International regulatory structure: a UK perspective

*In this speech,[1] the **Deputy Governor** considers the current debate on regulatory structure—both in the United Kingdom and internationally. In doing so, he takes as given that effective regulation needs input from market practitioners if it is to offer appropriate protection to the public without stifling innovation. The **Deputy Governor** looks first at the existing regulatory structure in the United Kingdom, and the proposals for change. He explores the case for a model comprising three agencies, focused on financial services, banking, and insurance; and he argues that the synergies between a supervisory function and other central bank responsibilities continue to justify keeping banking supervision within the Bank of England. The **Deputy Governor** goes on to consider the international regulatory structure—stressing its particular importance for the United Kingdom given London's international markets. He argues that, beyond information-sharing among regulators, effective supervision of international financial groups requires consolidated supervision; he also says that the United Kingdom is keen to examine the practicability of introducing the concept of a 'lead regulator'.*

It is conventional, and polite, to say at the beginning of a speech of this kind that one is delighted to have been asked to speak about the structure of financial regulation. But I cannot bring myself to do it.

This lack of enthusiasm for the topic is, I hope, not an emotional response. It is rationally based on two prior beliefs. First, that the relationship between structure and effectiveness is loose. I know of little evidence that structural reforms are quickly followed by enhanced effectiveness of the activity in which agencies are engaged. Second, I believe that regulatory structure should follow market structure, rather than the other way round. Regulators should respond to changing markets which, in turn, respond to changing customer demand and new product availability, rather than seeking to dictate either. So we should always ask ourselves whether the regulatory framework we adopt makes sense to market participants, rather than requiring them to structure their business to fit some government-imposed view of how product delivery should be organised.

But I recognise that, in practice, we cannot avoid constant attention to the maintenance of the regulatory framework. Though good structure will not necessarily generate effectiveness, a faulty, out-of-date framework will certainly make it very hard for regulators to do their job well. And, of course, our financial markets are heavily conditioned by the legislative and regulatory framework in which they have developed. (That is particularly true in the United States. It is hard to imagine that, absent Glass-Steagall, Regulation Q and all the rest, the financial landscape in North America would look as it does today.) So I conclude that the debate on regulatory structure should be a constant dialogue between the markets and the regulators, but with a prejudice in favour of the former. Our ultimate task as regulators is to ensure that markets work efficiently, and in the interests of consumers.

Against that background, how is this dialogue proceeding in the United Kingdom at present?

