For Release on Delivery
9:00 a.m. E.S.T.
November 16, 1995

Remarks by

Edward W. Kelley, Jr.

Member, Board of Governors of the Federal Reserve System

at the

20th Annual

National Conference on Banking

of the

American Institute of Certified Public Accountants

Washington, D.C.

November 16, 1995

Introduction

Good morning and thank you for your kind invitation to address the 20th national banking conference of CPAs. As the AICPA closes the second decade of its annual banking conferences, I would like to take stock of how the industry has changed and give my views on its future direction and keys to success. Then, I will describe how the Federal Reserve's supervisory approach is adapting to the new banking environment. Finally, I will offer a few thoughts on the important role of the accounting profession in the banking industry.

Single, Watershed Events

The banking industry in recent years has been evolving in response to both one-time, major events and steady, evolutionary pressures. Let's recall recent history. The last twenty years have been punctuated by events that caused severe stress to the financial system. Two decades ago, companies and banks were grappling for ways to deal with volatility in foreign exchange markets following the demise of the fixed foreign exchange rate system. Fifteen years ago, we saw double-digit inflation and, in taming it, interest rate volatility reached historic proportions. A decade ago regulators were cleaning up banks whose loans turned out to be sizeable gambles that OPEC would keep a firm grip on the price of oil. A half decade ago, the collapse of the iron curtain had severe economic repercussions in many sections of the country as defense spending was cut, while simultaneously the real estate and construction industry went into deep recession. As a result, banks in many regions

were severely tested as subcontractors competed for fewer orders, consumers lost jobs, and commercial real estate and new houses stood vacant.

The banking industry, however, has survived and has seized upon opportunities following these watershed events. Banks developed expertise in managing foreign exchange and interest rate risks, and created useful, new products to sell to their customers. The benefit of diversifying risk was learned and, unfortunately, relearned. New means for adjusting the risk/reward balance through securitizing, syndicating or underwriting credit were developed and became widespread.

Long-Term, Evolutionary Changes

There have been evolutionary changes as well in the industry over the last two decades, principally in competition, legal barriers, and technology. These changes have been beneficial, but some negative aspects have emerged as well.

Competition

Banks' nearly exclusive franchise in many areas of credit intermediation has significantly eroded. Following the lead of Merrill Lynch, retail brokers introduced close substitutes for insured demand deposit accounts. General Motors, Ford and other automobile manufacturers offer financing that has captured a large market share of auto loans. General Electric Capital Corporation and other industrial finance companies have certain advantages, such as superior credit rating and limited regulation, that have made them very able competitors in the commercial loan market. And, of course, the home mortgage market was completely transformed by the financial innovations of Fannie Mae and Freddie Mac.

More competition in the financial marketplace has clearly benefited the consumer and the overall economy as the returns earned on savings increased and financing costs fell. But the industry has benefitted in many ways, as well. Narrower operating margins resulting from this competition have meant that bankers have had to become more aggressive in obtaining business and more skillful in managing risk, which strengthened operating capabilities.

Legal Reforms/Consolidation

Banks have operated under a regulatory structure that was largely conceived to address the crisis of the Great Depression. The world has changed since 1934, but regulatory modernization has lagged behind what competitive realities call for in the marketplace.

For example, the most recent major banking reform to be implemented is interstate banking, which was passed only last year after many years of debate. This change in federal law built upon a decade-old innovation of the states that allowed regional banking across state lines. Since 1980, when the states began to ease these restrictions, over 6300 healthy banks have been merged or acquired, and the share of industry assets controlled by banks smaller than the 100 largest institutions steadily decreased from nearly half to under 30 percent last year.

Several strategies have emerged to drive this trend. Major banks are consolidating within their own market, such as the money-center banks Chase and Chemical, or linking together adjoining markets through such combinations as First Union and First Fidelity, and NBD Bancorp and First Chicago.

