[The bank regulatory environment]

An Address By

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Good morning.

Once again, it is a great pleasure to be with you and to have this opportunity to share my thoughts on the bank regulatory environment.

Each year, federal bank regulators like myself are invited to appear before you. We invariably talk about the changes that are occurring in the financial services industry, and each year we talk about the industry crossroads we approach and the imminent crises that demand reasoned, yet swift, decisions. Well, this year is no different. The rate of change in financial institutions gives us watershed decisions to make on a regular basis.

Many years ago, the late and esteemed Rep. Wright Patman, as Chairman of the House Banking and Currency Committee, spoke at the dedication of the FDIC building in Washington, D.C. During his remarks he said: "We have gone too far in the direction of bank safety. Last year there were no failures at all. To me, this is a danger signal." I suspect that Mr. Patman is now happy in that "great committee room in the sky." Change has increased the risk of failure by a factor of 20.

This morning, I would like to attempt answers to some sticky questions which have been put to me by some of your membership. Even if you find my replies to be wrongheaded, uninformed, or just plain dumb, remember we are dealing with complexity and answers aren't easy, <u>and</u> that we all seek a common goal -- a sound, stable and prosperous financial system.

<u>Question one -- What about our turf problems and our divided exam program?</u>
Effective supervision in a multi-state environment raises "turf" problems on all levels, and it requires an increased reliance on the supervision conducted by others. This is true for both federal and state authorities. Organizations like the CSBS will play a vital role in this environment by promoting effective supervision and in ameliorating minor problems when they arise. Our focus must be on developing adequate and appropriate supervision.

During 1986, over half of FDIC examiner hours were spent in 3, 4, and 5-rated banks. Further, our records show that, on average, banks with satisfactory ratings are examined only about every 2 1/2 years -- and of these banks, nearly a third have not been examined in over three years. These statistics account for state as well as FDIC examinations, where there is a divided exam program. Simply put, the FDIC is not spending a great deal of time in well rated state banks.

The divided examination program points to even more state reliance. The number of states currently in the program has declined to only 18 from 32. These remaining states are pretty much operating on an informal, "best efforts" basis. This decline primarily reflects our inability to examine satisfactorily-rated banks with agreed upon regularity.

Examination responsibility for state-chartered institutions is increasingly being administered by state banking departments. We hope to see this grow. Our bank examiners are diverted to perform their duties in the larger number of banks with unsatisfactory ratings. We must take notice of this situation and design a new program. This new program should (1) promote increased state responsibility, (2) encourage joint training, and (3) provide clear responsible assignment between regulators. We welcome your input.

Question two -- What about our views on the Bush Task Force Report? I'm happy you asked me that. In short, we'd like to forget it. First, let me say that Vice President Bush and the members of the Task Group performed a valuable service. Their 1984 Report, titled Blueprint for Reform, provided a vital first step in focusing the national debate on regulatory reform issues. Reform of our regulatory and supervisory structure is needed and it will occur. The questions we now face are (1) how to best accomplish this reform, and (2) when it should be implemented.

The reform proposals were submitted to the Congress a few weeks ago as part of the Administration's omnibus trade legislation package. While the specific bank legislation has not received a great deal of publicity, let me assure you that, if enacted, the impact would be revolutionary.

Some of the more noteworthy changes include:

1. The three existing federal bank regulators would be reduced to two. The FDIC would cease to have a superivsory role for state nonmember banks. This responsibility would go to the Federal Reserve. For national banks a new "Federal Banking Agency" ("FBA") would be created within the Treasury Department, incorporating the OCC.

   The FDIC would be refocused exclusively on administering the deposit insurance system. Responsibilities for environmental, consumer, antitrust and other laws not directly related to the solvency of insured banks also would be transferred to other agencies.

2. The regulation of bank holding companies would be changed substantially. In almost all cases, the agency that regulates a bank would also supervise its parent holding company. Thus, most banking organizations would have a single federal regulator.

3. Authority to establish the permissible activities of bank holding companies would go to the new FBA, although the Federal Reserve would maintain a limited veto right over new activities.

4. The Federal Reserve would continue to supervise the holding companies of the very largest domestic banks, as well as those with significant international activities and foreign-owned institutions.

5. A new program would transfer current federal supervision of many state-chartered banks and their holding companies to state regulatory agencies, creating new incentives for states to assume a stronger role in supervision.

6. The special regulatory system for thrifts would be maintained, but eligibility would be based on whether an institution is actually competing as a thrift, rather than on the nature of its charter. Also, the FDIC and FSLIC would be required to establish common minimum capital requirements and accounting standards for insurance purposes.

The FDIC strongly endorses the goals, objectives and basic thrust of the Task Group's 1984 recommendations. Removing unnecessary federal regulatory overlap, functionalizing federal oversight, and returning primary bank regulatory responsibility to the respective state or federal chartering authority are commendable objectives.

However, I think we need to consider the fragile state of our financial system today. It is undergoing a time of serious downturn in several key economic sectors. The number of problems and bank failures are at record levels. In my view, this is simply the wrong time to embark on a major, untried and unproven, change in the federal bank supervisory structure.

It also seems inappropriate to seek radical reform of the federal and state oversight and risk control mechanisms before bank powers and future structure of the banking industry, which is now being so hotly debated, is decided. When we decide where we are going, we can decide how to supervise. "If you don't know where you are going, any road will do." We also note serious flaws in the legislation to implement the Bush Task Group proposals. One primary area of concern is the limited flexibility the legislation would give the FDIC to identify and control risk in insured institutions. The Vice President's Task Group concluded:

"Current FDIC authority to examine banks for insurance purposes should remain unchanged," and then went further to grant additional authority which would be necessary under the proposed new federal regulatory structure. This included authority to revoke insurance, assess risk insurance premiums, and take enforcement actions against <u>any</u> insured institution or its management.