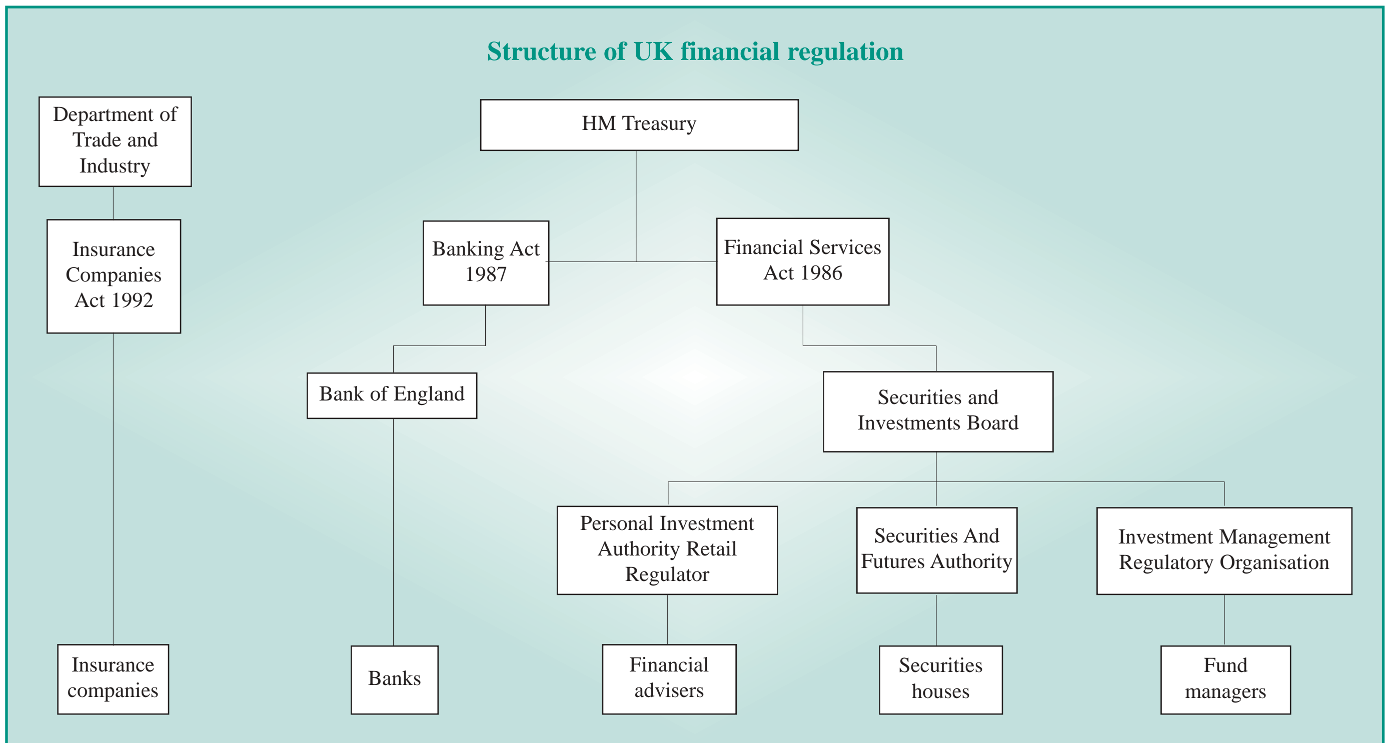
I should first say a little about the objectives we see for financial regulation. We think of five: to protect the economy against systemic risk; to protect individual depositors, investors and insurance policy holders against loss from the failure of their intermediary; to protect customers against business misconduct; to assist society at large in the fight against crime (for instance by making sure that firms have in place systems to detect and report laundered drug money and other proceeds of organised crime); and, last but not least, to create and sustain fair markets.

Described bluntly, these objectives make the job of regulators look impossibly daunting. But of course they are not absolute aims. Regulators cannot, and should not, offer blanket assurances to investors and depositors. They cannot, because the tools and resources to do so are simply not available. And they should not, because it would be quite wrong to remove from investors and firms the responsibility for assessing, taking and monitoring financial risks. This is a very important point, which Alan Greenspan has helpfully underlined on a number of occasions recently.

UK regulatory structure and proposals for change

Across the world we see a lively debate on how the regulatory cake should be cut. There has been change in France. The Australian Government has set up the Wallis Commission to look at the institutional arrangements there.

(1) Given at the Federal Reserve Bank of Atlanta 1997 Financial Markets Conference, on Saturday 22 February.



Reforms are in progress in Japan, and here in the United States there are proposals for change. Similarly, in the United Kingdom, a number of proposals have been put forward to amend, or in some cases fundamentally reorder, our regulatory structure. But before describing these proposals, perhaps a brief description of the British system would be in order.

Responsibility for financial regulation in the United Kingdom is divided between two government departments. Most falls to the Treasury, but prudential supervision of insurance companies comes under the Department of Trade and Industry (DTI). The DTI carries out its supervisory responsibilities using its own staff; the Treasury, on the other hand, sets the legal framework and policy directions for regulation, but leaves most of the detailed regulatory functions to others. Under the 1987 Banking Act, the Bank of England carries out prudential supervision of banks. Under the 1986 Financial Services Act, the Treasury delegates its powers to the Securities and Investments Board (SIB), which in turn recognises a number of front-line regulators.

These front-line regulators cover different sections of the market. One, the Securities and Futures Authority (SFA), is responsible for securities houses; another, the Investment Management Regulatory Organisation (IMRO), for fund managers. These two regulators undertake both prudential supervision and conduct of business regulation. The third, the Personal Investment Authority (PIA), is responsible for the retail sector, and has principally a conduct of business remit though it is also responsible for the prudential supervision of independent financial advisers (IFAs). So, in effect, there is a layered approach to the regulation of financial services in the United Kingdom, with different powers held at each level.

(To complete the picture, the Building Societies Commission supervises building societies—though the largest of them are now converting to bank status. And the Department of Social Security is responsible for the supervision of occupational pension schemes.)

