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Convergence of Global Financial Services

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Abstract

Speech given at Session 1: The Global Capital Market: What's Next. Michael Patterson spoke on aspects of the global financial markets that are common to Japan and the United States including the converging roles of traditionally distinct kinds of institutions participating in such markets; the impact of that convergence on legal and regulatory structures, particularly in the United States; and finally, the challenges of such global convergence for the supervision of global financial institutions.

CONVERGENCE OF GLOBAL FINANCIAL SERVICES

*Michael E. Patterson**

Thank you all for including me in this distinguished group.

Despite the differences between Japan and the United States, I'd like to focus my remarks this morning on three aspects of the global financial markets that I think are common to both Japan and the United States, and, indeed, across the globe: first, the converging roles of traditionally distinct kinds of institutions participating in such markets; second, the impact of that convergence on legal and regulatory structures, particularly in the United States; and finally, the challenges of such global convergence for the supervision of global financial institutions.

I won't dwell long on the macroeconomics, except to remind us that the explosive growth in global financial markets is driven by a variety of well-reported factors: the impact of demographic changes on world savings, which Paul Volcker mentioned;[1] trends toward less government control of financial activities, including liberalization, deregulization and opening of national markets, and the privatization of state-owned enterprises; and information technology that has reduced geographic distances, quickened the pace and reduced the cost of transactions, and enabled the rapid evolution of new financial products and techniques. Chief among those techniques is securitization, that is, the various ways by which financial assets increasingly become tradeable, directly or indirectly, in liquid markets.

As Paul Volcker reminds us, globalization — and, indeed, securitization — are not new trends, but I believe they are still in their relative infancy. It is estimated, just to give you one prediction, that the global market for tradeable financial assets, including money, is expanding at about three times the rate of the real economy, and that by the year 2000 the world's liquid stock will be three times the then-US$27 trillion nominal GDP of OECD[2]

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1. *See* Paul A. Volcker, *Perspectives on Global Capital Markets*, 21 FORDHAM INT'L L.J. 367 (1997).

2. Convention on the Organization for Economic Cooperation and Development, Dec. 14, 1960, 12 U.S.T. 1728, 888 U.N.T.S. 179.

nations.

But what is happening in this environment to the roles of traditionally distinct financial institutions? I'm referring to commercial banks, investment banks, insurance companies, and investment management firms. They are converging and are all becoming more alike. Not only has securitization eliminated traditional intermediary functions, such as bank loans to highly rated corporations, but customer preferences, synergies among financial products that take different forms but share economic and risk attributes, and the need to build economies of scale have driven many of us to broaden the range of products and services.

So, today, we find that many commercial banks have expanded into the capital markets activities of underwriting and dealing in securities of all kinds, as well as other traditional investment banking activities of brokerage, M&A advice, and merchant banking. J.P. Morgan was perhaps the hardest hit by the disintermediation of commercial lending to its traditional wholesale client base, and we have pushed furthest into investment banking, to the point where we rank in the top five or ten places in most investment banking league tables, and even have the number one ranking in some, particularly in Latin America. The market forced us to make a choice: change our clients or change our products. So we stuck with the former and changed the latter.

But, it has been very much a two-way street as investment banks have entered traditional commercial banking domains, including custody, retail credit, and syndicated corporate lending. Recognizing that syndicated loans are still the largest capital market, even in the United States, and that to clients these loans differ little from bonds in economic substance, nearly every major investment bank has pushed into this market, especially for non-investment grade credits. Neither investment banks nor commercial banks want to hold all these loan assets on their balance sheets, so increasingly liquid primary and secondary markets for them have developed that approximate the markets for debt securities.

New non-bank investors, including third-party funds created by these banks, increasingly participate in this market. From 1989 to 1995, the share of bank investors in non-investment grade loans declined from over ninety percent to less than seventy-five percent, while the share of non-banks, including insurance and finance companies, but most particularly public funds, grew to exceed twenty-five percent, and it is still increasing rapidly.