The legislative proposal, however, has been constructed quite differently. For one thing, the Federal Reserve's role seems to go noticeably beyond the original intent of the Task Group members. But, most importantly, it effectively emasculates the FDIC's ability to identify, limit and control its risk. No insurance company in the private sector could function under such constraints. If the FDIC is to function as the Nation's deposit insurer, greater authority -- not less -- is needed.

Another area of concern is the proposed "Certification Program" for state banking authorities. We question both the need to legislate a complex state certification process and the rationale for designating the Federal Reserve as administrator over such a program.

The FDIC believes that reform efforts in this area should focus on <u>expanding</u> the role of the respective state banking authorities and making more efficient use of your existing programs and strengths. The benefits to be derived by creating a potentially massive new bureaucratic hurdle are not evident.

<u>Question three -- What's our position on outside auditors?</u>
Actually, this is two questions, but I'm trying to save time. One concerns our pilot program to use CPAs in the examination process; the other concerns a possible regulation requiring outside audits for state nonmember banks.

Let me take the pilot program first. As you may know, accountants from two national accounting firms will join FDIC examiners in bank examinations in our Dallas and Kansas City Regions. If the pilot program is successful, we plan to move to a competitive bid program. We hope to do that during the summer months, which tend to be slow for most accounting firms. Let me emphasize that the goal is to help us to catch up. It is a stopgap measure -- not a long term solution. It, by no means, reflects a lessening commitment to a strong supervisory force -- federal or state.

What about requiring outside audits? I don't want to overplay this because it's not far enough along. Proposals haven't totally crystalized, and no decisions have been made. However, there is considerable sentiment that once a bank reaches a certain size, it ought to have the benefit of a good, independent opinion audit. We have noted the tendency to have such audits drops off quickly as problems intensify.

At present, we are thinking of a size threshold of around $50 million. Currently, about 2700 state nonmember banks are this big, and available data indicate somewhere between 45 and 65 percent already get annual opinion audits. We also may adopt some minimal requirements for smaller banks -- perhaps an independent review of internal controls and insider lending. Again, no decisions have been made. One reason is the other federal regulators are also studying the issue. Ideally, we would have uniform treatment for state and national charter banks.

I hope you don't think we believe the outside auditor holds all the answers. The FDIC, the undertaker of failed banks, has seen too many clean audits to believe that. Consider that 70 percent of the 1986 failures that had outside audits during the preceding two years had clean opinions. Compare this to the examination process. Of those banks getting clean opinions, about 80 percent were considered problem banks at the time of their audit. This is not unusual. Our records show that all but a relative handful of banks escape problem status when examined within two years of failure.

Of course the fact that a bank has serious problems does not preclude a clean opinion. But, I would have expected a few more going concern exceptions. Nevertheless, we still see opinion audits as a valuable safety precaution. It is noteworthy that most (2/3s) of the 1986 failures did not have recent audits. And, I would also add, the accounting profession has been taking a number of initiatives to ensure quality audits.

<u>Question Four -- What is our position on an FDIC/FSLIC merger</u>?
We do not favor a merger for a number of reasons. It would be unfair to place the burden of thrift problems on the shoulders of the banking industry. Banks are no more to blame for a broke FSlIC than any other participant in the financial services industry. Or <u>any</u> other taxpayer group for that matter. Another reason for not wanting a merger is the FDIC already has enough problems to deal with. I certainly do not have to tell this group of our recordbreaking failures (53 as of last Friday, not counting two assistance transactions) and our 1500+ problem banks. These problems are manageable and I'd like to keep it that way.

Of course we cannot ignore the thrift problem, and it is in all our best interests to find a solution. We support the Treasury recapitalization proposal, and we were disappointed to see the size of the program reduced in Congress.

On the other hand, I can understand the view of many thrifts. The depth of the hole is unknown and it was dug by a relatively few thrifts. There are a lot of good, well-managed thrifts who do not see why they should fill that hole. An increasing number of those thrifts are considering becoming FDIC-insured institutions. If they qualify, we have to take them. And, FSLIC's problems will become that much harder to solve.

While it's hard to find anything positive to say, I think the thrift situation holds some compelling lessons. First, the losses have been caused by a relatively small number of high risk takers. It doesn't take many to break an insurance fund, which means an insurance fund will not survive without sound safety supervision programs and resources. Second, the losses were caused to a large degree by poor practices in granting traditional credits. Too often I hear concerns about banks getting new powers because of all the risks involved. I'm strongly inclined to believe the powers banks are seeking, by and large, pose much less potential risk than commercial lending.

Question Five (and I'll make this my last one) -- How do we feel about loan loss amortization?
I recognize a number of parties find appeal in this approach. Moreover, the Senate recently passed a provision which, if enacted, would permit agricultural banks to amortize loan losses over ten years.

The FDIC does not favor the concept of loan loss deferral and also believes it is not desirable to legislate accounting practices. Accounting should reflect the facts. What to do about those facts is another matter. As you may have heard, the FDIC plans to expand its capital forbearance. Capital forbearance will be available to all banks whose problems stem from external economic events -- not just agricultural and energy banks. We will place less emphasis on specific capital ratio levels and more on viability in determining eligibility requirements. In other words, the 4% capital requirement will be waived if the bank has a viable plan for the future. We also are reevaluating the feasibility of a net worth certificate program for commercial banks. Rather than legislating accounting, a better approach is to target forbearance to keep well-run, viable institutions in business.

Well that concludes my prepared question and answer session. And, now I will follow it up with a speech - only kidding. But, I'd be happy to answer any other questions you may have.

Thank You