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Remarks by

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Financial Innovations and the Supervision of Financial Institutions

Once again it is my pleasure to address the Chicago Fed's Conference on Bank Structure and Competition, and I would like to begin by thanking Chicago's new president, Michael Moskow, for the opportunity to do so Michael's predecessors made this conference the single most important annual gathering of its kind in the United States I am both pleased to be a part of it and to see that the new president is continuing his predecessors' tradition of excellence

The theme of this year's conference -- assessing innovations in banking -- certainly continues two other traditions of these meetings relevance and timeliness Innovations in data processing and telecommunications, advances in the science and art of risk measurement and management, the increasing globalization of financial markets, and deregulation at home and abroad have permitted and encouraged a blossoming of new financial products and activities As a result of these changes, competition in the financial services industry has increased greatly, and millions of consumers of such services have been made better off But we have also witnessed some spectacular failures, such as the collapse of Barings Bank and the financial crisis in Orange County, in which some of the new financial instruments have played a highly visible role

I do not wish to downplay the controversies generated by these new instruments and activities, but in debates about the specifics we often tend to lose sight of the larger picture Thus, in my remarks this morning, I intend to focus on four major implications of these new developments in financial markets

- First, financial innovations have not changed the substance of banking The core functions of banking remain the measurement, acceptance, and management of risk
- Second, a critical result of the recent innovations is further blurring of distinctions between traditional forms of financial intermediaries, such as commercial banks, investment banks, insurance companies, and specialized finance companies
- Third, viewed in the context of this blurring of distinctions, repeal of the Glass-Steagall Act, at least insofar as such repeal permitted mergers between largely financial businesses, would not be a major innovation in itself Rather, such legislation would constitute more of a recognition of evolving market reality, much as was true of the recent repeal of federal restrictions on interstate banking and branching
- Finally, on the assumption that Glass-Steagall will continue to be "repealed" by the marketplace, and will, hopefully in the very near future, be repealed by the Congress, a critical issue for supervisors is how to achieve our ongoing and unchanged supervisory goals in an increasingly complex financial world, especially a world in which it is more and more difficult to make distinctions based on the functions of particular financial entities

The Blurring of Distinctions Between Financial Intermediaries

Last year I argued before this audience that a crucial difference between the banks of today and those of

the not-too-distant past is that risk information processing now lies closer to the core of the banking business Yet, the computer-driven risk management activities of today's banks do not differ in purpose from those of earlier banks, when credit officers made less formalized but equally critical judgments, and portfolio managers had far fewer types of financial instruments in which to invest and did so with less rigorous analysis In substance, banks have always been measuring, taking, and managing risk

This morning I want to push this point a little further, and to argue that it is becoming increasingly difficult to distinguish the core functions of banking from the core functions of other financial intermediaries Each of the various "types" of financial firm increasingly engages in activities traditionally the province of the others And each of these types of financial business has as its core functions the measurement, acceptance, and management of risk

Examples abound that demonstrate this blurring of distinctions For instance, the economics of a typical loan syndication, including the types of risks inherent in such a syndication, do not differ essentially from the economics of a best-efforts securities underwriting The expertise required to manage prudently the writing of OTC derivatives is similar to that required for using exchange-traded futures and options Except for differences imposed by law or regulation, it is difficult to identify substantive differences between a guaranteed investment contract provided by an insurance company, and a bank investment contract provided by a bank

My list could go on It is sufficient to say that, in my judgment, a strong case can be made that the evolution of financial technology has changed forever our ability to place financial functions in neat little boxes And, I would emphasize, this is both logical and appropriate.

Economists long ago observed that, over time, competition erodes the economic "rents" associated with new products This process also leads to the evolution of what we might term "generic" products for older, established goods and services At the same time, it causes firms to continually innovate in an attempt to establish new market niches This intense competitive pressure is a primary reason for the tremendous variety of products and services that characterize a market economy, and that meet the specialized needs of millions of consumers Financial services, including various types of risk and risk management, are subject to the same forces as any other sector of our economy

Indeed, financial derivatives are particularly good examples of the innovative process I am describing Derivatives allow the unbundling of the total risk of more generic products into that risk's component parts, and facilitate the transfer of the individual risk components to those most willing and able to bear them In addition, the decomposing of risk allows financial engineers to recombine the pieces in ways that mimic the risk profiles of other activities which were once thought of as separate and unique The end result is a set of financial instruments and strategies that make it increasingly possible for all financial institutions to do essentially the same thing

All of this is not to say that the blending of financial institutions is anywhere near complete There remain key products and services, such as the provision of small business loans, insured deposits, and certain payments services, that are likely to remain uniquely, or nearly uniquely, associated with banks for some time to come This is especially true for many community and regional banks that are not yet as extensively affected by financial innovation as larger institutions

