

Remarks
by
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before the
Institute of International Bankers
Washington, D.C.
March 4, 1996

In 1974, the collapse of Bankhaus Herstatt reminded us that a global system of financial institutions is only as strong as its weakest component. The failure of Herstatt -- a small bank in Cologne -- temporarily halted the Clearing House Interbank Payments System (CHIPS). In the words of Institutional Investor "its failure to meet its obligations to other banks nearly undermined the entire interbank payments system." Four months later, the closing of the \$3.6-billion-in-assets Franklin National Bank in New York taught us that we could no longer assume that no large American bank could fail. With those two failures, the American Banker said, "the fragility of the emerging global market became painfully clear."

By contrast, when Barings Bank failed last year, the global financial markets took note, and continued to operate smoothly, efficiently, and effectively. No panic in the international financial community ensued.

The world of 1974 and the world of 1995 were, in many ways, different places. One of the more significant ways they differed was in the closer consultation among supervisory agencies in 1995. Just as banking supervision on a national level produces confidence against systemic collapse, international cooperation gives greater global assurance of stability.

The failures of Herstatt and Franklin twenty-two years ago -- the fragility they revealed -- were two of the events that prompted national banking authorities to create the Basle Committee on Banking Supervision.

Global markets made cooperation among regulators imperative - - money knew no boundaries - and that meant that bank supervisors had to function more effectively across borders. There was no choice. It was necessary to find common approaches to international supervision over a range of institutions and national regulatory systems that differed widely. We had to develop principles such as consolidated supervision and structures such as capital requirements that

would pull the disparate systems into the same sphere. The structure that was built made it less likely that one irresponsible institution could trigger a systemic meltdown.

Complacency, however, has no place in bank supervision. In a fast-moving world of telecommunications, financial innovations and capital mobility, we must continually ensure safeguards, standards, and systems necessary to monitor and contain risks. Today's markets -- and financial institutions -- move quickly.

Given the technical and technological sophistication and orientation of the financial markets, it is striking how much they -- and international banking supervision -- rest on the human factor. Neither markets nor supervision would work if the participants did not cooperate. Neither markets nor supervision would work if the participants did not trust each other.

Sometimes that trust is betrayed.

Last year the Daiwa Bank revealed a loss of more than \$1 billion from trading activities in its New York branch. Later, it revealed a loss of \$97 million in its New York trust company during the mid-1980s.

It soon became clear that despite the success of international bank supervision in maintaining confidence, there had been a breakdown in the supervisory system. That breakdown arose from a breach of trust -- a conscious effort over time by senior Daiwa managers to deceive regulators about the losses. Simple fraud was compounded by collusion, which made the detection of various fraudulent acts more difficult to discover in bank examinations.

A bank examination is based on the books and records of a bank, statements made to the examiner by bank officials, and information obtained from other reliable sources. Like a medical examination, a bank examination is a disciplined look for warning signs. Where warning signs are concealed, examinations may not find significant problems.

U.S. federal and state regulators ordered Daiwa to terminate operations in the United States not because our citizens lost money -- none did -- nor because the FDIC insurance fund sustained losses -- it did not -- nor because Daiwa lost a lot of money from trading activities.

U.S. regulators withdrew the privilege granted Daiwa to operate in the United States because the bank betrayed our trust.

Trust is the cement that binds both the financial structure and the regulatory structure together.

Consider the alternative -- supervisors policing every aspect of the industry -- with every decision by every manager being suspect. None of us would find the alternative acceptable

. Bank examinations focus on detailed answers to the simple question: how good a job does this institution do in knowing, assessing and monitoring the risks that it faces? An examination is more than an inspection -- it is a qualitative evaluation -- ultimately an evaluation of the quality of management. Without communication between bank management and examiners -- communication in good faith -- the process will not work as it is intended.

Examinations are sometimes confused with audits. Audits are conducted to verify the numbers in an institutions financial statements and accounting records, and to provide an extensive evaluation of an institution's internal controls.

Audits have a somewhat greater tendency to detect fraudulent activity than do bank examinations, but even a complete audit may not expose deceptive practices.

To audit every bank in the country, U.S. supervisors would have to create an army of auditors -- and the benefits derived from doing so would not warrant the increased regulatory burden of imposing such comprehensive reviews on healthy, well-managed institutions.

