Comment

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Mr Heimann's observations concerning the design of regulation to eliminate systemic risks to the global financial markets caused by large, global financial institutions largely reflect those of the Group of Thirty Study Group on *Global Institutions, National Supervision and Systemic Risk* (Group of Thirty 1997) of which he was co-chair. He notes that the introduction of the recommendations of this study would represent a marked departure from the *status quo* since they call for "assigning enhanced responsibility to financial institutions" (Heimann, p. 181) for their own regulation. It "also implies that supervisors will be readier to rely on the institutions that they supervise" (ibidem). To avoid the obvious initial response that this proposal may be a banker's dream (in the sense Padoa-Schioppa (quoted in Sarcinelli 1997, p. 269) defines the "[...] taxpayer's dream to be free to devise his own income tax form") but a regulator's nightmare, it is perhaps useful to note the importance of some of the definitions used in the proposal.

Given the current concerns to strengthen banking supervision in emerging markets in the aftermath of the financial meltdown in Asia, it should be noted that the definition of 'systemic' risk that is employed is rather different from the idea of systemic financial instability associated with the work of Minsky. Japan may fairly be represented as currently experiencing conditions of financial instability – that is, conditions in which financial institutions are required to 'sell position in order to make position'. The fall in the Tokyo market index below 15,000, the level at which the contribution of the equity portfolio positions of Japanese banks to their BIS capital ratios ceases to be positive, means action to reduce their risk-adjusted assets. This resulting sale of assets, or withdrawal of collateralized lending based on market assets, will lead to further declines in stock prices, reducing

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collateral values and bank lending at precisely the point in time when clients need additional liquidity. Many of the Asian markets appear to be experiencing a Minsky crisis.

This is not what is meant by 'systemic' risk in the present context. Rather it seems to refer to a 1991 OECD study of securities markets in which systemic risk is described as "a disturbance which severly impairs the working of the system; and at the extreme causes a complete breakdown in it. Systemic risks are those risks which have the potential to cause such a crisis and, at the extreme, such a breakdown in the system. [...] our main concern is with the trasmission of shocks" such as "a default by one or more large securities dealers" that "will lead to further defaults and that the failure will extend into the core of the banking system and cause a breakdown in the flow of payments in settlement of financial transactions throughout the world" (OECD 1991, pp. 14-15). Extended to global banks, this definition would involve weakness in a global financial institution caused by any sudden, unanticipated economic or political event, which prevents it from meetings its commitments being transmitted to the other global banks and the rest of the financial system with repercussions in the real sector. To adopt the language of risk diversification, it deals with the spillover of idiosyncratic risk into systematic risk. It thus includes risks that one might expect in a normal state of affairs in the current financial system – say the breakdown of the Bank of New York computer settlement system for government securities, or the fall of Bank Herstatt, and is primarily concerned with isolating such risks from the rest of the system. It is thus really concerned with the ability of the system to withstand shocks – we might want to say with the structural stability of financial institutions, rather than with any fragility inherent in the design of the financial system itself.

The second point is that the recommendations do not concern the problems facing the banking and financial system supervisors in emerging market economies and which have dominated recent G-7 summits and produced a number of proposals (Group of Ten 1997 and BIS 1997), and have more recently concentrated the attention of the financial community on South East Asia, then on North Asia and finally Japan. Rather, these proposals deal with the regulation and supervision of a very small group of banks located in developed countries, usually well supervised and managed, that conduct their operations on a global scale. The assumption is that global financial markets will be dominated by a relatively small number of global banks. Some 15 years ago Heimann predicted that "twenty-five to fifty financial institutions, not all of them banks, will dominate the financial services industry worldwide" (quoted in Mayer 1984, p. 372). I must admit to some difficulty in creating a list reaching that number; the reduced estimate of around a dozen which emerged in Heimann's oral remarks seems more accurate.

Thus the proposals, directed exclusively to these 'core' banks, or what I prefer to call "global wholesale banks", are based on the idea that they require a special "regime [...] that is different and more elaborate than that imposed on smaller or less geographically diversified competitors" (Heimann, p. 181). Lest we be tempted to extrapolate Triffin's conclusion (first enunciated in the *Quarterly Review*, March and June 1959) that the difficulties created by a national currency (the US dollar) serving as a global means of payment could only be solved by the creation of a supranational financial institution, Heimann's closing sentence assures us that a supranational prudential regulatory body is precisely what is not required. The idea that the difficulties raised by the increasingly global operation of most financial and non-financial corporations can only be resolved by some form of global governance is not given any encouragement.