The convergence I talked about is also evident in investment management, with every type of institution — commercial and investment banks, insurance companies, and fund managers — competing in every product for every investor, from pension plans, defined contribution plans, and mutual funds, to annuities, and personal trusts. And, although I won't dwell on it, insurance and banking have also come together, especially in Europe but also increasingly in the United States.

I think the development of derivative products has been, in at least two ways, one of the most powerful agents in this process of convergence. First, since derivatives were not historically identified with any particular type of institution, all financial players have used them, both as clients and as end users. Secondly, and more importantly, derivatives enable the disaggregation and repackaging of financial risks that have always been common to all types of financial products, albeit in different forms and dealt with in different kinds of institutions. This has enabled banks, for example, to replicate products they have not traditionally offered such as some types of insurance or commodity hedging. In short, derivatives have brightened the spotlight on the artificiality of segregating financial institutions by traditional products.

I'll move on to my second point, which is how legal and regulatory frameworks are accommodating, or inhibiting, these market forces toward convergence. Again, I'll focus on the United States, not only because it has the largest of those markets, but also because its legal and regulatory structures significantly lag market reality. Now, that's not to say that the U.S. regulators themselves are lagging the reality. Quite to the contrary, our banking regulators have, by and large, been creatively progressive within their legal constraints — to wit, the Federal Reserve's authorization of so-called Section 20 securities affiliates of banks (I think there are around forty of these now, and many of them are owned by foreign banks) and the Comptroller of the Currency's support for banks' expanded insurance sales activity.

But, as Paul Volcker has vividly pointed out, the U.S. law itself has hardly changed at all. The explanation lies in a combination of the opposition of powerful interest groups who have benefitted from the anti-competitive protection of our fragmented financial system; jurisdictional battles among our plethora of federal and state banking, securities, and insurance regulators; and particularly in the case of Glass-Steagall,[3] obsolete and discredited, but persistent, notions of risk, on which I'd like to spend just a moment.

Defenders of Glass-Steagall have argued that its purpose — or at least its continuing justification — was to shield banks and the government safety net from the greater risk of financial loss said to inhere in securities activities than in commercial banking. This myth persists in too many quarters today, notwithstanding the uncontroverted evidence that losses from securities activities had almost nothing to do with the bank failures in the 1930s and that far fewer securities firms have failed from securities underwriting and dealing than the thousands of banks that have been brought down by bad loans. Indeed, it is self-evident that making a non-transferable term loan to a borrower is far riskier than underwriting or dealing in the same borrower's tradeable security, with the same economic terms but where a liquid market exists.

This irony — some would say absurdity — of Glass-Steagall was vividly illustrated by the process by which bank loans to less-developed countries in the 1980s were gradually converted to Brady bonds. The loans, on which banks lost billions of dollars, were eligible, of course, to be held and traded by the banks, while the bonds, with liquid securities markets and very substantial collateral, were not.

All objective observers would, I think, fully debunk the riskiness myth of Glass-Steagall. Yet its residue remains. Even the proposed legislation[4] to reform Glass-Steagall will not fully repeal it. Securities activities will still be required to be conducted in affiliates separate from the bank, separated by a variety of so-called "firewalls" whose purpose and effect is to deny the obvious synergies between such economically similar activities. The net

3. 12 U.S.C. §§ 24, 78, 377-378 (1988).

4. H.R. 10, 105th Cong., 1st Sess. (1997).

result is a material handicap for U.S. institutions in their global competition with universal banks.

One impediment to getting the law changed, ironically, is that the combined forces of market pressures, lawyers' ingenuity, and the regulatory flexibility I mentioned earlier have moved many U.S. market participants to the point where they feel they have a large percentage, if certainly not all, of what they need at the moment, and they are extremely leery of the hazards of the legislative process. Banks remember well the so-called Federal Deposit Insurance Corporation Improvement Act[5] of the early 1990s, which started out as a constructive plan for comprehensive reform but ended up without any expansion of permissible activities and instead imposed a whole new set of burdensome requirements. Add to that the reluctance of industry groups, and the challenge of crafting an acceptable alignment of regulatory and supervisory jurisdiction, and the prospects of legislation during this congressional session are uncertain at best.