This brief description of the legislative framework might lead one to suppose that the UK system is primarily statutory—yet the securities side is often described, at least by comparison with the US system, as one of self-regulation. Indeed, some argue that it is excessively so and therefore unreasonably lax.

We would reject that last charge. And, in practice, the distinction between statutory and self-regulating is not black and white. The UK system has elements of both. Prudential supervision of insurance firms is carried out directly by a government ministry, which is unambiguously government regulation. Banking supervision is carried out by the Bank. Constitutionally, this is not ‘government’ regulation, but rather regulation by a public body authorised by a specific Act of Parliament. Certainly no one describes what we do as self-regulation, even though the Bank is itself a bank.

On the investment side, the picture is more complicated. The SIB’s governing board includes people who are active in financial services, but they are appointed by the Treasury and the Bank (indeed I am one of them) and are required to act in the public interest. Again, this does not look like self-regulation. But the Act itself calls the various front-line regulators ‘self-regulating organisations’ (SROs). Their boards include a high proportion of active practitioners, elected by the industry to represent its views. Practitioners are also heavily involved in policy discussions, rule-making and enforcement. But like the SIB, the SROs operate

indirectly under statute, and have a duty to regulate in the public interest.

So we have no self-regulation in the strict sense, but rather a variety of statutory and statute-backed bodies with practitioner involvement, each with different relationships with the industry and government. Effective regulation needs input from market participants if it is to offer appropriate protection without stifling innovation. But to retain the confidence of the investing public, regulators must also must persuade them that regulation puts their interests first, not those of the firms and their shareholders.

The system we now have can undoubtedly achieve an appropriate balance between market sensitivity and consumer confidence; it has, in many respects, worked well. But it has been stress-tested in some difficult episodes: the Maxwell affair, the private pension mis-selling saga, the collapse of BCCI, Barings Bank and Sumitomo. These episodes have taught us something about the strengths and weaknesses of our system, just as the savings and loans crisis and the Daiwa New York problem have done in the United States. And markets themselves have moved on. The financial landscape today is almost unrecognisable from the one which informed legislators' views in the early 1980s. So it is not surprising that there is criticism of the existing structure and pressure for change.

Critics of the existing UK system object on three counts: that the failures of the last decade demonstrate that it cannot cope with strains and crises; that it is unnecessarily complex, with overlapping and sometimes even conflicting responsibilities; and that it has failed to keep pace with changes in institutional and market structures. I do not aim today to give a comprehensive assessment of the validity of all these arguments. And, as in the United States, there is a heavy political dimension to this debate. But I would make a few observations.

The UK system is complex, though no more so than the equivalent arrangements in some other countries with similarly sophisticated financial markets. Those who argue for simplification point to duplication of function and cost, especially between the SIB and the front-line financial services regulators. There is undoubtedly a case to answer in that area, as both the SIB and the SROs would acknowledge. But the UK legislation explicitly dictates a two-tier structure.

It is also true that institutions now tend to be involved in a variety of different businesses. Banks own securities houses, fund managers and insurance companies; insurance companies are diversifying into banking, and so on. So though there should always be a lead regulator, looking at the overall position of the business, institutions still face the costs of complying with the requirements of several regulators.

But the question underlying these arguments about complexity and overlap is more fundamental. Should regulation be based around institutions (it is institutions which fail, after all) or around functions or types of business needing specialist regulatory knowledge? The UK system is organised neither along wholly functional nor wholly institutional lines. In today's markets, where firms are a mass of subsidiaries and business units, no major market participant deals with a single regulator across all its businesses. Similarly, no regulator has unique responsibility for regulating one function of each business. The insurance operation of a firm, for example, is covered by separate prudential and conduct of business regulators.

Most people involved in financial regulation would recognise this problem. But resolving it is not straightforward, as shown by the wide variety of proposals for change. Some proponents of reorganisation would like to make all financial regulation the responsibility of a single government department—the Treasury. They suggest that this would clear up accountability for the legislative framework and for the powers and sanctions in the regulatory regime, and create consistency of regulatory approach across sectors. Straightforward administrative tidiness may also be a factor. There may be merit in these arguments, but such questions are for the Government to determine.