Given the restricted application of the proposals, the question that needs to be answered is why these core financial institutions require such special treatment. Is it because of the specific type of services they offer, or because they offer their services globally, or simply because they are large?

One line of argument suggests that the complexity of operations of these banks and the rapidity of change in the financial services sector mean that government supervisory authorities will always be 'behind the curve', regulating the last near financial disaster, but unable to foresee the nature of the next which the 'quants' that work for the banks are continuously perfecting, and their salesmen on the trading floor are energetically promoting to unsuspecting clients. Thus, it is the fact that a very small number of banks will be dominant players in dealing in complex proprietary instruments – LDTs (leveraged derivative transactions) as they have come to be called by the New York Federal. If any one of them were to take excessive position risk there would certainly be contagion to the others and systematic market risk.

However, since these products can be reverse engineered with relative ease they soon become commoditized, and offer monopoly profits for the very short period after their introduction, they will be changing very rapidly, much too rapidly for supervisory personnel to keep track of their peculiar features and risks, while their characteristics are much too valuable to be revealed publicly to regulators before their introduction. Further, since the core financial institutions will recognize the inherent risk involved in such operations they will themselves become more adept at handling the risks involved by the use of LDTs and other activities on a global basis through the application of model-based risk management systems. Since these proprietary systems are adapted to the operations of a particular bank, and are the equivalent of a patented production process for a manufacturing firm, it would be difficult to formulate a common standard which might allow regulators to evaluate them. Since core financial institutions will be active in building on these systems to provide revenue generating risk management services to their clients, it is unlikely that they will be made public to regulators.

We are thus left with the conclusion that while global core banks may present systemic risk, they are likely to be too complicated to be understood by regulators, and their internal risk reduction methods are in any case proprietary and could not be made public without damaging the financial strength of the banks that the regulators are trying to support.

Another line of argument says that because core banks operate globally, while supervisors are restricted to the application of national regulations, supervision centred on particular national conditions will be increasingly inappropriate to allow efficient risk management of the banks' global operations. Thus, while increased cooperation between regulatory authorities is helpful in pointing out problems caused by national regulations, it serves no positive purpose since regulators may be working at cross purposes as long as regulations differ across countries. In fact, the respondents to the Group of Thirty study questionnaire "rated global monitoring of supervised institutions as the most important contribution home country supervisors could make to reduce systemic risk. However, respondents indicated only moderate confidence that their own supervisor was achieving effective global oversight of their firm" (Group of Thirty 1997, p. 43). If national authorities are too wedded to local regulatory requirements, it might appear that a global licence for global banks regulated by globally agreed governance procedures such as exist within the EU might be a more appropriate solution.

Given the scepticism concerning the possibilities for a sensible global solution via official regulation and supervision, the conclusion follows that global financial institutions should be given special and separate treatment from nationally-based financial institutions, and allowed exemptions from national regulations in the form of increased self-regulation.

This conclusion would also be supported to the extent that national regulations either impede actions to implement efficient global risk management or that national regulations are inappropriate.

In a sense, the problem of conflicting national regulations is simply the problem of multiple regulation, a condition which has always afflicted US commercial banks, but not investment banks. Since the core banks here under discussion more resemble investment than commercial banks it would follow that they should be regulated differently. To the extent that the banks in question are not deposit-taking commercial banks, but rather broker/investment banks and those commercial banks in the US that have some time ago chosen to concentrate their activities in section 20 exempted investment banking activities, regulators should not really be concerned about those factors which have motivated traditional bank regulation. As example, within the US this would mean application of regulations applied to investment banks by the SEC, rather than regulations applied by the OCC (Office of Controller of the Currency), the Federal Reserve or the FDIC-OTS (Federal Deposit Insurance Corporation – Office of Thrift Supervision) to commercial banks or savings banks. Just as Glass-Steagall applied a different regulatory regime to commercial and investment banks, there is thus a plausible argument to be made to exempt core global banks from those regulations which are related to the provision of standard payments services and deposits to small savers to the extent that they do not offer these services.

