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South America and Emerging Risks in Banking
Florida Bankers Association
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Good evening. I am glad to be in Orlando with you all.

I've been giving a number of speeches this fall to different groups around the country. I have enjoyed talking to bankers about the future of the financial services industry and how we can better understand where we're going and what to expect - as bankers, as regulators, and as consumers.

This is very important. In the last 20 years, we've seen our economy, and the banking business, undergo profound changes - changes that have altered the economic playing field for every one of you. We've seen the number of insured institutions drop by one-third in the last 20 years. During the same time frame, there were about 1,500 failures and about 9,100 mergers.

The trends in the broader economy related to deregulation, technology, consolidation, and a focus on the consumer were mirrored in the financial services arena as well. Interest rates were deregulated. Geographic, structural, and activity restrictions were loosened. And technology played an ever-increasing role in serving customers, handling institutional complexities and managing risk. All of these changes served to transform the industry by empowering banks as well as their non-bank competitors.

These changes also led to an unprecedented consolidation in the industry - and the concentration of assets in a few very large and very complex banking firms. In 1982, the 10 largest banks controlled 25 percent of the industry's assets. This year, the 10 largest banks control about half the industry's assets. Here's another way of looking at it: the combined assets of all community banks with less than $1 billion in assets put together are exceeded by the combined assets of the three largest banks in the land.

This is a pretty significant shift. Another shift is in the transfer of what had been typical banking products to the non-bank financial services sector. This increased competition resulted in many more Americans placing their money in money-market accounts and

mutual fund shares than was the case 20 years ago. In fact, in 1982, more than 90 percent of Americans' money was in banks. By last year, that figure had fallen to about 45 percent of the overall total.

We've also seen a similar migration on the credit side. In 1980, just less than half of all credit-market liabilities were held by insured institutions. By last year, this figure had declined to about 25 percent. During the same period, mutual funds, asset pools, closed-end funds and money-market funds have seen their share of the credit pie increase from less than 10 percent to about 35 percent.

All this sometimes leads to the argument that banks are losing their piece of the pie. And it does sometimes keep me up at night. But it is important to remember - and many of you here already know this - that banks were not entirely left behind by this shift. The Call Report data continue to show that almost 2,000 banks report income from investment banking activities - including sales and servicing of mutual funds, merger and acquisition services, underwriting, and investment advisory services. It further appears that a significant portion of this shift has occurred out of the insured institution but nonetheless to an affiliate within the holding company shell.

Community banks remain healthy, too. New charters are up. Two years into an economic slowdown, we continue to see good overall CAMELS ratings, capital ratios, lower-than-expected drains on revenue from loan-loss provisioning, and increased diversification of the income stream.

This is all positive news. And given this data, it is fair to say that, while your share of the pie has never been richer, it has never been smaller either.

What should you do to deal with this trend? In talking to bankers around the country, I have stressed three points: stick to good fundamentals, be nimble and responsive to the marketplace, and keep an open mind. I cannot tell you what the marketplace of the future will look like. But I can tell you that it will be populated with institutions that wisely manage and maintain their capital, that are in tune with the evolution of the markets and consumers, and that create a culture - within their institutions - of action. Getting things done with skill and without delay - while upholding the highest standards of the business.

This is a high calling and will require quite a bit of effort on your part. But we regulators have a role to play, too. We must ensure that we are competent, we are efficient, we are responsive and we are organized to address and deal with the challenges the marketplace will throw at us. This underscores a fundamental philosophy of mine. The marketplace should decide how the business of providing financial services evolves. The regulators should work to make sure this evolution takes place in a way that protects the public's interest in a safe and stable financial system. All wisdom doesn't

reside on the regulatory side of the table - and we should not allow our internal inefficiencies to impede your ability to adapt, evolve and preserve the value of your business.

The last 20 years have been turbulent and full of challenges for you and the banking business in general. Many challenges lie ahead - and it is critical we understand as much as we can about these challenges and make good decisions together on how to deal with them.