NationsBank, formerly NCNB Corporation, became one of the largest bank holding companies in the U.S. through a series of acquisitions in Texas, the Southeast, and Middle Atlantic states. Bank of America, through its acquisitions of Security Pacific and Continental Bank, has greatly expanded its presence in the West, Southwest and Midwest. Now that federal legal barriers to interstate banking have been removed, mergers that will form nationwide banking organizations are likely to occur.

Creating multi-state banking organizations promises to yield gains in efficiency as institutions eliminate unnecessary legal structures and streamline operating processes. The industry, as well as the bank insurance fund, should benefit as individual organizations become more geographically diversified.

Unfortunately, consolidation can also mean that decision-making power is concentrated in fewer hands and that lending authority is sometimes too far removed to address customer needs quickly. But this has set in motion a beneficial counter trend. Entrepreneurs have found this centralization by larger banks to be an opportunity to charter banks that are focused on the local market. The consolidation statistics mask this dynamic aspect of the industry: Over 3200 banks have been started since 1980, which is about half the number of institutions that merged during that period. Many of these start-ups have been highly successful in serving their local community or focusing on an underserved niche, such as small business or professionals. The community bank is far from becoming an anachronism.

Information Systems

The long, ongoing trend toward lower costs in information processing has had a huge impact on banking. Banks can now sift through transaction data to tailor products to fit customer needs with a degree of sophistication that was undreamt of a decade ago, and have also been able to harness this computational "horsepower" to turn financial theories into practical tools for risk management. The growing volume and pace of transactions — for example, daily foreign exchange payments now exceed a trillion dollars — is possible only because of advances in computer and telecommunications technology.

While improved information systems offer tremendous opportunities for greater efficiency and effectiveness, new systems quickly become obsolete. This means that investments in training and technology cannot abate. With rapid change it may be very tempting to develop and implement new systems that skimp on internal controls in the rush to get products "out the door;" however, an effective control environment in both the front and back offices is critical. More automation of financial processes also makes it clear that security features and internal controls should be fundamental in system design to avoid substantial costs and disruptions in the future. The need for security, for example, was recently and vividly illustrated by the failed attempt by persons in Russia to breach Citibank's electronic transfer system and move funds into their control. Alternatives to the current payment system, such as smartcards and commerce over the Internet, also pose questions about the security of both financial assets and customer privacy that will soon need to be answered.

Financial Innovation

Clearly, many recent financial innovations would not have been possible without the data processing capabilities now widely used in the banking industry. With expanding power to quantify and model risks and returns, banks are unbundling financial products and changing the balance of their overall risk profiles. Traditional banking functions are beginning to benefit as these analytical tools and concepts migrate from the trading floor. We are also seeing the techniques used for transferring market risk beginning to be applied to credit risk, for example through the use of credit derivatives.

With derivatives (as well as other trading instruments), banks can now take on risk with amazing speed and some institutions have been slow to adjust their internal processes to this reality. Large and sometimes catastrophic losses have occurred as a result. These innovative products have also highlighted weaknesses of financial reporting in clearly conveying information about risks arising from derivatives and trading activities.

Two Constants Emerge

In the face of all this change and the uncertainties it entails, two ongoing constants are worth noting. The first is, at its core, the business of banking will continue to be the measurement, acceptance and management of risk. The ability to measure, repackage, and transfer risk has advanced substantially as the tools for managing derivative and securitization products are improved upon and applied to more traditional products. Coupled with the faster pace of transaction volume in banking today, it is all the more important that management understands the markets it operates in, the products and services it offers or uses,

and the risks it is likely to face. The most effective bankers are those able to weave their human resources, systems and internal controls into an effective means of risk management.

The four keys of sound risk management set forth in Federal Reserve supervisory literature are worth reiterating:

- Active board and senior management oversight;
- Adequate policies, procedures and limits;
- Adequate risk measurement, monitoring, and management information systems; and
- Comprehensive internal controls

As banking organizations merge, rationalize their operations, and offer new financial services, there will be increasing tension between operating at maximum efficiency and enhancing the effectiveness of internal controls. Estimating the cost of an internal control is easy. Calculating its benefits — a financial loss avoided or a blow to the corporation's reputation that did not happen — is not easy. Management must realize the importance of effective internal controls. Based on press reports of the two most recent trading scandals, Barings and Daiwa, it is distressing that they appear not to have been due to high tech systems breaking down, but that the most basic principle of internal control — segregation of incompatible duties — was ignored.