This argument is compelling as it applied to the US institutions: for example, Bankers Trust and J.P. Morgan both operate with commercial bank charters, but do not engage in retail deposit business. Indeed, a substantial number of the banks that are likely to fall into Heimann's category of global core bank would be commercial banks operating investment banking affiliates under section 20 exemptions, while the rest would be investment bank-broker dealers who are only subject to Securities regulation. This neat arrangement does not apply so clearly to the banks of other countries that might be included in the list. While the German and Swiss banks are not dominant in their retail domestic deposit markets, as universal banks, they are subject to a single regulator for both their domestic retail and global wholesale activities, and it might be much less easy to convince their domestic regulators to allow the special self-regulation regime proposed here.

The basis of the proposal would then seem to be the proposition that these core global wholesale banks do not provide the same services as domestic retail banks, are not subject to the same risks, and thus do not require standard national regulation and supervision. But, if we are to accept the proposal, we must also enquire as to the type of risks that these banks do face. There are three broad categories, which can be designed to be as similar as possible to those that might apply to non-financial firms: financial leverage (position or market risk), operational leverage (risk of fluctuations in product and market demand given relatively fixed labour and other production costs) and operational control risk (cf. Thieke 1997, p. 2).

In general, direct position risk is probably of decreasing importance as these banks expand their activities in the areas of asset management and risk management services which are independent of market movements and generate fee income. They still generate a substantial amount of income from proprietary trading, but this is precisely the area in which their model-based quantitative risk assessment and management systems are strongest and which supervisors will have the greatest difficulties. Operational leverage is more of a problem for traditional domestic banks which have large branch networks, fixed staffing commitments and so forth, investment banks usually are much more flexible in terms of pay and costs structures.[1]

However, the much heralded model-based quantitative risk-management systems simply do not apply to the third category of operational control risk exposure. Nor is it possible to argue that increasing 'market regulation' through deregulation can help in this

[1] Even though investment banks have much higher efficiency ratios (i.e. costs to revenues) at 70% or above due to the high labour compensation, these are traditionally composed to a substantial extent by annual bonuses, so that costs are more closely correlated with revenues than in commercial banks.

area, for as Coase has pointed out, this is precisely the area in which organisation within the firm is supposed to be more efficient than market organization. It is perhaps more transparent to classify this simply as a question of corporate governance. Here it is impossible to invoke increased market regulation to replace official regulations.

Indeed, this would appear to be the basic reason for the claim that self-regulation is the more efficient solution. It is telling that it is precisely this aspect of risk that appears to have been the proximate cause of the 'serious financial problems' that might have caused systemic risks: Continental Illinois, Barings, Sumitomo, etc. In fact, "operational risk raised greater anxiety" than market risks for the Group of Thirty study survey respondents. They were particularly concerned that "internal controls may fail to detect excessive risk-taking or fraud, permitting initially modest losses to grow hidden to view" (Group of Thirty 1997, p. 41).

First, this does not seem to be a problem that is restricted to core banks, and is just as important in the banks in Thailand. In fact, the G-30 (p. 13) report notes that "the responsibility of management in the area of internal controls is no less at smaller firms". Nor does there seem to be any reason why these banks should be any better equipped to deal with it, even though the report notes that "by far the largest proportion of serious financial problems which beset financial organisations (whether or not they involve systemic risks) arise from problems which the organisations ought to be able to control themselves" (through appropriate management governance of the institution. However, if global wholesale banks operate increasingly in LDTs, which will involve increasingly intricate and layered positions, sold in increasingly separated far-flung areas, in conditions in which markets are going to be increasingly volatile, it would seem that the problems of control will be exponentially greater than in smaller domestic banks. Of particular importance will be the fact that "what isn't fully captured in the traditional notions of risk is the element of speed. [...] Economic events crystalize faster for securities firms than for commercial banks, and faster for commercial banks than for insurance companies" (Mendoza 1995, p. 2 and Group of Thirty 1997, p. 9). An extension of this aspect is both legal risk (the LDT do not correspond directly to existing national legislation governing financial instruments) and model risk (a correlation that has held for twenty years suddenly changes its value). Thus to the extent that the global banks more resemble securities firms it would seem that the risks of operational control are not only not restricted to these banks, but that they will in fact be more difficult to resolve than for other types of financial institution, rather than less.