One such challenge - for both the regulatory community, and many of you in the business - is the increasing relationship between banks in the United States and customers and markets in the international arena. I know this is a timely topic for many of you and I'd like to spend a few minutes today discussing the situation in South America.

The FDIC has a significant interest in events in that part of the world and how they impact the risk in the U.S. banking sector. While we cannot match the expertise in this room, we do have a team of risk management experts at the FDIC who specialize in Latin America, and who follow both the political and economic developments in the region.

Much has been written about the current difficulties, but I must stress that overall, for much of South America, the long-term trends have been positive. The last generation has seen significant political reforms and advances in both fiscal and monetary policy. We've seen a continuing movement away from the rule of authoritarian governments and toward more democratic processes, and the region has shown progress in embracing the model of free market capitalism.

For many South American countries, this resulted in the gradual opening of markets to foreign investment and trade. Privatization of formerly government-controlled enterprises has attracted foreign investment, particularly in Brazil. There are also encouraging examples of enhanced transparency, strengthened systems of governance, and protection of the rights of the small investor.

These are important advances. However, we all know that assessment doesn't tell the full story of what's happening in the region. We have seen this important part of the world come under significant stress - particularly in the last couple of years. Poorer nations still grapple with difficult developmental challenges. Others are, only now, putting in place the political and economic policies needed to stabilize their countries, open their markets and better serve all their citizens. Persistent high unemployment and prolonged recessions pose a threat to free market reforms, and indeed pose a threat to the advances made over the last generation.

This regional stress is of interest to the FDIC and others in the bank regulatory community. There are several components that contributed to these problems, not the least of which was a loss of investor confidence in the major economies of the region.

Argentina's problems originated with overspending. After three years of rising fiscal deficits and unemployment, in 1999 foreign investors began to seriously question Argentina's ability to rein in its spending and repay its obligations under the peso-dollar peg. Argentina's country risk premium began to rise, leading domestic and foreign investors to pull money out of the country in massive country-wide bank runs. After IMF loan packages and debt swaps proved ineffective in stemming the exodus, last December the Argentine government resorted to restrictions on bank withdrawals and the largest sovereign default in history. Finally, in January 2002, Argentina suspended the peso-dollar peg.

Brazil suffered some of the same economic problems as those we saw in Argentina, including a very high debt load linked to the dollar and rising unemployment. In Brazil, however, investors' confidence has been most affected by political concerns related to this year's election. Since Brazil's current president is ineligible for reelection, investors do not know where economic reforms will be headed under the new regime. Next week's second round of elections will definitely be a crucial event for the Brazilian economy. And the actions of the new government will have a lot to do with whether investor confidence is restored.

Overcoming economic and political problems will be an enormous challenge to the leaders of these nations, and to policymakers in the United States. But I think it is important to note that hard economic work in these countries is being done by a partnership between the international community and the elected leaders of these countries, within the confines of a constitutional order. This is a significant signal of progress that shouldn't be forgotten.

But lest you think I am skeptical about the future of South America, let me assure you that I stand foursquare with the Administration in remaining confident that every nation in our hemisphere has the potential to succeed in laying sound political foundations and establishing strong economic policies that will benefit all their citizens. That will be accomplished, as President Bush has said, by "ruling justly, investing in people, and encouraging economic freedom."

I see examples of those three principles being put into action across South America and that gives us cause for optimism as we look at the long-term prospects for the region.

Many of you here in Florida understand firsthand the importance of South America. It has been said - partially in jest - that one of the most important cities in South America

is Miami. But you all know, when it comes to banking and financial services, that this statement is certainly true.

Trade statistics alone tell the story. Florida leads the United States in exports to South America, coming in at about $6 billion in 2000. Florida alone produces almost a fifth of all U.S. goods sold to South America.