Most of the discussion about UK regulatory structure has concentrated on the area covered by the SIB and the SROs, where the arguments about duplication of function, unnecessary cost and poor communication are most often heard. The various alternative models all feature some degree of consolidation, and some would go as far as to fold all the main financial services regulators into a single body. Others propose two bodies, each reporting directly to the Treasury, one for wholesale business and one for retail, acknowledging the different regulatory imperatives of the two sectors, especially in the conduct of business field. This would reduce the number of domestic regulators large institutions would have to deal with, and better match regulation to function.

Even more radical changes have been proposed, encompassing not only the SIB area, but the prudential supervision of banks and insurance companies as well. One model, colloquially known as 'Twin Peaks', would replace the present system with two commissions: a Financial Stability Commission, with responsibility for systemic risk, the prudential supervision of all major institutions, and conduct of business regulation of wholesale activities, and a Consumer Protection Commission, which would be in charge of conduct of business regulation in retail markets, as well as detecting market manipulation and insider dealing. It would also carry out prudential supervision of those stockbrokers and fund managers who deal with private clients, and of independent intermediaries.

Underlying this model is the contention that the traditional separation between banking, securities and insurance is breaking down and so the difference between institutions and functions is less meaningful. I am not persuaded of

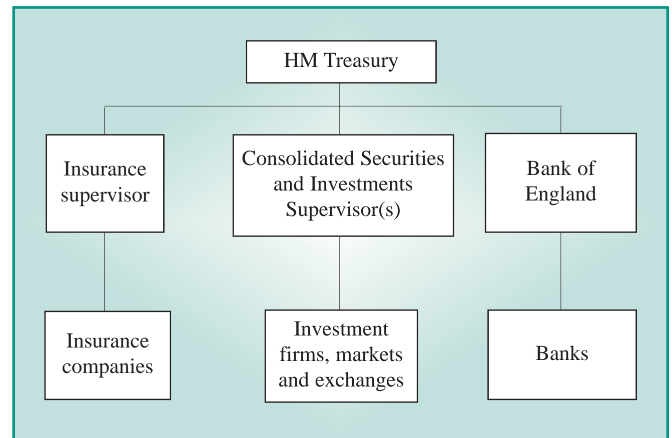
this—though the activities of banks and securities firms do overlap at the margin, this is not true of the core activities. Banks in particular continue to have a number of distinctive characteristics. First, the risks associated with the maturity transformation seen in their balance sheets. Banks experiencing a drain in their liquidity, perhaps a classic 'run', could face insolvency through the forced realisation of illiquid assets at 'fire-sale' prices. Second, there is the risk of contagion—problems at one bank can spread to others, not just through direct financial linkages but also because without timely, transparent information on bank assets, depositors become concerned about other (similar) banks. Finally, banks play a central role in payments systems, including payment flows generated by foreign exchange trading.

I conclude that there is enough that is special about banks for their prudential supervision to be retained as a separate activity in any new regulatory structure, and that this argument at present outweighs the case for change. Whether this should be a function of the central bank is a separate question. Some argue that other central banking responsibilities (such as the conduct of monetary policy) make for conflicts of interest and so supervision should not be carried out by the central bank.

I am not persuaded by these arguments either. Nor am I aware of many examples where the suggested conflicts between a supervisory role for the central bank and its other responsibilities have arisen in practice. Indeed, there are important synergies between the supervisory function and other central bank responsibilities. It makes sense for the 'micro' supervision of individual banks in the system to be carried out by the same body that carries out the 'macro' function of maintaining the stability of the financial system as a whole—stability that is essential if monetary policy is to be executed effectively and efficiently.

It is no accident that in all major countries the central bank has a significant role in banking supervision, even if in some cases others have been given the legal powers to carry out the front-line tasks. Having tried their best as supervisors to limit the likelihood of failure, when faced with it central bankers are uniquely well-placed to provide assistance to the institution in trouble, the market, or both. Those who wish to separate banking supervision from central banking must acknowledge that there are certain things that only the central bank can do, and that therefore there needs to be a strong link between the central bank and any new regulator.

