Coping With Globally Integrated Financial Markets

Mr President, My Lord Mayor, Mr Governor of the Bank of England, My Lords, Sheriffs, Ladies and Gentlemen, it is a privilege and an honor to have this opportunity to address the London Overseas Bankers Club. The City of London has enjoyed a long history as one of the truly dominant financial centers of the world. While that history has entailed more than a few difficult episodes of economic and financial uncertainty, the current situation is certainly formidable. Sluggish growth in the world economy, massive and unsustainable imbalances in international trade and finance, the rising tide of protectionism, and the continuing—and in some respects more vexing—problems associated with the LDC debt situation constitute major and interrelated points of vulnerability. Simultaneously, financial markets around the world are caught up in a near frenzy of activity. Coming to grips with these problems in an orderly way will not be easy and, under the best of circumstances, will take time and patience—a lot of time and patience. But it will also require that our financial markets and institutions are functioning in a smooth and disciplined way so that they can play their historic and vital role of helping to allocate the world's scarce savings in a manner that best helps to improve productivity and living standards.

Sluggish growth in the world economy, massive and unsustainable imbalances in international trade and finance, the rising tide of protectionism, and the continuing—and in some respects more vexing—problems associated with the LDC debt situation, constitute major and interrelated points of vulnerability.

Remarks of E Gerald Corrigan, President, Federal Reserve Bank of New York, before the Overseas Bankers Club Annual Banquet, London, England, on Monday, February 2, 1987

In the current circumstances, I have a nagging sense of unease about how well financial markets and institutions are serving that basic purpose, in part because they are caught up in an unprecedented wave of change and innovation which makes it very difficult to distinguish ends from means, causes from effects, and actions from reactions. For example, while it is unquestionably true that many new financial instruments and practices gained popularity as devices to protect against unforeseeable changes in credit conditions, interest rates, or exchange rates, it is also true that these same instruments can be the source of instability and risk. In a similar vein, we now see some individual firms incurring the costs and, at times, the risk of commencing new activities or moving into new markets not because they are all that keen to do so but because competitive pressures seem to leave little choice. All of this, of course, takes place in a setting where rapid advances in the application of telecommunications, sophisticated mathematics, and computer technology to banking and finance have introduced new elements of

Financial markets and institutions are caught up in an uprecedented wave of change and innovation which makes it very difficult to distinguish ends from means, causes from effects, and actions from reactions.

speed and complexity into the marketplace and in the process have amplified incentives to take advantage of domestic and international differences in laws, regulations, and tax and accounting practices. If it can't be done on the balance sheet, it is done off the balance sheet; if it can't be done onshore, it's done offshore; and if it can't be done with a tried and tested instrument, it is done with a new one.

Globally integrated markets and institutions with round-the-clock trading and position-taking are a tribute to man's creative genius, but they also entail dangers that shocks or disruptions can be more quickly transmitted to markets, institutions, and geographic locations far removed from the initial source of the shock.

Globally integrated markets and institutions are a tribute to man's creative genius, but they also entail dangers that shocks or disruptions can be more quickly transmitted to markets, institutions, and geographic locations far removed from the initial source of the shock.

In the light of the force of these events, the recent agreement between the Bank of England and the banking authorities in the United States regarding a comprehensive and consistent approach to capital adequacy standards for U.S. and U.K. multinational banking organizations takes on particular importance.

For one thing, the initiative is a forceful illustration of the fact that meaningful and successful international cooperation in economic and financial policy matters is possible even when the subject matter is laden with highly technical issues. Hopefully we can build on that success, for I am hard pressed to think of any major aspect of economic and financial policy which will not call for greater international understanding and cooperation in the future.

In the light of the force of these events, the recent agreement between the Bank of England and the banking authorities in the United States regarding a comprehensive and consistent approach to capital adequacy standards for U.S. and U.K. multinational banking organizations takes on particular importance.

In more specific terms, the U.S./U.K. initiative strikes a balanced yet flexible approach to judging the adequacy of a banking organization's capital while taking explicit account of balance sheet and off-balance sheet activities. We also recognize that the proposal is complex and will require care in its final implementation. And it is also an approach which can be easily refined and adapted to future developments as they occur. In short, taking this rather large step of applying these common standards to major U.S. and U.K. banks constitutes a major breakthrough in the effort to better rationalize and harmonize the competitive and prudential framework within which our international banks conduct their business. Having said that, I would also want to stress that capital adequacy standards—no matter how well structured—are only one element in an effective overall supervisory process.

