SPEECH

Patrikis: Supervision and Regulation

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Remarks by First Vice President Ernest T. Patrikis before the PSA 1997 Annual Meeting

Introduction.

I appreciate the invitation to spend some time with you this morning to discuss supervision and regulation. During my talk, I will share with you my definitions of oversight, supervision, and regulation as somewhat distinct concepts and practices and will discuss the current regimes in place today. I will then try to explain the benefits of the bank supervisory approach. Of course, my view is colored because I work at 33 Liberty Street in New York City. Nonetheless, I hope that you will find this discussion helpful as you come into contact with the various issues that have and will surface over the coming months as Congress considers various bills that would alter and improve upon our nation's financial structure. Finally, I will discuss how the efforts of the Federal Reserve and other Federal bank supervisors should integrate with efforts of the industries they supervise to ensure that safe and sound practices are followed. This integration is necessary if we are to have a flexible forward-looking supervisory system that provides a framework for safe and sound operations both for the present and the future.

One of the things I like to do when embarking on a definitional course of this sort is to seek out the source of the terms I am defining. "Regulation" can trace its roots back to the Latin "regula" or straightedge or ruler. To me this conjures up the image of a teacher with a ruler and a student with knuckles. "Supervision" also comes from Latin and is defined as involving inspection and critical evaluation. "Oversight" is defined as general supervision or watchful care. Therefore, one could call oversight a form of light supervision or "Fed lite", if you will.

Oversight, Supervision, and Regulation.

While I can describe the differences between oversight, supervision, and regulation by drawing sharp lines, in reality, the lines are not that sharp. ***Regulation*** is prescriptive, often quantitative, and generally not very flexible. It may prohibit an activity or prevent it. It may prevent it in a limited way, for example, in proportion to capital. It involves the formulation and issuance of specific rules and regulations, under governing law, for the conduct of business. ***Supervision*** is more qualitative. It depends upon the judgment of an examiner or inspector. It involves the safety and soundness of specific institutions, in the light of the general continuous review of the activities of the entire industry to ensure prudent operation and compliance with law and regulation. ***Oversight*** is a form of general supervision. It typically is used to refer to the monitoring of a corporate group, as opposed to a specific firm. Oversight is considered much less intrusive than supervision and might be viewed as surveillance, normally conducted at a distance, while supervision involves close, first-hand, observation and analysis.

Recognizing that I am not exactly an impartial observer of the regulatory and supervisory schemes, I am partial to supervision.

Some regulators refer to themselves as "cops." I regard a regulator as a flag man on the highway telling motorists when to stop and when to go and under what conditions they may use the highway. (In this analogy, the bank examiner is a backseat driver.) The problem is that, if the flag man is not up to the job, traffic backs up and motorists switch to other highways or to airplanes.

I do not regard the supervisory process as an adversarial proceeding. The bank supervisor will want to ascertain whether the bank is operating in a safe and sound manner and in compliance with law and regulation. In most cases, the examiner and the board of directors of the examined institution will have broadly common goals, although they may not always agree on how to get there. Of course, part of a supervisory examination includes compliance and that is regulatory in nature. The bank supervisor can use a number of remedial tools. The key tool is the periodic report of examination. The senior supervisor at the Reserve Bank meets and discusses the results of the examination with the examined institution's board of directors. If the findings are adverse but not serious, various kinds of supervisory action can be taken -- such as requesting the institution to sign a supervisory letter or a memorandum of understanding. For more severe problems, formal public action, such as a written agreement or a consent cease-and-desist order, can be taken. If you look at these actions, I think that you will see that most of them are remedial not penal in nature. They spell out a series of necessary corrective steps that need to be taken. The goal is to cure the deficiencies uncovered during the examination and to help ensure the health and vitality of the financial industry over time.

Having said that, you should not conclude that the supervisory process is perfect. Because it is a discretionary process, the supervisor can and should change it as necessary. As you are probably aware, the process is shifting towards risk assessment -- to becoming less of a static review of current financial condition and more of a dynamic assessment of the processes that produce and control the bank's exposures. We are always working on making it more efficient and effective.

I think that the strength ***and*** weakness of regulation is that it is done in the open. The strength comes from the openness that permits fair treatment across a range of industry participants, by setting out ground rules that must apply equally to competitors at the same time. Regulation is probably most effective when it deals with general approaches or minimum standards and breaks down when it becomes overly prescriptive. Furthermore, the longer a particular regulation operates in the open, the more it breaks down as interpretations and amendments are set forth to deal with every day business developments. Along these lines, frequent, full scope re-evaluation of existing regulations are important to weed out useless and counterproductive rules.