The logic here might point instead to a 'Holy Trinity', rather than a 'Twin Peaks' model, with three agencies, focused respectively on financial services, banking and insurance. That might allow the most sensible, albeit incomplete, match of regulation to function and institution. It would also evolve fairly readily out of the present structure. This last point is not trivial, since the cost and disruption caused by reorganisation would be considerable and reflect the degree of change. The process would inevitably



generate uncertainty among firms and the public, and make the regulatory system more difficult to manage meanwhile.

This argues for building on the present arrangements if at all possible, rather than starting again with an entirely new structure that could take years to settle down.

Moreover, what matters to the financial system and the public is that regulators are effective. Effectiveness needs, at the very least, good communication between supervisors. Whether structural change (including bringing functions together under one umbrella) would improve communication and co-operation and so increase effectiveness is a key question, and the answer is far from clear.

We have been making considerable efforts recently to enhance communication between different UK supervisors. This has involved putting in place Memoranda of Understanding. But we have also sought to achieve cross-membership of some of our most important institutions. For example, Sir Andrew Large, the Chairman of the SIB, has become a member of the Bank's Board of Banking Supervision and, reciprocally, I have joined the SIB. Though one should not exaggerate the importance of individual appointments of this kind, they do help to create a climate of co-operation, signalling to the respective staffs of the two institutions that they are expected to work together as closely as possible, and to the outside that they can expect this to happen.

The approach to regulation in the United Kingdom

The discussion of regulatory approaches is often phrased in terms of rules versus judgment or, as academics tend to put it, rules versus discretion. Should supervisors simply set the rules, and shoot those who break them? Or does that create too rigid a framework, which stifles initiative and imagination? There is no simple answer. The Bank of England imposes an increasing number of rules: it has, for example, implemented detailed regimes for capital adequacy introduced by the Basle Committee and the European Union. We set capital requirements to cover the more readily quantifiable risks; we enforce limits on banks' large

exposures to individual counterparties; we have rules on banks' liquidity; and we seek to ensure that banks have robust systems and controls, as well as management with the skill and integrity to ensure, to use the US phrase, that the bank is 'safe and sound'.

But our judgmental approach—allowing supervisors the discretion to exercise informed judgment within approved guidelines—still contrasts with that of many other regulators. This flexibility allows us to be tough where appropriate, but to avoid inappropriate requirements. Most fundamentally, perhaps, we can ask questions, and try to use all the information at our disposal to form a judgment of the risks facing depositors and investors, as well as of the quality of a bank's management. So in addition to enforcing rules and looking for problems, we can help management. We can spread knowledge of best practice: asking banks about the full range of risks they face (including those—like reputational and settlement risk—that they would often rather ignore); and pointing out to complex groups the extent to which their managerial and organisational systems have moved away from their legal structure.

The Bank is also commonly viewed as doing relatively little on-site supervision. But this depends on how you define the term. Accountants are well aware that the Bank does, for example, make extensive use of reports prepared by auditors—who, of course, operate on-site—to assess the adequacy of internal controls. In particular, the Bank regularly instructs banks to appoint reporting accountants to report on systems and controls, and on the accuracy of prudential returns.

The Bank's supervisors also spend a growing amount of time on-site. Since 1986, Review Teams have carried out focused visits to banks to evaluate the risks in an institution as well as the systems in place to identify, monitor and control them. And in 1995 we introduced a Traded Markets Team to focus on banks' pre-processing models, which can be recognised under the CAD (Capital Adequacy Directive), as well as sophisticated risk modelling techniques used by the banks to manage treasury activities. These teams make short, highly focused visits to banks, based on a great deal of preparatory work, not just between team members and the line supervisors but also by the bank itself in providing detailed answers to a series of questions.

The Bank has also recognised the need to be more systematic in its approach to risk assessment and has announced its intention to introduce a more formal approach, known as the RATE model, to identify—using a series of qualitative and quantitative measures—the risks faced by each bank. RATE is an acronym for the three stages of the process: Risk Assessment, Tools of supervision and Evaluation. By performing periodic risk assessments, we shall aim to gain better understanding of the quality of management, the characteristics of the business and the risks the banks face. The greater degree of consistency across banks in the new approach will allow the Bank to be more focused in performing its supervision: the tools of supervision will be targeted at the areas of greater risk and concern in individual banks.

