

Remarks
by
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at the
Federal Deposit Insurance Corporation
Capital Markets Symposium
Arlington, VA
February 9, 1996

I see my job as Chairman of the FDIC as asking questions that may lead our highly skilled professional staff to reflect on where new directions are leading and how we should consider them. In that spirit, I see my role at mid-day in this symposium as asking questions for all of you to consider.

I will also throw out a few thoughts on supervisory issues that I have been ruminating about in the bank regulatory community and some thoughts about the progress we are making in risk assessment, as well.

It is clear that the development and use of derivatives have increased the efficiency of financial markets. Of course, greater efficiency may, paradoxically, also bring greater risk. Bank supervision inevitably comes down to practice -- where the human element -- complete with individual judgments and less than perfect knowledge -- comes into play. Faster, more powerful automobiles are, by definition, a more efficient means of transportation than slower ones, but improved drive-train technology does not necessarily result in better drivers.

We have been throwing around a lot of different numbers today. According to the definitions we at the FDIC use, in the last five years, the notional amount of off-balance-sheet derivatives at commercial banks has increased by more than 150 percent, from \$6.8 trillion to \$17.6 trillion. As bank supervisors, what are we to make of this startling growth -- and what -- if anything -- does it mean to the individual bank examiner evaluating the condition of a specific institution?

Five hundred and ninety five banks hold at least some off-balance-sheet securities, but the nine largest dealer/traders account for 94 percent of all off-balance-sheet derivatives. About 92 percent of off-balance-sheet derivatives are held for trading at some 159 banks. Another 436 banks hold off-balance-sheet derivatives for other purposes. What are we bank supervisors to make of this distribution -- and what -- if anything -- does it mean to the individual bank examiner evaluating the condition of a specific institution?

Both the income and balance sheet results of banks trading activities in off-balance-sheet derivatives exhibit considerable volatility. In the last eight quarters, trading gains and fee income attributable to these activities have ranged from as much as \$2.6 billion to as little as \$1.1 billion. Revaluation gains and losses on these contracts have produced shifts of tens of billions of dollars in asset and liability values in

a single quarter. What are we bank supervisors to make of this considerable volatility -- and what -- if anything -- does it mean to the individual bank examiner evaluating the condition of a specific institution?

The earnings impact of off-balance-sheet derivatives held for purposes other than trading has been mixed. For example, through the first nine months of 1995, 486 banks indicated that these contracts had had an effect on their net interest income, suggesting that they were being used to hedge against interest rate risk. Of those 486 banks, 315 reported lower net interest income as a result of holding off-balance-sheet contracts, while 171 banks reported higher net interest income. What are we bank supervisors to make of this mixed performance -- and what -- if anything -- does it mean to the individual bank examiner evaluating the condition of a specific institution?

Most banks -- approximately 9,400 -- do not have any off-balance-sheet derivatives, and any interest rate risk management takes place on-balance-sheet. Many of these institutions hold on-balance-sheet derivative securities. Holding on-balance-sheet derivatives can introduce considerable interest-rate risk to bank balance sheets. In 1994, mid-term -- that is to say, five-year -- interest rates rose about 150 basis points. This period of rising rates witnessed a decline in the value of all bank securities of about 3.5 percent, with the sharpest declines coming in derivative securities. The decline of industry-wide security values was equivalent to about 10 percent of Tier 1 capital. What are we bank supervisors to make of the considerable interest-rate risk that on-balance-sheet derivatives present and what does it mean to the individual bank examiner evaluating the condition of a specific institution?

These are not rhetorical questions -- we are working on the answers.

The Federal Deposit Insurance Corporation -- and our sister agencies the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision -- generate a treasury of data on the banking and thrift industries as a byproduct of regulatory and monetary policy functions. We also have an abundance of economic expertise.

Historically, however, we have found it difficult to bridge the gap that separates the macro from the micro perspective, to translate the data into directions that examiners can use in institutions with differing levels and types of risk exposures. That is the reason I created the Division of Insurance at the FDIC -- to help bridge that gap. It is an effort to find ways to enhance the examination approach we take in bank supervision.

Leveraging our statistical and analytical resources will help examiners focus their efforts so that they can increase the effectiveness of examinations and stay on site only as long as necessary to address the risks that individual institutions present. It will also provide a basis for supervisory notices to banks on economic and other macro trends that may affect the way that they do business.

At the FDIC, we have several initiatives underway to close the gap between the macro and micro perspectives. As I noted earlier, the new Division of Insurance will help join the picture of the industry

that the economic data provides with the traditional institution by institution analysis of bank examination. The new division will work closely with our examiners, economists, financial analysts and other FDIC staff -- as well as with the same types of analysts in other regulatory agencies and in the private sector -- to monitor, assess and address risk in the banking industry.