The solution that is proposed is for management and supervisors to pay more attention to the "organisational culture" of the bank and to "people issues" (Group of Thirty 1997, p. 14) in order to encourage strong internal controls. It is not altogether clear how this is to be done, although Thieke (1997, p. 4) suggests the possibility of "rogue trader" or "investment guideline non-compliance" insurance. The G-30 report goes on to recommend greater transparency and disclosure. This is consonant with the well-established US tradition for securities market legislation practiced since the 1930s – sunshine: increased transparency and disclosure. Part of these recommendations include a Board of Auditors independent of management and the Directors. "The survey revealed strong support for external review of a firms' global operations by independent external auditors, with the results published at least annually" (Group of Thirty 1997, p. 42). Sarcinelli has suggested that the risk assessment and management unit report directly to the Auditors and Directors, without passing through management. But these recommendations deal primarily with corporate governance in the sense of external control by shareholders and stakeholders over the degree of risk assumed by the conscious decisions of management. They appear less efficient in dealing with what is the main problem of internal operational risk control, i.e. of managers insuring that employees are in fact operating correctly. The G-30 report (p. 21) in fact suggests that supervisors should "examine organizational culture and the ethical climate in the firm" as well as the more technical aspects of the bank such as "appropriate management and control structures [...,] appropriate board oversight [...] evaluate the basic building blocks of risk management – global monitoring systems, sophisticated models, with the appropriate staff to operate them" and in addition to make recommendations to the management on its procedures. Given this required combination of philosopher king-management consultant, it is not surprising that the report suggests that this "may exceed the current capability of some supervisors" since it "will require a high level of skills".[2] Given the insufficient financial incentives, the legal impediments and other factors in the way of any such possibility, the natural conclusion is that supervisors will have to depend on the banks themselves. But it does not tell us how the banks themselves are going to solve the problem which would appear to be more difficult the more global their operations, and the more dependent their operations are LDTs.

But even increased disclosure may soon cause additional operational control risk. Recent events in the US suggest a variant that might be called 'disclosure risk'. It has generally been assumed in US legislation that counter parties possess what may be called 'universal financial literacy', which means that a seller may presume knowledge by the buyer of the properties applying to the particular asset class. Indeed, the whole basis for a separate class of global wholesale financial institutions implicitly assumes that they and their counter parties are well versed and knowledgeable in the products and services exchanged. However, according to the approach adopted by US bank regulators in the resolution of the Bankers Trust legal suits, financial institutions will now be required to ensure that clients understand the products that they are being sold and that the products are appropriate to the needs of the clients (cf. Hu 1996). The financial institution effectively becomes responsible for the client's risk management. I am not sure if this is what Heimann had in mind when he mentioned that the key to managing risk is understanding counter party risk management, but this is clearly a new form of operational control risk which global banks will have to meet for it now becomes possible for a client, irrespective of the inherent understanding, to plead that he was not sufficiently well informed or his needs were not adequately assessed by the representative of the bank that sold the product. These are problems that were not present at J.P. Morgan at the turn of the century. They might be eliminated by returning to small, private partnerships. But for large global banks they are likely to be an increasing problem.

An alternative approach to pure self regulation would be a form of joint regulation. There are examples of private joint regulation sys-

[2] Compare the Bank of England's (p. 10) description of the "institution specific responsibilities" of a supervisor: "a good understanding of the businesses in which a bank is engaged, and the groups of which they form a part. This includes assessing the relevant strategies, activities, organisation structure, quality and style of management, risk and earnings profile, and systems and controls". In short, supervision of this sort duplicates the optimal management structure – but this must involve misallocation of resources or mispricing of labour services, and raises the question of who is watching the watchers, etc.

tems that have functioned effectively. The New York Clearing House provided internal regulation of the operations of its members by its members. There was effective monitoring and control of counter party risks and corrective measures applied. Thus, while there are good reasons why large global banks themselves are their own best regulators when the primary risk they face is operational control risk, rather than the risks which have traditionally given rise to bank supervision, I would be less inclined to judge the current proposal as a 'bankers dream' if it were couched as a process of joint regulation in which large banks act as co-supervisors of other large banks, rather than as a system in which large banks supervise themselves. Specifying the organizational and incentive structure for such a private self regulating organization of large global banks would seem to be the necessary next step if the present proposal is to gain credibility.

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