To move to my third point, the mismatch between converged financial institutions and national legal and regulatory structures has a corollary in the mismatch between the way global financial institutions seek to operate and manage themselves, on the one hand, and, on the other hand, the way they are supervised on a piecemeal basis by domestic regulators in the various countries where they do business.

The basic problem is that global firms, like J.P. Morgan, manage themselves to the greatest extent possible on a consolidated basis. Absent local restrictions, they would allocate their capital, book their transactions, manage their risks, and organize their people in the most efficient way. They would generally prefer to maximize capital efficiency by operating in as many places as possible off a single capital base, rather than splitting it up among different legal entities or otherwise. Yet, many countries do not permit, or else otherwise restrict, branches of foreign institutions.

Global firms would also generally prefer the cost-saving and better controls of a single booking center for global transactions, rather than having to satisfy the informational demands of each country's authorities. Also, we would not be worried about, for

5. The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236.

example, a short market position in one country offset by a long position in another, or an excess of liabilities in one country offset by the opposite in another, so long as the net risk and leverage position of the firm as a whole were in prudent balance. And we would not worry about fully staffing, for example, the credit, audit, or senior management ranks at every location, so long as these functions could operate effectively from off-shore.

Now, this is an ideal world from a global financial institution's point of view, and obviously it runs up against significant concerns of the local regulators, who feel a responsibility to protect their own citizens and taxpayers from the failure of a global institution. Therefore, they naturally seek to "ring fence" the institution's local activity in a variety of ways.

The result is twofold. First, global institutions are faced with a plethora of costly, often inconsistent requirements in the multiple jurisdictions in which they do business. Second, especially given local secrecy laws that deny information to home country supervisors, there may be no supervisory body that has a comprehensive view of the safety and soundness of the global firm as a whole, a situation which many cite as giving rise to potential systemic risk in the event of a serious financial problem in that institution.

These problems have been much discussed by industry participants and regulators over the last few years, the most recent product of which is the Group of Thirty report urging that the industry itself create a standing committee to develop comprehensive standards of risk management and control for global institutions, against which such firms would be audited by an independent auditing firm every year, and for compliance with which regulators would provide various incentives. This ambitious proposal would supplement efforts already underway by many of the world's financial regulators to share information and cooperate in the supervision of globally active institutions.

I think all approaches recognize the impracticality of a single supranational supervisory body. At best, the hope is that, with greater harmonization of standards and accounting principles and more information sharing and cooperation, the host countries would increasingly defer to the consolidated oversight of the home country's supervisor with respect to the overall safety and soundness of the global institution. This is the mutual recognition model that is embodied already in the European Union's banking and investment services directives.

Now, to the extent that national regulatory structures have been consolidated — which is of course necessary if you're going to have a single home country supervisor — the direction of regulatory and supervisory responsibility seems to have been away from central banks. The United Kingdom is the most recent notorious example, with the Bank of England stripped of bank supervisory responsibility which will be lodged, together with securities, investment management, and maybe insurance as well, under a single Financial Securities Agency. This more closely approximates the model of countries with universal banking.

There is much debate about the necessary degree of involvement of central banks in the supervision of financial institutions, but there is no doubt that when financial crises loom, only central banks can provide the liquidity — the money — to avert systemic risk. Therefore, if the objective is greater deference by host country supervisors to the safety and soundness oversight by the home country supervisor, it may be that they will be more reassured to see the agency with the money in that role.

My final observation is that while many steps can be taken to improve the conditions for effective supervision of global financial institutions, we should hesitate to put too much faith in the concept of a single set of global standards. Any body, even a self-regulatory body, with standard-setting or rule-making authority, tends toward the seduction of excessively detailed "one size fits all" prescriptions, which not only raise unrealistic expectations, but also risk undermining the market discipline and sound discretionary management that are more critical to the safety and soundness than any rule book.