Banking exposure is significant, too. Our figures show that cross-border exposure of U.S. banks to countries in South America totaled $46.15 billion at the end of the second quarter of this year. Brazil accounted for almost 60 percent of this total. While a majority of this is in the large money center banks, economic and political issues in South America are critical to smaller institutions too. Many smaller banks in Florida have international loans or trade financing that represents a significant portion of their capital, a sizeable foreign customer base, and, in some cases, foreign ownership. Recent data from the Florida International Bankers Association indicate that Florida banks alone hold almost $18 billion worth of foreign assets, most of which are from South America. On top of that, foreign assets under management are estimated at $39 billion.

Another issue we follow closely is failed bank trends. Two recent failures involved institutions with strong ties to South and Central America. The latest loss estimate for AmTrade in Atlanta is $5.7 million. For Hamilton in Miami, the loss estimate currently ranges from $175 million to $225 million. Now you understand why we're interested - and follow closely - the events in our hemisphere.

Since January of 2002, the FDIC has joined the other bank regulatory agencies in issuing two Financial Institution Letters to banks regarding risk management and international activity.

The first, issued in March, defines the elements of an effective country risk management process. The principles include effective oversight by the board of directors, an accurate country exposure reporting system, an effective country risk analysis process, and country exposure limits. These principles will guide examiners when they evaluate the management of country risk in banks that are internationally active.

The second letter, issued in April, addressed the characteristics and potential associated risks of parallel-owned banking organizations, which is created when a U.S. bank and one or more foreign banks are affiliated through the common control of a person or group. The letter also describes the approach that will be taken to supervising those risks. I urge you all to study these documents carefully if they apply to your own banking operations.

The FDIC also established a policy in August concerning agreements that must be executed by foreign entities or individuals who seek to control FDIC-insured institutions.

These agreements are intended to safeguard our interest in making sure foreign owners are on the same legal and regulatory footing as domestic owners.

These are all steps toward encouraging effective risk management and establishing an appropriate supervisory posture in an economic world that is increasingly integrated and connected to events in the international arena. We want to leverage our resources at the FDIC to help you manage your risk in this area. If we can provide you or your bank with individual assistance in understanding our supervisory actions or in understanding the risk in the countries you're operating in, please let us know. We'd like to help.

The FDIC continues to work with banking regulators from other countries, including those in South America, to identify and address common risks. For example, we are an associate member of the Association of Supervisors of Banks of the Americas (ASBA), a group that includes bank supervisors from most of South and Central America, Mexico, the Caribbean, and Canada. We actively participate in and support ASBA's technical assistance initiatives, most recently with a training program presented in Panama this past June.

The South American situation doesn't impact all of you - I know that. Other folks will have their own challenges to deal with. We're looking at a number of them right now at the FDIC. There is the question of banking and commerce - and how policymakers are going to deal with that sort of integration. Corporate governance is an issue we're involved in - as we seek to ensure good controls as financial organizations get larger and more complex. There is the question of maintaining a good credit culture within banks across the economic cycle. There are important consumer protection questions - like privacy, tying, and predatory lending that all deserve our attention and scrutiny. And there is the coming Basel Capital Accord, which will have profound implications for risk management techniques and capital management in the larger banking organizations. These are just a few issues - I could go on all night.

My point is that the FDIC is engaged in this discussion. We recently kicked off a major, year-long study on the future of banking in America. Over the next 12 months, we intend to aggressively explore these issues and others that impact your business as bankers and ours as regulators. Given the profound changes in the financial services business over the last 20 years, it is time to take a step back and assess where we've been, where we're going, and how best to get there. I hope you will share your views with us as we go along - we look forward to your input.

Again, I appreciate the opportunity to speak here tonight. Please call on us whenever we can be of help.

Thank you.

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 9,480 banks and savings associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars - insured financial institutions fund its operations. FDIC press releases and other information are available on the Internet at www.fdic.gov or through the FDIC's Public Information Center (800-276-6003 or (703) 562-2200).

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