Some of the debate on restructuring our financial system has centered around regulation and supervision. In the bank holding company area, the Federal Reserve has done both, and we are well aware of the concerns of those who have not been subject to a regulatory process and those who might be. I hope that this debate will result in legislation which will get the balance between supervision and regulation right, with prescriptive regulation kept to a minimum and business left principally to those charged with managing the firm's risks -- its management and board -- and close external supervision of those management processes.

Examples.

Is there a need for a level playing field in the supervision and regulation of various types of financial institutions? I do not see that need. For example, I do not think that

loan syndications and securities underwriting need to be treated the same way. One area we have explored over the past few years relates to "suitability" and "appropriateness." As you are no doubt aware, the securities self-regulatory organizations have imposed a suitability requirement on broker/dealers. The bank supervisors might well adopt a rule similar to the NASD rule for Government securities. But as a general matter, the bank supervisors have not promulgated a suitability regulatory requirement on banking organizations. Instead, the bank supervisors have imposed an appropriateness requirement. That is, in order to protect itself, a bank should take steps to ensure that a proposed transaction is appropriate for the counterparty. In the insurance and futures industries another approach is used; the futures customer is provided with risk disclosure when opening an account. Each regulatory and supervisory approach is geared to the particular industry.

Another example is the capital-adequacy policy which covers a broad range of trading activities. Look at the treatment of swaps and like instruments. The Federal bank supervisors have cautioned against legislating a regulatory regime at a time when the market is still evolving. As bank supervisors and market participants have become more familiar with these instruments, the bank supervisors have been receptive to allowing banks to use their own models to calculate their market-risk exposures. The advantage of this approach is that, in comparison to the formula-based standardized approach, it uses the common, but internal, language and understandings the bank has developed to define and measure the activities covered by its market-risk models. The models-based approach does not impose a supervisor's concepts on the bank, but the opposite -- a requirement that the examiner understand the bank's methods and intentions. Further, it relies on the bank's own models and information systems, which the bank has every incentive to improve and refine in response to ongoing changes in technology and the business climate. Certainly, this is more effective than relying on static forms and supervisory reports that no one uses or pays attention to within the bank until the examiner arrives. Bank supervisors and market participants are now studying other ways for this supervisory regime to work, including the precommitment approach.

At the same time, bank examiners have been devoting a greater effort to reviewing banks' risk management and internal-control systems. These examinations cannot be done "by the book." They require a case-by-case evaluation of each bank's systems, with considerable examiner judgment necessary. This places a great burden on the examiners. It also requires a skilled examinations force, one that is harder to retain considering the salaries paid bank supervisors compared to private-sector risk managers.

In order to ensure that examiner judgment is well informed, the bank supervisors will have to work with market participants in developing a strong understanding of appropriate risk management and control processes -- only then can appropriate benchmarks and guidelines be developed. Our examiners draw on all available sources of sound practices: commercial bankers, but also with investment bankers, insurance companies, external auditors, and other firms to learn about practices. Examiners are able to benchmark a firm, according to the examiner's experience of what he sees in a cross section of similarly situated firms.

Our broader oversight responsibilities as central bank and our bank supervisory responsibilities also lead us to ensure that sound industry practices are being followed in such key areas as clearing and settlement systems. Oversight of the payments system by the Federal Reserve rests on several foundations. One of these is the fact that settlements for these systems are handled over Fedwire or are directly settled on Reserve Banks' books. Another is the fact that some of these trade and payments clearing and settlement arrangements can be regarded as providing bank services. The Federal bank supervisors have the authority to examine any firm that provides bank services.

Several years ago, while the Federal Reserve had some concerns about the rules under which CHIPS, operated by the New York Clearing House Association, and its participants managed risk associated with participation in that payment system, the Federal Reserve left it to the Clearing House to devise the needed changes. The changes devised and implemented by the Clearing House were creative and effective. A cookie cutter approach was not mandated and probably could not have been as effective.

In the area of clearing and settlement risk, a similar oversight approach has been taken by the governors of the G-10 central banks. The governors approved the Lamfalussy standards, under which cross-border clearing and settlement systems should be measured. It is up to market participants to devise the system that will meet that standard. For example, in the area of foreign-exchange settlement risk, we see three efforts underway, ECHO in London, Multinet Bank in New York, and the proposed continuous linked settlement bank. The Committee on Payment and Settlement Systems of the G-10 central bank governors, chaired by Bill McDonough, and a subgroup chaired by Chris McCurdy, of the Federal Reserve Bank of New York will work with the developers of those systems to see how the standard applies to their proposals. This is done on an informal and multinational basis.

Role of Industry Associations.