I would also want to stress that while this initiative is of great importance, much remains to be done. For example, I would hope that other industrial countries—especially those that have major international financial centers—will move quickly to bring capital adequacy standards into alignment with emerging international norms. Indeed, broadly accepted capital adequacy standards for all internationally active banking organizations is a goal that must be pursued with vigor. Fortunately, considerable groundwork has been laid toward this end through the BIS and other international organizations. Yet despite those efforts, it remains true that in some countries progress will come more easily than in others. But even where the obstacles to be overcome are formidable, progress must be made. The competitive and prudential implications of major international banking organizations operating around the world with distinctly different capital requirements and resources is simply not in the best long-run interests of strong, stable, and appropriately competitive international banking markets.

I would hope that other industrial countries—especially those that have major international financial centers—will move quickly to bring capital adequacy standards into alignment with emerging international norms.

While internationally harmonious bank capital standards are important, they are only part of the task that lies ahead as we seek to better rationalize the structure, operation, and official oversight of international money and capital markets. Let me, therefore, briefly cite four other areas that I believe will require attention in the period ahead:

- First, many of these issues that arise in the context of efforts to achieve a greater degree of harmony and convergence internationally in banking markets also arise in other areas. For example, a case can be made that greater convergence in securities market regulations among countries is a necessary corollary to greater harmony on the banking side.

The case for greater convergence can also be made in regard to specific markets such as foreign exchange and swaps where banks and securities companies compete directly.

While internationally harmonious bank capital standards are important, they are only part of the task that lies ahead as we seek to better rationalize the structure, operation, and official oversight of international money and capital markets.

- Second, the international payments system requires, in my judgment, continued attention with a view toward ensuring that we have done all we reasonably can to ensure its reliability and stability. This may be especially true for the vast flows of payments denominated in U S. dollars, many of which are interbank in nature and almost all of which are associated with financial transactions These dollar-denominated payments—including those which originate here in London and flash through New York as electronic blips—can aggregate to more than $1 trillion per day. As such, they entail operational, liquidity, and credit interdependencies of very sizeable proportions among virtually every major banking organization in the world

  There are numerous efforts underway within the Federal Reserve and within and among private banking organizations—foreign and domestic—aimed at strengthening credit and operational characteristics of these payments systems. However, these efforts take time and as time passes the volume of transactions continues to grow very rapidly. In these circumstances, I believe it important that parent organizations of foreign branches and affiliates with major operations in the United States, as well as their central banks, are taking steps to ensure that they understand the risks that can be associated with international payments flows including but by no means limited to dollar payments that are settled in New York.
- Third, fresh questions are arising concerning the powers and privileges granted to financial institutions operating on foreign soil. We in the United States have for some years followed a policy of national treatment whereby foreign banks and securities firms operating in the United States have the same privileges and responsibilities as our domestic institutions Others follow that same policy, but in some countries reciprocity, or a blend of reciprocity and national treatment, is the rule. However, even where national treatment is the policy, questions arise about whether practices are always consistent with that policy.

  The policy of national treatment is coming under attack in the United States amid perceptions that U S. firms are not always treated even-handedly in certain other countries. While this has not been a particular problem here in London, we must recognize that protectionism in banking and finance is susceptible to those same insidious forces that we all fear on the trade side; in short, once unleashed, it is very difficult to know where it will stop
- Finally, and perhaps most importantly, there is a host of questions regarding the implications of efforts underway in a number of countries to reshape the basic legislative and regulatory framework within which banking and financial institutions operate in the face of the changes that have been induced by market forces over the past decade or more In addition to difficult issues of legal and regulatory philosophy, custom, and tradition, these efforts must also come to grips with differences in data reporting and consolidation requirements, tax policies, disclosure rules, and accounting standards

The policy of national treatment is coming under attack in the United States amid perceptions that the U.S. firms are not always treated even-handedly in certain other countries.

Reflecting the importance of these related issues, the Federal Reserve Bank of New York is in the final stages of establishing an International Capital Markets Advisory Committee. This advisory committee, which will be comprised of leaders drawn from United States and foreign banking and securities firms operating in the United States, will meet with us from time to time for an informal exchange of views on the kinds of issues I spoke of a moment ago. While the Committee will be consultative in nature, I am hopeful that at the very least it can promote better understanding in both private and official circles of these complex and difficult issues

On the subject of financial market structure in the United States, I believe it is widely recognized that the current situation is an acutely troubling one.

