Federal Financial Analytics, Inc.

EU FINANCIAL SERVICES ACTION PLAN:

Promise and Problems from a U.S. Perspective

Testimony Before the

Financial Services Committee

United States House of Representatives

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It is a pleasure to appear at a hearing scheduled in 2002 to consider a plan that the European Union believes will demonstrate its competitive impact by 2010. Ordinarily, Congress considers developments as complex and uncertain as the European Union Financial Services Action Plan (FSAP) only as their impact is fully felt — or sometimes even later than that. Congressional review now will ensure that policy-makers have a clear and anticipatory view of the potential costs and benefits of the Plan, allowing U.S. interests to be represented long before any confrontation with our good friends across the Atlantic might be necessary. This hearing also will help those in the U.S. who have yet to focus on the EU Plan from their own institutions' perspective or that of the financial services market more generally.

Today, I would like to highlight the likely benefits of transformation of the European Union into a single financial market. The changes proposed will, in general, make the EU financial system far more efficient, thereby serving consumer and economic development needs far better than the divided and often-anachronistic current system can do. However, it is vital that these reforms ensure the safety and soundness of the overall EU system to prevent systemic risk. Further, the proposed changes should promote EU competitiveness without creating implicit barriers to trade in financial services that harm the fair competitive power of U.S. companies. U.S. policy on trade in financial services has traditionally been set by several, sometimes competing U.S. government agencies, and the

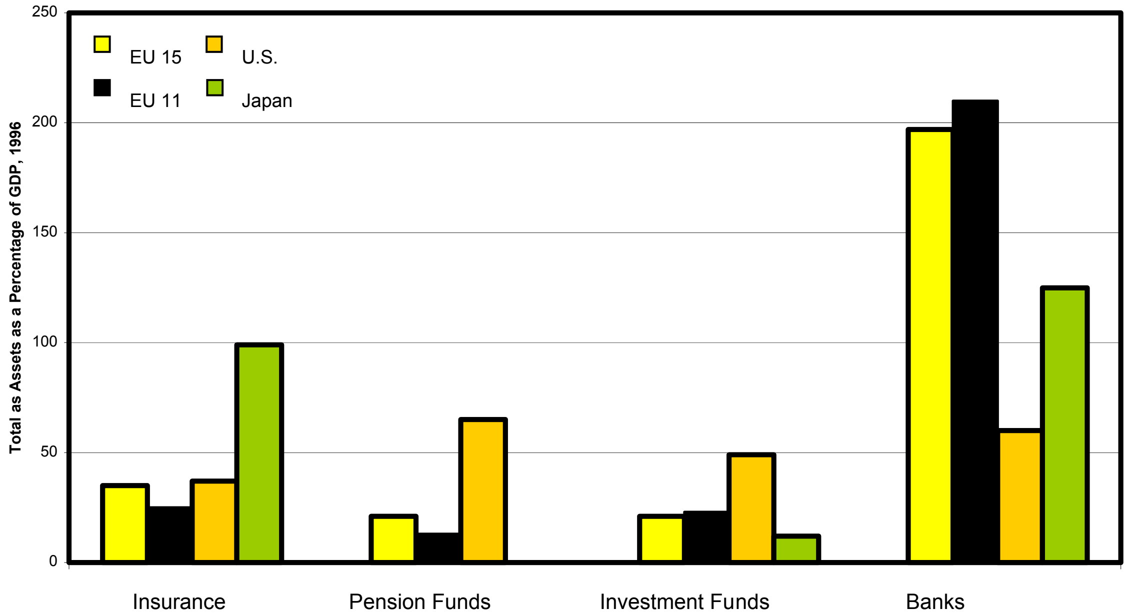
Committee would do well to look into ways to ensure that the U.S. interest is clearly represented in this critical segment of the U.S. economy.

I. The EU Plan

Other witnesses have already provided the Committee with a thorough description of the FSAP, as well as of the complex way in which the EU will consider and adopt it. One can only say that it makes the process of changing U.S. law look like a slam-dunk. The legislative and non-legislative measures under consideration (over 40 in total) cover the entire range of financial issues — spanning from dictating how on-line banking will be offered to standards redefining securities settlement, pension law and a wide range of associated technical and tax issues.