What is probably clear from my remarks is that I think that governmental regulation should not be developed in a vacuum but must involve extensive industry contact. In fact, typically, when I think of regulation, I do not focus solely on governmental regulation. I also regard it as including the type of self regulation that can be brought to bear by an industry association, such as PSA. Self regulation can accomplish results similar to governmental regulation but often with greater sensitivity to marketplace and business realities. In addition, good self regulation can reduce the supervisory burden, and good targeted supervision can make such self regulation more reliable and, hence, more effective.

While I am not very familiar with PSA's efforts in the municipal securities area, I do have some familiarity with its work on Government, agency, government-sponsored enterprise, and mortgage-backed securities: products such as the master repo agreement, which has become a model for the repurchase-agreement transactions around the world. The terms of such an agreement establish good practices on a private contractual basis. Of course, good practice is also found in other documents which describe operating procedures.

There should be, however, no rest for the weary. It is incumbent on PSA as an industry association and, at least in my view, as a nonstatutory self regulatory organization to continue to encourage market participants to follow the best practices. I am not so naive as to believe that the individuals who participate in these efforts are motivated solely by altruistic stimuli. Naturally, self interest is a significant motivation. Still, I like to believe that efforts that enhance the efficiency and integrity of a financial market are also motivated by something more than narrow self interest but rather what is best for the industry and its participants. After all, in your business, confidence is crucial. Your customers and counterparties want to have confidence not only in your firm but in the market in which they are dealing. If they do not, your firm will ultimately lose along with everybody else. Simply stated, these markets provide you with a lot. You should continue to devote some effort to repaying that benefit.

In saying this, I am preaching to the converted, to some extent. But I want to bring home the point of how important groups such as PSA are. A nonstatutory SRO is subject to limitations, antitrust laws for one. A statutory SRO is, in effect, the government operating through a delegate. Therefore, there are practical limits to what a nonstatutory SRO can do. Nevertheless, that should not discourage you from carrying out these vital activities.

Principles and Practices.

I was pleased that, when I suggested to a number of industry associations that we investigate the need for an over-arching code of conduct for the wholesale financial

markets, PSA readily agreed to participate in that effort. I had been struck by the fact that each industry association had practices tailored to that industry. Some had codes of conduct; others did not. The original group was composed of PSA, SIA, ISDA, the Foreign Exchange Committee, the EMTA, and the New York Clearing House Association. Later the Principles and Practices was picked up by the Bankers Roundtable and the Institute of International Bankers.

The drafting effort was headed by Woody Teel of Bank of America and the Foreign Exchange Committee and Gay Evans of Bankers Trust and ISDA. The drafting group succeeded in preparing the Principles and Practices for Wholesale Financial Market Transactions. Some controversy was generated by the fact that the document did not, for the most part, distinguish between dealers and end users. The drafting group prepared a document which was accepted by their organizations. The organizations recommended the Principles and Practices to their members. I note that several other organizations which provided comments and suggestions on the draft were not pleased with the result. The basic difference boiled down to the view expressed in the Principles and Practices that, for the most part, all active participants in these wholesale markets should be treated the same and no special burdens should be imposed on one class of counterparties over another. The Principles and Practices enunciated the general rule that, in these markets, the relationship is an arm's length principal-to-principal relationship, not an advisory or fiduciary one. I believe that is the better legal view in the United States; it is enunciated in the London Code of Conduct, and I understand that that also is the result in Germany.

Requests have been made to reassemble the group to review the Principles and Practices in light of the year-and-one-half experience. I expect that Gay Evans and Woody Teel will assemble a group to do that and am sure that PSA will continue to be an active participant.

The Principles and Practices is a nonstatutory SRO effort, one of many encouraged by the Federal Reserve Bank of New York. Others include the Foreign Exchange Committee, Payment System Risk Committee, and the Financial Markets Lawyers Group. We believe that these types of groups can set the bar higher and help the over-the-counter markets improve their practices. The participants in these markets are well able to judge and balance the cost/benefit of various approaches. They can do so in a way that those of us on the official side could not if left to our own devices. While many are familiar with foreign-exchange settlement or Herstatt risk, such as myself, thought themselves familiar with all aspects of that risk, the Foreign Exchange Committee prepared a report demonstrating that the risk was much higher than typically believed.

The Committee encouraged banks to quantify that risk more accurately. It encouraged correspondent banks to provide better services which would reduce that risk. The Committee on Payment and Settlement Systems of the G-10 central banks, chaired by Bill McDonough, has issued a report encouraging foreign-exchange market participants to reassess their systems and controls to better manage this risk. This is one of a number of cooperative supervisory or oversight efforts where central banks have worked with market participants to make markets safe and sound but to do so in ways that do not adversely affect the liquidity and efficiency of these markets.

Conclusion.

I hope that these remarks will help those of you not very familiar with the supervisory approach gain a better appreciation of that process and aid you in your participation in the public policy debate on the future of our nation's financial structure and where the supervisory approach best fits within that structure.