As part of the effort to close the gap, the FDICs Division of Supervision is developing ways to factor economic data into the process of risk analysis. For example, one of our projects seeks to provide our examiners with a structured and consistent approach to identifying and quantifying the level and trends of risk, while encouraging analytical thinking. Economic data would provide contexts to the examiner in addressing such questions as: Is this banks balance sheet structure short term in nature? and Do earnings and capital mitigate interest rate or other risk concerns?

As part of this process, a flow or decision chart has been developed to provide structured and consistent guidance to our examiners as they assess the level of risk. In the case of interest rate risk, for example, it will provide guidance as they assess the increase or decrease of risk that is associated with capital market holdings. Further, we have at least three corporate operating projects and one supervisory study that focus on developing the best ways to aid examiners in identifying, quantifying and communicating findings as to level and trends of risks -- be they credit risk, interest rate risk, market risk or other risks. We are working under the assumption that it is one thing to identify the major areas of risk that financial institutions face, but it is a more difficult task to develop a system that helps examiners identify, quantify, and most importantly, explain the examiners view of the level and direction of risk to bank managements and boards of directors.

A key consideration in this work is that, while our goal is to develop a system that provides structure and consistency, we encourage examiners to think analytically, as opposed to adherence to arbitrary parameters. A simple example: We do not want a structured system for credit risk, say, that has a decision point that states: Is the level of nonperforming loans less than x percent? If so, no further action is necessary.

We do want a decision point that states: Is the level of nonperforming loans increasing, decreasing or stable? This type of decision point ensures that nonperforming levels and trends are included in the analysis of credit risk, and serves as a talking point with the bank. Examiners have access to a wide variety of data, but no specific guidelines on how to factor this data into the decision making process of risk analysis.

In a credit risk decision chart, one decision point could be: What are the results of relevant economic sector studies prepared by the Division of Insurance? Does the bank utilize other sources of outside economic studies? Do all relevant sector data indicate an improving, declining or stable economic situation? Again, our projects are focusing on bringing structure and consistency to the existing risk assessment process. In addition, we are concentrating on developing systems that will encourage a proactive look by building-in proactive decision points and asking proactive questions.

We can structure this process more effectively by thorough off-site pre-examination planning in order to assure that on-site examination time is used efficiently to analyze the effectiveness of a banks system of internal controls for monitoring and assessing risk. In short, using this approach, the scope and focus of our bank examinations will become more a flow of risk evaluations -- some based on economic data -- and less a checklist of procedures to be followed.

We have several other projects underway that will support this objective.

One is a loan underwriting survey to develop information on the . level of -- and trends in -- credit risk. This survey would result in a forward assessment of current underwriting standards.

We are reviewing whether to name case managers in our supervisory regions to centralize responsibility for risk assessment decisions, which would result in more timely and accurate risk assessments and would provide one contact for bank management and other regulators. Case managers would work closely with the Division of Insurance regional economists.

Finally, a group of our field examiners is now working with our information resources management staff to develop an automated examination package, incorporating some sampling procedures. Sampling data would be used to develop some of the data for our flow, or decision, chart examination approach.

The projects I have described seek to marry concepts to practice in bank supervision.

This shifting of emphasis toward risk assessment, of course, is not completely new at any of the bank regulatory agencies. These concepts have been developed on an inter-agency basis over time. No one in this group needs to be reminded that -- almost two years ago -- we instructed our examiners to analyze derivatives and off-balance-sheet activities by assessing the risks they pose to institutions, and in particular seven risks we identified. We noted then that most of these risks are present in varying degrees in more traditional financial institution products and activities, and can largely be assessed and evaluated in similar fashion. All bank supervisors are indeed turning toward that wider application.

The traditional CAMEL rating system involves risk analysis. The analysis, however, is not as systematic as it could or should be. It can vary by examiner, the field office or the regional office across the banking agencies. I do not think that we should scrap the CAMEL rating system -- although we may want to produce the next generation of CAMEL. Its contribution has been in providing a banks management and its board of directors with a context in which to judge an institutions performance against a benchmark standard, as well as serving as the strongest predictor we have now of a banks likelihood of failure, even if the lead time is not always as great as we would like.

I believe the system would be improved if our examiners disclosed the individual component ratings of the overall CAMEL rating of an institution to its management and board of directors -- as 12 states currently do. I believe it would put boards of directors on notice of problems in individual components

before an overall rating drops and it may add more discipline to board review of the management of individual banks.

Derivatives -- a spectacular increase in the efficiency of financial markets -- encouraged a re-examination of bank supervision.

The need to assess the risks that derivatives pose in some measure has led us to take a new look at risk assessment generally. Innovation in the market is bringing about innovation in supervision. This symposium is an important part of that effort. It is providing the FDIC -- and our colleagues at our sister agencies -- with a greater understanding of market developments. That understanding will be put to good use in promoting the safety of the deposit insurance funds and stability in the financial markets.

Last Updated 06/28/1999