It is important to note that the EU plan envisions reform for a financial services industry structured in a strikingly different way from that in the U.S. Thus, as I shall discuss in more detail below, much of the EU plan is based on the dominant role of banks and the long tradition of bank regulation. The chart below demonstrates the dominant role of banks as financial intermediaries in the EU, in contrast to the far more balanced relationship between banks, investment houses, insurance companies and other providers of financial services in the U.S. As noted, industry structure in Japan is also sharply different than that in the EU and U.S.

Importance of Financial Intermediaries in the EU, US and Japan



Source: CEA, EFRP, FEFSI, and OECD

As is shown, relative difference in the role of banks can be seen by comparing bank-held assets to a country's overall economy. As measured as a share of GDP, a 2001 study of bank consolidation by the G-10 found that the banking industry has been relatively less important in the U.S. than elsewhere. In three of the European countries studied — Belgium, Netherlands, and the United Kingdom — banking assets were more than three times annual GDP during the late 1990's. In other EU member countries, France and Spain in particular, banking assets were about double GDP. However, banking assets in the U.S. did not exceed 100% of GDP at any time in the 1990s, generally remaining steady at around 70% of GDP.

The EU system is not only far more dependent on banks than the U.S., but banks are also far more consolidated. The G-10 study found that the United States had many more banks and lower concentration levels than European countries (with the possible exception of Germany). In 1998, the study found that about 36% of U.S. assets were concentrated in the largest 10 banks, while 59% of the United Kingdom's banking assets were in that nation's top 10 banks. In France, 85% of assets were concentrated in the top 10.

II. Potential Competitiveness Concerns

Given that the EU system is a big bank-dominated one, it's unsurprising that the FSAP implements a bank-like regulatory scheme. However, this can raise problems for U.S. institutions, some of which may result in effective trade barriers that limit the ability of U.S. firms to continue to compete effectively in the EU. Two principle areas of concern are the pending capital adequacy standards and the overall rule governing financial "conglomerates."

A. Capital Rules

The EU FSAP calls for implementation of a revised "Capital Adequacy Directive" as part of the overall harmonization plan. This Directive, in turn, is generally derived from the bank capital rules now under development by the Basel Committee for Banking Supervision, a panel currently chaired by the president of the Federal Reserve Bank of New York and one that includes senior U.S. regulators in numerous respects. As a result, one might think that the capital rules would have no potential adverse competitive impact, but indeed they have this, as well as a potential risk for the stability of the financial system more generally.

One especially controversial aspect of the pending Basel rules is a proposal to impose a new capital charge for "operational risk." This is the risk of human or systems failure, as well as that associated with natural or manmade disasters. The most clear and dramatic case of operational risk, of course, is the September 11 attack on the World Trade Center, but other cases include day-to-day systems problems and more costly cases of internal control failure (like the recent losses due to a rogue foreign exchange trader and those related to a fraudulent metal-trading scheme). All financial services firms, of course, have operational risk. The time-honored way to mitigate it is through effective risk management, contingency planning and — to absorb the cost— adequate reserves, revenues and insurance. To date, no bank has failed due to operational risk. The proposed capital charge could well create a perverse incentive against effective operational risk management, because institutions will not be able to invest both in proven forms of risk mitigation and the new, very high capital charge. Ironically, because the capital charge may be arbitrarily based on gross income, the banks that have made the necessary investments to mitigate operational risk and are the best managers of such risk may end up bearing the highest effective capital charge.

The overall idea of the operational risk-based capital charge arose in the EU. There, bank regulators depend far more on explicit capital charges than on effective supervision. Most EU regulators do not engage in the regular, in-depth examinations to which U.S. banks are subjected, and they must instead use capital standards to insulate taxpayers from the cost of bank failures. Further, EU regulators need not worry about the potential risk associated with a perverse capital charge because they can impose it on all regulated financial services firms, thus spreading the pain more or less evenly across banks and non-banks alike.

In sharp contrast, while U.S. banks are subject to much stricter supervision, our laws permit bank regulators to impose bank capital charges — including the proposed new operational risk one — only on banks. However, non-bank firms are major players in many of the lines of business — asset management and payment processing, for example — on which the capital charge will fall most heavily. They will have a significant capital advantage over their bank competitors, some of whom may choose to abandon their banking charters or move key lines of business outside a bank. This will increase the relative riskiness of the U.S. banking system, while also placing U.S. banks at a significant and unnecessary competitive disadvantage in the EU.