A better understanding of the risk profile of each supervised institution will assist the Bank in setting risk asset ratios. As you all know, Basle sets a minimum capital ratio of 8% of risk-weighted assets. The 8% ratio is sometimes interpreted as a 'one-size-fits-all' standard. But the Bank sets the trigger capital ratio for each authorised bank at, or above, the 8% floor and considers adjusting that trigger ratio whenever it sees a substantial change in the bank's risk profile.

Where does this all leave us in comparison with other regulators? I suggested earlier that our flexible, judgmental approach is somewhat distinctive. But we are no longer, if indeed we ever were, outliers on the supervisory spectrum. While the Bank has decided to implement a more systematic approach to risk assessment, other supervisors—who traditionally operate a rule book—are (in a fast moving market place characterised by rapid product innovation) moving towards regimes with more scope for supervisory judgment.

But this convergence does not necessarily mean that international supervisors are right. They may all be converging on an inappropriate model. Indeed some would argue that regulators do as much to create problems as to solve them: that regulators create perverse incentives—even as we speak bankers may be designing products purely to exploit anomalies in our rules. Why not let the market regulate itself and concentrate on rules of disclosure, obliging banks to publish accurate information on their capital adequacy and risk profiles, and leaving the rest up to the market—perhaps with some safety net for small depositors and investors?

To answer that question, it may be helpful to go back to first principles. Back in 1958, Modigliani and Miller demonstrated that in a frictionless world a firm's capital structure cannot affect its value. In the real world, however, departures from the M&M assumptions—such as taxes, bankruptcy costs and agency costs—may influence the capital decision of any firm; capital may after all be costly. Furthermore, banks differ substantially from most other firms because their soundness and safety is crucial to maintaining systemic stability; without (costly) capital requirements some will exploit their position by taking large risks with little of their money, in the hope that the taxpayer will bail them out. In other words, some may believe that they are (partially) insulated from potential market discipline. So from a regulatory perspective, banks must be required to have capital to absorb the possible losses that result from risk-taking and still remain solvent.

It is tempting to conclude that the only problem is a perception of a government-funded safety net for large banks; remove that and our problems will be solved. But systemic risk cannot be wished away that easily, even though the UK regulators have shown that they do not

rescue every bank that gets into problems. So while we try to stay clear from ever more detailed rules, we do not believe everything can be left to the market; certain minimum 'regulatory' capital standards are in our view necessary. Of course, we must aim for a credible and comprehensible regime that does not require constant updating and elaboration, is not immensely costly, and is reasonably consistent. The value-at-risk (VAR) approach is an attempt in that direction. It recognises that there is a crucial role for judgment in supervision and does not prescribe the key qualitative factors in legalistic detail. But it does set out the parameters to ensure that there is a framework to deliver broad consistency and also some degree of prudence.

Some have argued that regulators should go further than the VAR approach: rather than defining the key parameters and endorsing particular model types, why not leave it to the banks, and give them an incentive to improve their internal models as much as possible? Under this pre-commitment approach a bank would specify the maximum portfolio loss on its trading activities and this would become the institution's market risk capital requirement. Banks exceeding their pre-committed maximum loss would be penalised, for example through financial penalties or corrective supervisory action.

In some ways pre-commitment can be seen simply as a means of ensuring that supervisors work with the grain of a firm's business, and monitor ratios that are seen as meaningful by management. To that extent, we support it. But there are potential drawbacks. It could amplify the moral hazard problem: if the bank wins, its shareholders—as well as its traders under their bonus packages—pocket the profit, and if it loses, the regulator/taxpayer ends up with the bill. A penalty would not act as a deterrent to a bank prepared to gamble its capital because that bank would not be affected by such a penalty when it failed. And regulators could over time become less familiar with banks' risk management systems, which might make them less effective in a crisis. Early supervisory intervention is more difficult if supervisors only become aware of problems after the limit has been breached. It may be possible to devise an approach to pre-commitment that avoids these potential handicaps. But for now our attitude remains somewhat hesitant.