On the subject of financial market structure in the United States, I believe it is widely recognized that the current situation is an acutely troubling one The process of loophole exploitation amid mixed, if not conflicting, signals from the courts, the Congress, and industry representatives has, to date, stifled efforts aimed at legislative reform. This helter-skelter of events, left unchecked, could in subtle but certain ways undermine the strength and independence of the banking system.

All of the problems we face in this regard cannot be overcome in the very near term. However, an essential first step that should be within reach would center on federal legislation that, among other things, would close the so-called "nonbank bank" loophole which, if not done, could be the vehicle that effectively undermines the historic separation of banking and commerce; provide authority for banks to engage in the underwriting of certain classes of securities; facilitate the acquisition of troubled banks or thrift institutions; and provide fresh capital resources for the Federal Savings and Loan Insurance Corporation. Such a legislative package would go a very long way toward alleviating the points of greatest immediate pressure and, at the same time, provide a context in which longer term questions regarding the evolution of the banking and financial system in the United States can be discussed and resolved in an orderly way.

In the expectation that the immediate legislative needs will be addressed, and in anticipation of attention being shifted to those longer term questions, I released last Thursday in New York a rather lengthy essay entitled *Financial Market Structure: A Longer View*. While the essay and its proposals are far too lengthy to go into on this occasion, I do want to stress that my purpose in presenting it was much more to shape the debate—with emphasis on its public policy elements—than to press for a particular legislative or regulatory agenda.

This approach seeks to blend competitive and market realities, together with public policy considerations, in a manner that yields structural arrangements that are market sensitive but also consistent with a stronger and more viable banking and financial system.

This approach seeks to blend competitive and market realities, together with public policy considerations, in a manner that yields structural arrangements that are market sensitive but also consistent with a stronger and more viable banking and financial system. The approach is based on six guiding principles:

- First, the separation of "banking" from commerce should be preserved.
- Second, in the interest of competitive equity and supervisory harmony, the regulatory costs associated with special "banking" functions should, to the fullest extent possible, be neutralized or eliminated across classes of institutions.
- Third, the approach should provide scope for achieving the benefits of greater competition in the marketplace for financial services while preserving the important public benefits growing out of an appropriate degree of supervisory oversight of the system.
- Fourth, supervision should take account of function, not merely institutional form
- Fifth, the structure of the system should incorporate principles of "volunteerism," whereby individual firms can choose their position on the financial landscape based on their own corporate strategies and their own assessments of the costs and benefits of one form of corporate organization over others.
- Sixth, and most importantly, the approach should strengthen the stability and soundness of the system in part by providing greater room for self- and market-discipline but also by enhancing the strength and flexibility of the official supervisory apparatus where necessary.

The initial and primary responsibility for ensuring that our banking and financial institutions are fulfilling their role in a safe and stable manner lies not with the authorities but with the managers of these institutions.

While the agenda for public policy initiatives relating to the evolution of our banking and financial system in the United States and around the world is long and formidable, public policy alone cannot and should not bear the full burden of adjustment. To the contrary, the initial and primary responsibility for ensuring that our banking and financial institutions are fulfilling their role in a safe and stable manner lies not with the authorities but with the managers of these institutions. In that regard, I must confess, as I said earlier, that I have a nagging sense of unease that competitive and other pressures are producing patterns of behavior which may not make a great deal of sense in the fullness of time. From my perspective at 33 Liberty Street, let me cite three quick examples of the kinds of things that give rise to that sense of unease.

- Since 1984, the wave of takeovers, buyouts, and buybacks has resulted in a cumulative net retirement of $230 billion in nonfinancial corporate equity in the United States. Over the same period, nonfinancial corporate debt has risen by $480 billion.
- The volume of trading activity and the volatility in financial markets have mushroomed in part because computer-driven program-trading strategies now

unleash huge buy and sell orders that, as far as I can see, have little or no relationship to economic fundamentals

- Attracted by the "action" and by lofty compensation rates, the best and the brightest from our universities flock to Wall Street while questions about the competitiveness of our manufacturing sector and thus our ability to wind down our massive trade deficit in an orderly way persist.

I could go on, but you know the symptoms as well as I do. And I suspect most of you will agree with me when I say that financial discipline and stability cannot be taken for granted Indeed, as we continue to seek out lasting remedies to these problems, it seems to me that success will come sooner and surer in a context where we also see a reaffirmation of what I have called "prior restraint"—saying "no" to unduly risky activities and transactions—rather than slipping into a situation in which restraint and discipline are achieved only as a by-product of instability or failure. I, for one, am confident we are up to the task.