The co-ordination of regulation

*The **Deputy Governor** discusses(1) the arguments for greater harmonisation and co-ordination of securities supervision, analogous to the measures that have been taken in banking regulation, and suggests some directions in which progress might be made, at both the bilateral and the multilateral level, in the years ahead. He stresses that, while a greater convergence of standards is desirable, there must be realistic expectations of the degree of progress likely over the next few years. The immediate priority is to continue the work under way to explore the current structure of regulatory responsibility: only when this is accomplished can efforts begin to fill any gaps and agree the allocation of supervisory responsibility. In the meantime, other steps can be taken to tackle risks in securities trading—particularly counterparty risk, where improvements in settlement arrangements can reduce the fear that a failure of one house will bring down others with it.*

Seen with the wisdom which hindsight always provides, the events of last October represented a correction—albeit a sudden and dramatic one—after a period of unduly rapid rises in share prices in many of the major international stock markets. But at the same time they highlighted some important features of world securities markets.

First, they provided a graphic illustration of the growing integration of financial markets, which should now be considered in global rather than national terms. The major banks have had extensive international networks for many years, but more recently securities houses have expanded their overseas operations, helped by advances in communications technology. Second, they demonstrated just how closely banking and securities businesses are connected. This partly reflects bank funding of securities firms, on which attention focused in New York on the 19th and 20th of last October, but also, particularly in Europe, the fact that both types of business are often carried out in the same firm or by firms in common ownership. Third, they served as a reminder of the importance of counterparty exposure in the assessment of risk. This has given additional impetus to the re-examination of the role of settlement systems and of arrangements to ensure the performance of contracts.

With these points in mind, some observers argue that the failure of a major securities house could result in a disturbance to the financial system as serious as a failure within the banking system itself, with the consequences spreading rapidly from one financial centre to another, not least because of the impact on confidence. There is general agreement on the need for regulatory frameworks which adequately recognise the evolution of financial structures and the internationalisation of financial business. There have also been calls for a world-wide re-examination of standards in securities supervision, to reduce the risk that firms could find themselves in difficulties because of the failure of an inadequately supervised institution in another centre, and also to bring about greater equality of competition by providing—in that tediously over-worked phrase—a 'level playing field'.

Of course, the banking supervisors meeting in Basle have worked steadily since 1975 on related questions in the banking field. They have constructed arrangements based on what may be called the three Cs—the Concordat, which allocates supervisory responsibility; the consolidation principle, which enhances the effectiveness of parental supervision; and, most recently, the convergence of standards of capital adequacy.

Harmonisation of securities supervision is, however, in its infancy. This is partly because while international banking has been a commonplace for many years, the internationalisation of securities business is more recent and partial. Indeed, in most countries international capital markets are still unknown or have not yet developed to the extent that they have in London, New York or Tokyo; and in such domestic markets there is little perceived need for co-ordination of regulation with other countries.

There is also greater fragmentation of responsibility for the regulation of securities markets than for banking, with statutory supervisors like the SIB and the SEC, stock exchanges, self-regulating organisations, government ministries and central banks all having a role. There is of course general recognition of the need for close co-operation between supervisors within the same country. In the United Kingdom, for example, this is based on the identification of a lead regulator, a concept with which most of you will be familiar. But there is still no similar international co-operation in securities regulation and as yet no fully convincing or credible body for developing it corresponding to the Basle arrangements for banks.

(1) In a speech to a Financial Times Centenary Conference on 6 July.

So much for our starting point. I would like now to consider where we should be aiming to go and how we might get there.

There are three main components of a regulatory regime, each of which has relevance to issues of co-ordination. First, authorisation—the judgement, for example, as to whether the owners and controllers are 'fit and proper'. Second, conduct of business; and finally capital adequacy, both at the initial stage of authorisation and thereafter.

