC, NCUA and FTC as well - not well known, but these privacy provisions apply to any company engaged in fin. services, whether or not affiliated w/ bank. Every fin co, ins co, securities or travel agency → not aware

(1) likely scenario would be joint work with functional regulator – similar to current BHC scenario when there are concerns at an OCC or FDIC bank within a BHC

VI. Looking Forward:

- Increased attention will have to be devoted to monitoring systemic risk

⇒ As consolidation continues and global enterprises become larger and cross more lines of business, the web of interconnectedness among our largest financial institutions grows more complex. Since this extensive interconnectedness provides the route for isolated shocks to turn into systemic crises, regulators will be compelled to give close attention to these inter-firm relationships.

⇒ As the web of interconnectedness grows more complex, the supervisory structure will have to focus some of its attention to counterparty risk, netting arrangements, concentration of assets, relationships within the payments system and securities clearing systems, and coordination with foreign regulators.

• Other GLB issues

- As financial modernization succeeded this Congress (several times) political focus shifted from the grand purposes of legislation - how to shape the evolving U.S. financial system - to more mundane but highly politically charged matters - I'll note three of them

- Merchant Banking -

- Treatment of Fgn Bns

- in a sense this is not mundane; in the absence of U.S. regulation change much of the "action" in international ~~regulation~~ ^{bank sup} world has been on ways to level the playing field for large internationally active financial institutions

- two issues - (i) are ^{interrelated} institutions from different countries held to same regulatory & supervisory standards and (ii) ^{can} institutions from different countries do similar things (have similar powers)

- BIS Committees ^{Bank} have addressed these issues several times - Capital standards and Payments and settlements standards

- Agreement that ~~there~~ to be internationally active banks must meet capital standards (home country supervision must enforce Basel stds). In return if stds enforced and banks meet them can participate in major banking markets and P&S systems