The second constant to keep in mind is that, while the next watershed event that challenges the banking industry cannot be predicted, it is virtually certain that one will occur. The truly successful banks will be those that have embraced developments in risk management techniques and have trained and equipped themselves to fight the "next war," not

just the "last war." Successful banks will be those that are able to assess and quickly adapt to a new environment. They will be those institutions that train their people to recognize risk and prudent opportunity, that adapt their internal controls to reflect the strongest risk management techniques, and that maintain sufficient financial resources to weather turmoil and expand into attractive, new markets.

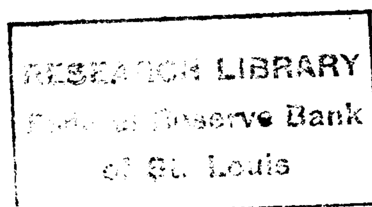
Evolution of Federal Reserve Supervision

Turning now to the Federal Reserve, in many respects changes in our supervisory approach mirror the changes taking place in banking.

Well before "risk management" became the latest fashion in the financial press, the Federal Reserve began investing its resources in a "risk management system," to stretch the phrase, for supervisory use. An important piece of our system is extensive guidance, developed over the years and continually refined, that our examiners use for assessing banks' risk management policies and practices. Our latest guidance to examiners, issued this week, directs them to rate risk management, including internal controls, during examinations of state member banks and bank holding companies. Examiners will give this rating considerable weight in their overall evaluation of management.

The Federal Reserve's risk measurement techniques have been among the many areas that have benefited from advances in computer power. For example, our economists and statisticians have developed models that are proving useful in predicting problem banks and targeting institutions for corrective action.

For examiners, computer-aided examination tools are being developed to increase their effectiveness and free them to devote more time to larger issues. As banks


LIBRARY
Reserve Bank
of St. Louis

themselves are finding, data processing resources can help in spotting trends and patterns that were difficult to see in an earlier, manual era. The Federal Reserve is also improving its internal mechanisms for identifying and reporting industry risks. For example, one system quickly transmits the observations of field examiners to the Board's senior management and its governors. It is through this channel that we have learned that examiners are seeing more evidence of relaxed credit standards, a concern I will return to in a few moments.

Another key ingredient is human capital. Training is critical since the quality of risk management depends heavily upon the knowledge and talent to those performing it, and in this area, the Federal Reserve has made substantial investments. We are training our examiners thoroughly on examining internal controls and new developments in financial products, and this effort will be increasing.

Indeed, all of these evolutionary changes to our supervisory approach will continue. Regulators who understand industry innovations will be better able to intelligently assess exposures and avoid impeding prudent changes that meet market challenges or customer expectations. Supervision that fosters and evaluates robust risk management and internal controls will be open and adaptable to changes in business lines and more in step with the volume and sophistication of tomorrow's banking. And improved internal communication of examiner findings lends itself to faster identification and resolution of problems before they can become disruptive to the financial system.

Let me stress that an important goal in redesigning our methods is that supervision not impede innovations and structural changes that can strengthen the banking industry's ability to more effectively and efficiently meet customer needs, meet market

challenges, and prudently manage financial resources. But, to be sure, the focus of bank supervision will continue to be the safety and soundness of the industry and preserving the stability of financial markets.

Reducing the Cost of Supervision

Reflecting the industry's focus on cutting costs, the Federal Reserve has sought opportunities for reducing regulatory burden. For example, one proposal would allow institutions to use their own internal models for determining minimum capital to cover market risk. Permitting a firm to adopt its own model avoids the burden of maintaining a parallel supervisory model, and related data, for measuring its capital needs. It also avoids the risk of creating a static method for measuring market risk in a dynamic environment and provides incentives for banks to invest in improving their own measurement methods.