Fortunately, experience has shown that mutual trust can be an effective, if not perfect, foundation for the operation of markets and for bank supervision.

Experience has also shown that -- in developing bank regulation -- dialogue between a bank and its supervisor will enhance, not impede, supervision by assuring that regulation comports with the facts and the real world.

Accordingly, bank supervisors around the world have increasingly opened up the process of developing bank regulations to the reasoned views of other market regulators and the private sector. In recent years, the Basle Committee has recognized the value of including the views of other financial regulators and the private sector in its deliberations on international supervision.

I commend Dr. Tommaso Padoa-Schioppa, the president of the Basle Committee, for his leadership in this effort.

As you know, the Basle Committee broke new ground recently in formulating capital charges to market risk by responding to the private sector's request that banks be allowed to use their own internal models to measure these risks.

Several large, internationally active banks participated in testing the internal market-risk methodology. They ran a test trading portfolio through their models and reported the results to the Committee, along with analyses and suggestions for improvement.

A second test of the internal market risk models produced results that gave policy makers sufficient confidence in the methodology to endorse the internal model approach. The successful interaction between the Committee and the banks in these testing exercises resulted in what the committee recognized as a "significant innovation in supervisory methods."

Federal banking regulators in the United States have long sought reasoned views from the private sector in developing U.S. regulations. For 50 years -- since the enactment of the Administrative Procedure Act in 1946 -- our laws have spelled out detailed procedures for proposing regulations and receiving public comments on them. We have also long considered regulations in public deliberations. Better regulations have been the result. Working together in the regulatory process has enhanced trust.

Just as trust is indispensable to banks if they are to attract customers and retain them over the long run, trust is indispensable to supervisors if we are to communicate and work with supervised institutions most effectively.

Because trust can be betrayed, however, banks maintain systems of internal controls and conduct audits, and bank supervisors conduct examinations. Because trust can be betrayed, supervisors retain the power to compel.

The privilege of any bank to operate in the United States carries with it obligations -- among them the obligation to maintain accurate records and financial reporting, the obligation to maintain adequate internal controls for assessing risks; and the obligation to maintain the utmost credibility. While cooperation in international bank supervision has made it less likely that one institution could trigger a systemic meltdown, we U.S. regulators must still deal with the institutions -- foreign and U.S. -- that betray the trust placed in them and the privileges granted them.

Last year, the FDIC began a top-to-bottom review of how the FDIC supervises the international banking activities of federally insured institutions -- both the U.S. operations of foreign organizations and the international operations of U.S. banks. As part of this effort, we will establish a special unit within our organization with expertise in international banking.

In these efforts, we know that we have to strike a balance -- we take care to assure that, by legislation, by regulation and by supervisory practice, we do not put foreign banks at a competitive disadvantage in relation to our domestic institutions.

We value your presence here.

From its beginnings, the United States has been open to international finance -- not surprisingly in that we were a debtor nation during the formative part of our history when we were, to use a modern term, a developing nation. To a large extent, international capital financed our revolutionary war, our railroads and our early factories. As a beneficiary, we saw the virtue in the international flow of funds.

Today, in the U.S. foreign banking organizations hold 21 percent of banking assets and hold 30 percent of all bank loans to U.S. commercial borrowers. You are a large part of the U.S. banking system.

A threat to the integrity of the U.S. banking system is a threat to all of you who act in good faith. You have a direct interest in seeing that the bad actors are identified and that the threat they pose to you is addressed.

The coda to the collapse of Franklin National 22 years ago is apt. Those of you with long memories know that the FDIC resolved the failure with a purchase and assumption transaction - - and that the winning bidder was European-American Bank, a New York-chartered bank that was a subsidiary of several very large European banks.

A domestic bank failure triggered international worries -- and an international solution ultimately resolved the domestic failure. The circle closed. The FDIC learned a number of lessons from the Franklin failure -- and one was that the U.S. banking system can benefit if foreign banks or their U.S. subsidiaries are a part of efforts to resolve problems and crises.

The greater lesson was also clear: we are all in this together -- or, as the former head of state of Canada once put it, we may be in different boats, but we are all afloat on the same lake.

We here today come from many different boats, but all those boats are affected in some measure by the same winds, currents and tides. Working together, we can enhance our common ability to address the risks that we -- and our financial system -- all face.

Thank you.

Last Updated 12/6/2011