The need for *authorisation* is of course common to both banks and securities firms, although the criteria need not be identical within a country, let alone between countries. *Conduct of business issues* tend to be more important for securities regulators than for their banking counterparts, although where banks are operating in securities markets they should observe the same rules or codes of conduct as other firms. But discussion of convergence has tended to focus on the third component of regulation: *standards of capital adequacy.*

In this context, there are in most countries significant differences between the rules applied to banks and to securities houses. For banks, capital adequacy has been related primarily to credit risk—the risk that borrowers will not repay loans in full—whereas securities supervisors have paid more attention to position risk springing from changes in the prices of a portfolio of securities. This difference has conditioned the regulators' approach to the kind of capital each type of institution must hold, and is reflected in the fact that the recent convergence agreement for banks relates very largely to credit risks. It is apparent, however, that banks' involvement in securities markets means that they can also be exposed to position risk, although in most cases, even for the 'universal' banks, this is still slight relative to credit risks. Equally, securities houses are exposed to some credit risk, notably in the process of trading securities where counterparty risk arises; a party may fail before completion of the bargain, leaving his counterparty with an unbalanced book or conceivably—if he has been unlucky or foolish enough to be out of both his money and his securities—with a loss of the full capital value.

If capital requirements are not harmonised, differing standards between countries could result in a form of regulatory arbitrage, with firms shifting their locations to the least demanding centre and adding to the riskiness of the international system; although this danger could be mitigated by a reluctance by others to deal with lightly-regulated counterparties.

Differing capital requirements between countries can also cause problems for the regulation of branches, which unlike subsidiaries have no capital of their own. If standards of capital adequacy are significantly more stringent in the host country than at home, a branch operation may not be acceptable, with the firm being required to be separately capitalised as a subsidiary even though this is inefficient from the owner's point of view.

While a greater convergence of standards is desirable, we must be realistic about the degree of progress we can expect in the international co-ordination of regulation in the next few years. The immediate priority is to continue the work already under way in the OECD and elsewhere to explore the current structure of regulatory responsibility: which agencies are responsible for regulating securities business in different countries; the arrangements to cope with regulatory overlap; the regulation of branches and subsidiaries of overseas firms; and whether there are any gaps in regulatory coverage. In this context, there are several other multinational fora where securities regulators exchange information, although mainly in relation to conduct of business issues rather than capital adequacy: for example, the International Organisation of Securities Commissions; the Federation Internationale des Bourses de Valeurs; and the inter-governmental Wilton Park Group.

All this has to be done before any exploratory discussions can begin, aimed at filling any gaps and agreeing the allocation of supervisory responsibility. This second stage, when it comes, will correspond to the lead-up to the first Basle Concordat in 1975. Achieving that was a demanding task; but in securities supervision it will be even more demanding because of the greater heterogeneity of regulatory arrangements. Indeed, it may be best to start with the relatively few countries that have securities markets which are essentially international—possibly even on a bilateral basis.

In so doing, the lead regulator arrangements developed in the United Kingdom may provide a useful model. Indeed, the SIB is at present taking the lead in working out analogous arrangements with other countries. In this context, and given the scale of US firms' presence in London and the involvement of many of them in wholesale markets, the SIB and the Bank early this year started bilateral discussions with our counterparts in Washington and New York in order to explore the details of supervisory responsibility and to discover if there are any gaps in the supervision of London branches of US non-bank securities houses.

The SIB's approaches have brought to the fore several problems. If a branch of an overseas financial institution wishes to be authorised to do investment business in the United Kingdom, the SIB may rely on its home supervisor only if the standard of investor protection in the home country is judged to be broadly equivalent to that provided under the Financial Services Act. Even then, the regulators in some countries may not be allowed to release necessary information to the SIB.

Apart from the absence of a single international forum for securities regulators, there are also no formal arrangements for collaboration between them and their banking colleagues. This is plainly a lacuna and I commend the recent call in the BIS Annual Report for a global forum for consultation and co-operation among the different types of national supervisory authorities.