Another approach to reducing burden that has been advocated by the Federal Reserve is the adoption of GAAP for bank regulatory reports. In this regard, I supported the recent decision by the Federal Financial Institutions Examination Council (FFIEC) to change the accounting basis for bank call reports. The Federal Reserve has long believed that eliminating one of the multiple sets of books institutions must maintain would help reduce compliance burden, and bank call reports will resemble Federal Reserve bank holding company filings that have long been prepared under GAAP.

We are also exploring ways to decrease compliance burden by granting greater latitude to well capitalized and well managed institutions in conducting their affairs, such as by streamlining the application process and revising the scope of examinations. Finally, the Federal Reserve is working to improve coordination and consistency in supervision with other

federal banking agencies, with state agencies, and with supervisors of nonbank financial institutions, such as the SEC and CFTC.

Our goal for greater coordination carries over to international supervision as well. I expect that examination policies for risk management will become more consistent between supervisors in the U.S. and other industrialized countries. More foreign countries will carry out consolidated supervision of their organizations, and there will be more sharing of information among regulators.

Challenges for the Accounting Profession

The Federal Reserve has long recognized that accounting, auditing, and disclosure play a crucial role in the financial marketplace. Disclosure is a key means to communicate a firm's operating results and its overall health, and makes more transparent its various operating activities. Disclosure of reliable information facilitates market discipline, strengthens confidence, and reduces the chance that rumors and misleading information could cause market instability. In addition, since regulatory reports are largely based on GAAP, accounting and disclosure standards can have an important impact on the information that is available for examination and other supervisory purposes. We are confident that accounting standards-setters will continue to develop guidance that will result in financial statements that clearly communicate information about firms' financial strategies and use of capital markets products.

As bank managers and supervisors increasingly stress the importance of risk management, I believe accounting practitioners have a very important role in advancing the state of that art. Because of their training and experience, managerial accountants and

internal auditors are ideally positioned to foster the development of strong systems of internal control that remain effective, current and adaptable to change.

External auditors can also play an important role. Since they assess a company's system of internal procedures, for example for compliance with FDICIA, they clearly have an excellent opportunity to helpfully strengthen them. The accounting profession's efforts to sensitize senior management in this area, for example the COSO[1] framework for internal controls, have been a significant contribution. I trust the profession will not rest on its laurels.

There is an additional contribution that I urge upon the accounting community, practicing both internally and externally in the banking industry. In recent periods and continuing today, credit quality has been excellent, with low losses and delinquencies. But there is evidence that we may be slipping from that high ground. Some of our senior examiners report declining credit standards and terms, credit card delinquency rates appear to be off their lows, and some banks are offering 100 percent home equity loans. For these reasons and others, Robert Morris Associates warns that a slow erosion is taking place. Let us all be vigilant now, while times are good, so that a deteriorating asset-quality trend does not gain momentum and become a major problem in the future.

---

[1] Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Conclusion

Banking plays an essential role in a modern industrial society. Its mission must be performed well for an economy to perform well. In a rapidly changing commercial and financial world, bankers, regulators and the accounting profession must all adapt to and shape the evolution of the industry and prepare for the next watershed event that is sure to occur. Each of us is responsible for advancing the state of the art in risk management and internal control practices. This requires a continuing investment in both human resources and systems development. It is an important challenge. Together we shall be up to the task.

Board of Governors of the
Federal Reserve System
Washington, DC 20551-0001

OFFICIAL BUSINESS

U.S. OFFICIAL MAIL
NOV 6'95
PENALTY FOR PRIVATE USE $300
U.S. POSTAGE
0.55

First Class

0057117 000000 612 (0001) F-C
FEDERAL RESERVE BANK OF ST LOUIS
RESEARCH LIBRARY
411 LOCUST STREET
P O BOX 442
ST LOUIS MO 63166