Nor, in my judgment, should the vast majority of banks of any size be intimidated, either by the pace of financial innovation, or by the blurring of functional distinctions that has accompanied the innovations In particular, community banks have repeatedly demonstrated their competitive resilience in the face of larger rivals History has also shown that smaller, more locally oriented banks can profit from innovations that occur at their larger bank and nonbank brethren For example, community banks now profit from the brokering of nonbank financial products supplied by others Similarly, community banks are finding it increasingly to their advantage to participate in the activities of the securitization markets, either as the originators of assets to be securitized or as the purchasers of senior asset-backed securities However, these examples illustrate that, as the basic trends of innovation and change continue, it will become ever more important for banks of all sizes to plan carefully how they can continue to profit from market innovations

Viewed in this broader context of the evolution of financial institutions and markets, repeal of Glass-Steagall would appear to constitute not so much a major reform as a recognition of market realities Certainly, legislative reform would improve the efficiency of financial markets by removing artificial barriers to the realization of production economies Equally important, competition would be increased by the lowering of entry barriers to both the investment and commercial banking businesses All of these effects would provide real benefits to both financial customers and most financial institutions, and for these reasons alone Glass-Steagall should be repealed as soon as is possible But the changes brought about by Glass-Steagall repeal would not, I submit, be radical Rather, they would constitute the next logical step in the on-going evolution of the financial system

Regardless of whether legislative reform of Glass-Steagall occurs this year or at some future date, financial supervisors will have to deal with the implications of rapidly evolving financial institutions In particular, we must decide how, and with what tools, to supervise the evolving financial services organizations of the 21st century

Supervising Financial Services Organizations

When thinking about how to supervise a multi-product financial firm, I believe it is important to begin by stating clearly the primary goals of the supervision and regulation of financial institutions These goals, I think we would all agree, are to maintain the stability of the financial system, to enhance the efficiency and competitiveness of U S banking and financial markets, to protect consumers of financial services from fraud and deceptive business practices, and to protect taxpayers from the risk of loss associated with the federal safety net provided to insured depositories

Today, these goals are pursued by a variety of entities, including the federal and state banking and thrift agencies, the SEC and the CFTC, and the state insurance regulatory bodies This system, while certainly subject to a number of inefficiencies and capable of being improved, in principle could work reasonably well in a world in which financial institutions and their supervisors could be identified with particular financial <u>functions</u> But how should we supervise financial institutions, with or without Glass-Steagall reform, in a world in which all financial organizations perform essentially the same functions and use many of the same tools? In particular, how can we achieve our supervisory goals without extending the too often

excessively complex bank-like supervision over a wider range of activities?

We can pose this question in another, but equally critical way That is, how can we supervise a wide-ranging financial institution that has, as part of its array of services, the offering of insured deposit products, without a *de facto* expansion of the federal safety net subsidy? Indeed, as I look back over my presentations to this Conference in recent years, a recurring and central theme has been how to limit the safety net and mitigate its moral hazard problems Despite progress in this area, such as substantially improved bank capital ratios and the implementation of prompt corrective action, the problems inherent to the safety net remain and cannot be ignored

Traditionally, the management of important tradeoffs among possibly conflicting supervisory goals has employed so-called functional regulation To most observers, functional regulation is thought of as a system in which each separate "function" -- such as commercial banking, investment banking, or mortgage banking -- is supervised by the same regulatory body, regardless of the function's location within a particular financial institution Practically, this means that a single financial organization would have several functional regulators, and that different functions would be somehow separated, most likely through the creation of legally separate subsidiaries, within the broad financial organization

Functional regulation is likely to remain a cornerstone of our supervisory theory and practice for the foreseeable future, since it is extremely unlikely that all federal, much less state regulators, would be -- nor should be, in my view --rolled into one Indeed, as I have argued in other contexts, I believe that the creation of a monopoly regulator would be highly undesirable on both political and

economic grounds. In any event, it seems reasonable to assume that in the future, as today, financial institutions will be regulated by multiple agencies, each with specific responsibility for one or more functions But if we are to make functional regulation work as effectively as is possible, we would be remiss if we did not, at the very beginning, incorporate into our supervisory practice the recognition that it is becoming increasingly difficult to define separate financial functions

The need for such recognition and action is reinforced by the fact that evolving risk management practices, quite apart from the economics of risk taking, are making the identification of separate functions even more difficult and even less meaningful for supervisory purposes Today, the largest and most sophisticated financial institutions are increasingly conducting their risk measurement and management on a centralized basis with respect to the entire financial organization This is as it should be, for such "macro" risk management is highly desirable and has long been the rational goal

Advances in management information systems are beginning to permit a more integrated approach to the application of the insights of modern finance, and it is only natural that financial organizations should utilize these conceptual advances While still in its embryonic stage, a few institutions are measuring major categories of risk, such as credit risk, with an eye toward the covariance of losses across product types, regions, and customers Moreover, I believe it likely that, in the future, institutions will produce integrated measurements of firm-wide risk, including credit, market, liquidity and other risks In such a world, attempts to pigeonhole financial functions into narrowly defined roles traditionally ascribed to a particular type of financial institution would severely curtail some of the risk-reduction benefits of consolidated

risk management, and could reduce the overall effectiveness of firm-wide risk management Enlightened functional regulation must strive to avoid such results