Finally, a discussion about rules is not complete without touching on the question of a 'level playing field'. When banks and securities houses do similar business it seems only fair to apply similar capital rules. But the total business of banks and securities houses is still vastly different. Much of a bank's regulatory capital is held against credit risk. By contrast, securities houses invest primarily in liquid, marketable assets, with illiquid assets typically only 2% or so of the total, and the bulk of a securities firm's regulatory capital tends to be held for market risk purposes. So it is not obvious that we need to set the same detailed rules for banks and securities houses. That is not to say that we should entirely ignore differences in supervisory regimes, but rather that we should focus on areas where those differences are on a scale that seriously distorts competition. In other words, we should spend rather less of our time discussing risk weights, and rather more discussing risks.

Globalisation and the regulatory response

How far do these general principles, which I have discussed so far in relation to the United Kingdom, apply to regulatory structures in a global environment? The biggest institutions now span 50 or more countries and may have 300 or more entities within the group. This has been a feature of banking since at least the 1970s. But, partly owing to the development of whole-book VAR models, firms are now also tending to centralise the controls and management for all these far-flung entities, consolidating similar risks being run in different subsidiaries. This leads to a matrix management structure, and allows the head office to exercise much stronger control over the volume of a particular type of risk being run across the group. (For example, for some UK banks, the management of their global foreign exchange book will be in London during London office hours, then it will switch to the US operation but under strict limits set by London; after the United States close it will move again, to the Far East, but still under the control of limits set by London.)

So for global groups, the control of the activities in the various scattered legal entities now hinges on the adequacy of centrally located controls. In a way this is simply an extension of the vulnerability of banking entities to problems arising elsewhere in the group, but in this case, solvency of individual entities will depend on the adequacy of systems and controls located elsewhere.

One obvious question is why firms do not dispense with such a plethora of legal entities and operate a simpler branch structure. The answer seems to be that differences in tax structures and even regulatory requirements in some countries still encourage the use of legal entities in different jurisdictions.

I do not think that the regulators should try to discourage greater central control of risk: where a firm is running one type of risk in different locations it must make sense for the total risk to be controlled centrally. But this does create a problem for supervisors, because supervision has to be structured along legal entity lines (given that it is legal entities that fail), and each supervisor must therefore take a view about the soundness of the entity in its jurisdiction, even where this hinges on controls located elsewhere.

Regulators' first response to centralised controls has been an increased focus on information sharing, and on agreeing respective responsibilities. In the banking sector, at least, they have also supplemented solo supervision of individual entities with consolidated supervision of groups as a whole. The initial focus of the Basle Committee on Banking Supervision, set up by the central bank governors of the G10 countries in 1974, was to define the role and responsibilities

of home and host supervisors of internationally active banks. These were set out in the 1975 Concordat, which has been updated on a number of occasions since. Securities supervisors too have a long tradition of international co-operation, including arrangements for information sharing and mutual assistance in enforcement, with IOSCO playing a key international role. There is also a long history of discussion between Basle and IOSCO.

Individual supervisors in both the banking and securities industries have chosen to reinforce co-operation arrangements through formal bilateral agreements with their overseas counterparts. Partly as a consequence, there has been an increasing number of informal meetings between line supervisors with operational responsibility for different parts of financial groups.

The importance of international regulatory co-operation is now widely acknowledged and is on the agenda of inter-governmental meetings. At last June's G7 summit in Lyon, the heads of state called for maximum progress before the Denver summit in June 1997 on 'enhancing co-operation among the authorities responsible for supervision of internationally active institutions, importantly by clarifying their roles and responsibilities'. Ahead of the Lyon Summit, Basle and IOSCO announced a joint initiative to strengthen co-operation in this area, referring to the work of the Joint Forum of banking, securities and insurance supervisors, set up to promote information exchange on international financial conglomerates and consider establishing for each a lead regulator.

The need to meet the challenge of supervising multi-functional global financial conglomerates is particularly significant for the United Kingdom because of the extent to which the London markets are international. The failure of one or more major overseas firms may cause systemic problems in London, where at the end of last year overseas banks accounted for 57% of the total assets of the UK monetary sector, with US banks contributing 8%. Moreover, almost three quarters of the 478 banks taking deposits in the United Kingdom are branches or subsidiaries of overseas financial institutions, including 37 from the United States. US firms have, of course, particular importance in certain markets. Our April 1995 derivatives survey showed US firms (including securities houses) accounting for around 40% of turnover in both foreign exchange and interest rate derivatives.