There is, however, one multilateral organisation in which tangible progress in convergence is likely to be made with reasonable speed: the European Community. The Commission is currently putting through a series of related Directives on banking. Between them they will have the effect of enshrining in Community law requirements similar to the Basle arrangements for the supervision of capital adequacy. This is all to the good.

One of the principal planks in the Directives is the concept of a single Community 'passport'; if a bank is authorised by its home state regulator in any or all of a list of specific activities it will be able to operate freely in them throughout the Community. The activities specified include securities trading.

Non-bank securities houses will be put at a competitive disadvantage without corresponding provision for a single passport. This has led to the drawing up of a draft Investment Services Directive. This is not the occasion to go into any detail, but the Commission's move presents a problem and an opportunity. The problem is that the single passport allied to home state regulation of capital adequacy will not be acceptable unless there are broadly common minimum standards of sufficient rigour throughout the Community. The Commission's proposal may, therefore, provide the opportunity for consideration within Europe of the many difficult issues which still stand in the way of progress towards harmonisation of securities regulation.

These preliminary steps towards convergence are important ones, and I would hope that progress can be made at both the bilateral and multilateral level in addressing them. But at the same time, we can also take other steps to tackle risks in securities trading, particularly counterparty risk.

Counterparty risk can be dealt with by imposing capital requirements in respect of unsettled bargains, providing an incentive for firms to improve their systems. But moves can also be taken to improve procedures directly. The starting point must, I think, be at a national level. Essentially, our aim should be to reduce as far as possible the gap in time between striking a bargain and settling it irrevocably. This can be done by means of delivery against payment, probably involving the immobilisation or dematerialisation of securities and their translation to book entry form. The transfer of title to the securities, on the agreed settlement cycle, would be effected simultaneously with the final payment by the purchaser, either through a real-time funds transfer system or through an assured payments mechanism with an assurance by a bank or other monetary institution that payment for the transfer will be made even if the buyer becomes insolvent. In turn, the guarantor of payment would require collateral over which he would have undoubted lien in the event of his customer's default. In other words, we should aim for fully collateralised settlement systems. Nor need our ambitions stop there. Settlement cycles could be shortened so that final payment for, and transfer of, securities would occur as soon as the necessary computer entries have been made and have been confirmed by the parties to the deal. By means of such steps, counterparty risk should be much reduced, and with it the risk that a failure by one securities house would bring down others with it.

There is a coincidence of interest here between regulators and market practitioners. On the one hand, improvements will strengthen the system by identifying more clearly the exposures to counterparty failure which present arrangements entail and by reducing their size and duration. On the other, more efficient settlement systems should reduce costs for market practitioners and their customers.

The urgent need to improve settlement arrangements applies internationally as well as domestically—perhaps with even more force. In this connection I welcome the recent initiative by the Group of Thirty to bring together practitioners from around the world to examine these issues. One way forward would be through developing bilateral linkages between exchanges and their clearing corporations in different countries, and in the process gradually building up a network of such relationships on converging principles and standards.

The settlement of international transactions may involve the transfer of title to securities held in one time zone, against final payment in the currency of a country in a different time zone. In the absence of special arrangements, this inevitably leaves a settlement risk on the two parties. This is of course a particularly complex area for practitioners, regulators and central banks. But whatever solutions are chosen, they should be designed to reduce the risk of contagion, the fear of which is one of the major reasons behind calls for convergence of capital requirements.

Desirable as the goal of convergence undoubtedly is, I do not expect progress towards it to be rapid. The matter is complex, as witness the fact that the banking regulators took more than a decade to move from the original Concordat to preliminary agreement on capital convergence. Convergence in capital adequacy for securities business will probably present a more demanding challenge, particularly if it has to satisfy the needs of both securities and banking regulators. I do not want to suggest that it will necessarily be a decade before progress is made. But a quick fix is neither feasible nor desirable. The European Community will, I hope, encourage discussions in this area. But I see the need also for wider multinational negotiations which might usefully be spurred by bilateral initiatives from time to time.