There are other reasons why we cannot rely solely on a decentralized form of functional regulation of the financial supermarket First, perhaps in recognition of the trends I have been discussing, but also for other reasons, the customers, creditors, and the general market view today's evolving financial institutions as essentially single entities Moreover, it seems likely that this view would survive any legislative reform True, judging by debt ratings and risk premiums, market participants make significant distinctions between the insured and noninsured portions of a bank holding company, and these distinctions give important support to the view that functional regulation can be effective But the critical point for bank supervisors remains Trouble in the nonbank portion of the financial firm cannot be expected to leave completely unscathed the market's view of the bank subsidiary In the worst scenarios, runs on a healthy bank may result In addition, legal barriers to the transfer of risk between the insured depository and the rest of the financial organization -- the much discussed firewalls -- may not be as effective as desired precisely when they are needed the most

What, then, is the solution to the difficult supervisory puzzles I have raised? In my judgment, prudent functional regulation must include some type of umbrella supervision of the entire financial institution In short, someone must be responsible for assessing how the behavior of the entire organization, viewed as an organic whole, is consistent with our supervisory goals Indeed, most industrial nations now subscribe to the need for consolidated banking supervision

But precisely what should the umbrella supervisor be responsible for? Virtually as we speak this issue is being debated in the Congress, in the financial industry, in the regulatory agencies, in the press, at this Conference, and, I am sure, in many other places This morning I would like to suggest some basic principles that, in my estimation, should guide this debate, and offer a few ideas for implementing these principles

A core function of the umbrella supervisor must be to monitor and assess the risks that the nonbank portions of the financial institution impose on the insured depository subsidiary, and on the safety net in general But knowledge alone is not enough It is equally important that the umbrella supervisor be able to take actions that reduce to acceptable levels the risks to taxpayers and to the financial system While achieving these objectives, the umbrella supervisor must be careful to maintain a delicate balance The supervisor must know enough and do enough to protect the insured depositories and the safety net, but must not be so involved in the affairs of the nonbank affiliates and the parent that regulatory costs are excessive, or that the market perceives that the safety net has been expanded to the nonbank activities of the organization

Achieving this balance will be difficult and, given the nature of financial innovation, will inevitably be a dynamic process. One promising area for minimizing regulatory costs with few, if any, risks to financial stability or the safety net, is the area of applications procedures Today, banks and bank holding companies must apply to their supervisors for a wide variety of things -- from opening a new branch to engaging in securities underwriting Surely we can reduce, hopefully by a substantial degree, the need for financial institutions to make such applications in the future In this regard, the

Board is attracted to an approach embodied in recent legislative proposals That approach would eliminate the current applications procedure for holding company acquisitions by well-capitalized and well-managed organizations whose proposed acquisitions, or *de novo* entry, are both authorized and pass some reasonable test of scale The bills would also streamline the process for evaluating the permissibility of new financial activities

It may also be possible to target supervisory examinations and inspections more narrowly on the bank, and on the implications for the bank of activity in the rest of the holding company Bank exams would be conducted much as they are today But it might be feasible to concentrate inspections of the rest of the financial firm on its risk management practices, reporting systems, and internal controls, perhaps reducing the frequency of exams or inspections in some cases Less intensive on-site reviews of nonbank activities would be even more feasible and appropriate if the insured depositories of a larger organization were well capitalized and in otherwise outstanding condition Less intensive nonbank reviews -- perhaps, for most affiliates, only reports -- might be especially appropriate if the insured entity were neither unusually large, nor a significant portion of the entire organization The current supervisory regime uses procedures for bank holding companies in which the insured bank typically has constituted virtually all of the organization As the insured bank becomes a smaller proportion of the entire entity -- and assuming the organization is under an obligation to maintain the capital adequacy of the bank -- we might well reconsider the necessity, let alone the desirability, of bank-like supervision for the nonbank affiliates

This list of possibilities is obviously not meant to be either exhaustive or sufficiently detailed to be

operational Rather, it is meant to suggest that the proper balancing of supervisory goals will require substantial creativity and hard thinking by all parties involved It is my hope that the current round of debate will resolve these difficult and complex issues in a way that allows for the repeal of the Glass-Steagall Act, and the establishment of a viable and durable institutional and supervisory framework for the continuing evolution of our financial system

In conclusion, the forces shaping our banking and financial system are fundamental and on-going Through it all, the core functions of banks and bank supervisors remain unchanged In addition, while the blurring of traditional distinctions between the institutional forms of financial intermediation makes repeal of the Glass-Steagall Act seem ever more natural, nonstop innovation raises new challenges for both the public and private sectors Critical aspects of these challenges are how to design and implement a system of financial supervision that addresses evolving realities and balances the inevitable tradeoffs in a realistic manner

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