One can argue that an individual regulator can successfully meet his own objectives by seeking to build firewalls between his entity and the rest of the group to which it belongs. These might include restrictions or even prohibitions on both financial exposures and operational interlinkages. In addition capital adequacy and other requirements might be set at a more onerous level than if the potential for parental support was taken into account.

Such measures may be the best that can be achieved at present; they certainly provide host supervisors with a measure of comfort. But they are, and always will be, a second best. For example, there will always be a risk of reputational contagion. Counterparties might refuse to deal with a member of a failed group because they fear that the firewalls may be flawed, or that cultural or control weaknesses are repeated in that entity also. Second, as the firm will incur additional costs to comply with these ring-fencing arrangements, while possibly at the same time being denied the risk-reducing benefits of group-wide controls, it is unlikely to provide the most efficient solution. Concern about these deficiencies has heightened as we have learned more about how many global financial groups are managed. The lack of overlap between legal entities and the management of business lines means that the amount of true ring-fencing possible for a globally managed institution is open to debate.

The Bank has always believed that effective supervision of financial groups must involve consolidated supervision. As Alan Greenspan said in his recent testimony to the Congressional Sub-Committee on Financial Institutions and Consumer Credit, 'Risks managed on a consolidated basis cannot be reviewed on an individual legal entity basis by different supervisors'. It is important to define the term 'consolidated supervision'. The underlying philosophy is that for, say, a bank operating in a large financial group, one must look not only at the soundness of the bank itself but also of the group as a whole. This requires both a quantitative and a qualitative assessment.

The quantitative element involves examining the financial strength of the whole group. The basic measures are capital adequacy and large exposures. At the Bank, we look at these against the minimum standards set out in the EU Directives and against the more stringent criteria that we have developed and apply to individual banking groups to take account of their particular circumstances. It is worth noting that the EU Directives and the Basle Capital Accord both set these minimum standards on a consolidated basis only.

The qualitative element involves assessing factors such as the group's risk management process, internal systems and controls, capability of key personnel, culture and business strategy. Any supervisor will hardly need reminding that, in the Barings case, weaknesses in a subsidiary in just these areas brought about the collapse of the parent.

Consolidated supervision is a relatively widely understood concept involving the range of activities set out above. Alan Greenspan has also talked of 'umbrella supervision', which he described as a 'realistic necessity for the protection of our financial system'. I also referred earlier to a 'lead regulator', though the term 'co-ordinating supervisor' is gaining currency in some quarters. As noted, one of the tasks of the Joint Forum is to define this role, on which there have been extensive discussions. Among the possibilities suggested have been:

- Carrying out a quantitative and qualitative assessment of the group as a whole;

- taking a primary role in managing emergencies;
- facilitating the exchange of information between the relevant regulators in a group; and
- (in the longer term) considering how supervisors' efforts could be better co-ordinated when looking at (for example) controls.

It should be stressed that the existence of either a lead regulator or a consolidated supervisor in no way affects the legal responsibilities of the individual regulatory authorities for regulating the different group entities. The objective is not to shift the balance of supervisory responsibility from host to home supervisors. Rather, the intention is that each host authority should be able to carry out its responsibilities more effectively by relying to some extent on the work of others.

We are keen to examine the practicability of allowing one co-ordinator to carry out the role defined above. Enthusiasm from the United States has been more muted, although commercial banks are, of course, already subject to consolidated supervision; I know there are political issues at stake too. I would hope, nevertheless, that these important issues can be considered carefully.

Conclusions

Though I have attempted to identify some features of regulation on which we might well agree, I doubt whether there is such a thing as an 'optimal' regulatory structure. Each country has its own legacy of supervisory structures and approaches. But an appropriate international structure is one that works as seamlessly as possible and has clear lines of responsibility (at least, that is what we expect from international banking groups' controls). One co-ordinating regulator for each institution could play a crucial role in such a structure. The number of regulators is, in my view, less important. No one has yet suggested that we should set up one body worldwide to carry out all supervision. So whatever our own vision of an optimal regulatory structure, it will have at its centre a requirement for supervisors from different disciplines and in different countries to communicate effectively with one another. This weekend's conference is a good opportunity to do that.