The EU is also pushing for capital charges against asset securitization that could create a serious competitive problem for U.S. institutions. In asset securitization, loans, mortgages, credit cards, etc. — are structured into securities that are then held by investors, freeing lenders up to make additional loans to new borrowers. The U.S. is the dominant provider of asset securitization services around the world, reflecting the high degree of technical innovation in the industry. Perhaps because of this, EU participants in Basel are working hard to enact a very high asset securitization capital charge, while at the same time pressing aggressively to lower the capital charge for certain whole loans held on their portfolios, not securitized. The risk is the same, with only the structure made different through securitization, but the risk-based capital charge would be very different.

Punitive capital charges on asset securitization and operational risk would permit EU regulators to substitute a capital requirement for effective supervision, while at the same time hindering U.S. competitiveness at home and abroad. They therefore should be omitted not only from the Basel risk-based capital rules, but also from the EU FSAP.

B. Conglomerate Rule

Another potentially problematic aspect of the EU FSAP is its proposed new regulatory structure for financial "conglomerates." Under the proposal, all companies doing business in the EU — including U.S.-based ones — will be required to meet holding company regulatory standards dictated by the EU. Home-country regulation will have to meet EU standards, or firms will be required to restructure all of their EU operations into a single entity with numerous barriers between them and their U.S. parent.

This conglomerate rule could create significant problems for all U.S. financial services firms not structured as financial holding companies (FHCs). Since passage of GLBA, many non-bank financial services firms have eschewed the FHC structure because of its very bank-like nature. This is particularly true with regard to the FHC capital standards, which would now bring non-banks into a capital framework potentially inappropriate for them — let alone pose the risk of the operational capital charge outlined above. Further, U.S. law requires insurance companies to operate under state regulation, without a parent holding company governed by any specific state or federal standards. Many Europeans are puzzled by the diversity of our regulatory structure, in which firms in essentially the same lines of business can select among a wide variety of charters at both the federal and state level. However, that is the way we like it — in large part because the diversity of competing regulators promotes precisely the competitiveness that has made U.S. firms such successful competitors in the EU. Any effort by the EU to force U.S. firms into conglomerates under a single regulator here, as well as in the EU, could have significant and adverse effects on the U.S. financial services industry.

Congress should therefore monitor the EU process to ensure that the rules solely govern business done in the EU, where the EU has the full right and privilege of deciding how things should be done. Trade in financial services has long been governed by the principle of "national treatment" — that is, financial firms in a foreign country are allowed to do everything home-country firms can do, even if these powers don't match up with theirs at home. In the U.S., for example, we have long allowed foreign financial services firms with impermissible activities in their own countries to operate in the U.S. as long as they abide by our market restrictions here. The EU should carefully adhere to this principle of national treatment as the FSAP is finalized.

This is not to suggest, however, that Congress could not do more to position U.S. institutions to compete successfully in the EU. In GLBA, for example, a new "investment bank holding company" structure was established, giving investment banks a "conglomerate" option if the FSAP proceeds, as well as certain potential benefits at home.

III. Trade in Financial Services

Finally, consideration of the EU FSAP provides an opportunity to review how the U.S. itself handles questions related to international trade in financial services. Currently, responsibility for this issue is split among various agencies, with the U.S. Trade

Representative responsible for insurance issues and Treasury handling the rest. While Treasury has worked hard on trade in financial services issues over the years, giving it responsibility in this area is like asking the State Department also to handle trade negotiations. Congress rightly split trade negotiations for other industrial sectors from the State Department into the USTR to give the U.S. an agency that could take on trade issues without having to downplay disputes because of larger diplomatic or military concerns. A similar problem arises with trade powers in Treasury, given the Department's larger responsibilities.

In this Congress, responsibility for financial services legislation was rightly consolidated into a single panel, reflecting the increasingly indistinguishable structure of the industry itself. The same should be done with trade in financial services. A single agency — preferably one without competing responsibilities — should be charged with representing U.S. interests in international financial services matters, drawing on the expertise of bank regulators, the SEC, state insurance regulators and all other parties with a rightful voice in this important issue.