

For release on delivery
10:00 a.m., E.D.T.
April 30, 1996

Statement by
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Member, Board of Governors of the Federal Reserve System
before the
Committee on Banking and Financial Services
U.S. House of Representatives
April 30, 1996

Mr. Chairman and members of the Committee, I am pleased to be here today to discuss with you issues concerning the supervision and regulation of the U.S. banking system. Let me begin by pointing out that the overall condition of the American banking system is very strong. At home and abroad, U.S. banks are viewed as highly competitive, extremely innovative, and financially sound.

The focus of these hearings, as I understand it, is the effectiveness of the current regulatory structure and the desirability of changing the regulatory and supervisory structure for insured depository institutions, an issue considered by the Congress two years ago. You have asked several questions that I want to respond to, but first I would like to indicate that the Board believes that it is important to keep certain principles in mind as we assess the need for changes in the U.S. bank supervisory system.

First, the federal supervisory system should complement market evolution, and adjustments to its structure should follow, not precede, changes in the structure of the banking system that will result from statutory and regulatory proposals to alter substantially the powers of banking organizations. I need not explain to this Committee how the forces of technological change and globalization of financial markets are blurring traditional distinctions between financial institutions that we all once took for granted. Thus there is an urgent need to modernize the U.S. banking structure. Among the more important modifications in structure being considered, now that Congress has taken action to allow interstate banking and branching, are those dealing with a new charter for thrifts and new activities for banking organizations. Repeal of the Glass–Steagall Act's separations of commercial and investment banking and authorization of insurance activities for banking organizations are the most important changes being considered by the Congress.

Each of these proposals raises complex matters of regulatory structure. Once these issues have been resolved, then we will have a better idea of what changes are needed in our supervisory system. In the meantime, it seems premature to make any far reaching decisions altering the structure of our bank and financial supervisory system. Such changes could easily prove to be a poor fit once industry restructuring takes place. In the interim, the existing regime seems to be sufficiently effective so as not to require legislative changes.

As a matter of principle, we should also guard against the unintended extension of the safety net, an issue that has been of longstanding concern to the Board, the Congress, and many observers of, and participants in, the U.S. financial system. The Board is of the view that the business risks from securities and most other financial activities are manageable for banking organizations. However, we must not forget a more subtle and corrosive risk. The federal safety net—deposit insurance, the discount window, and access to Fedwire—creates moral hazard, risk of loss to taxpayers, and—importantly—a competitive advantage over firms that do not have safety net protection. That safety net reflects society's need to reduce systemic risk and its desire to protect small depositors, but the line at which that safety net is drawn is important for minimizing moral hazard and maintaining both market discipline and competitive markets. The Board continues to believe that the holding company structure creates the best framework for limiting the transference of the subsidy provided by the safety net. We have concluded that the further the separation of new activities from the bank, the better the insulation. The present regulatory structure supports this notion.

Another important principle is to preserve the dual banking system, which has served the United States so well. The current federal regulatory structure supports the dual banking system by linking the federal regulator to charter class. The

dual system has facilitated diversity, inventiveness, and flexibility in American banking, characteristics that are vital to a market economy subject to rapid change and challenge. It has also provided a safety valve to protect against the potential for inflexible federal and state positions. The most recent example is the evolution of interstate banking, an evolution that was begun by the states in the mid-1970s, and was well advanced by the time federal laws were revised. Such state actions also provide arenas for limited experiments in financial reform, experiments that can provide valuable insights for designing policies at the federal level. The Federal Reserve Board believes that any actions taken by the Congress to change the federal bank supervisory system must be designed in a way that preserves the vitality of the dual banking system. In the supervisory process, the Federal Reserve and the FDIC have already arranged in a large number of states extensive sharing arrangements with state authorities, eliminating examination duplication.

In considering the need to revise the current regulatory structure, it is important to clarify the nature of the concerns. The period of most vocal criticism of the regulatory structure by banks was exactly the interval when those organizations were suffering the most significant financial stress in more than 50 years. It is understandable that clashes between those responsible for safety and soundness and those experiencing financial reversals would result in criticism by each of the other. It is instructive to note that as banking conditions improved, criticisms of supervisors and the supervisory structure have receded. Nevertheless, the earlier period of conflict exposed a number of inefficiencies in the current regulatory system. As I shall discuss in a moment, the regulatory agencies have in particular attempted to address the burden of regulatory overlap and to increase coordination of efforts, major concerns highlighted in the late 1980s and early 1990s. However, before doing so, it is important to clarify the dimensions of the existing overlap in bank supervision, and to

consider whether realignment of supervisory responsibilities would in fact reduce the supervisory burden on depository institutions.

About 40 percent of bank and thrift organizations are subject to only one federal regulator: the independent banks and thrifts and the holding companies whose subsidiaries are state member banks. A significant proportion of the statistical measure of multiple supervision among the remaining entities reflects the Federal Reserve's jurisdiction over holding company parents with national or state nonmember bank and thrift subsidiaries. However, most holding company parents do not engage in significant, if any, nonbank activity and these so-called "shell holding companies" thus have always been subject to only minimal onsite supervision by the Federal Reserve. If we remove the "shell holding companies" from the statistics, the proportion of depository institutions supervised essentially by a single federal regulator increases from about 40 percent to over 75 percent. Moreover, consolidated bank holding company organizations generally have a quite small proportion of their *depository institutions'* assets supervised by an agency other than the one responsible for their lead bank. In those remaining one-fourth of institutions with multiple supervision (e.g., a holding company with a national bank subsidiary supervised by the OCC, a state nonmember bank subsidiary supervised by the FDIC, a state member bank supervised by the Fed, and an S&L supervised by the OTS), the non-lead federal bank supervisors, taken together, oversee, on average, less than 10 percent of the consolidated institution's banking and thrift assets.

The federal and state dual supervision of insured state-chartered banks is another area of potential overlap, and is not included in the above statistics. However, as I noted earlier, the FDIC and the Federal Reserve have worked out arrangements with most states in which either the appropriate federal authorities join the state supervisor in joint examinations, or conduct the examinations in alternate

years. In such cases, Federal and state supervisors do not separately examine the bank in the same year.

No matter how small the proportion of bank and thrift assets subject to multiple supervision, every effort should be made to reduce the resultant burden on depository organizations. Toward that end, the agencies have for many years divided examination responsibilities so that only one federal agency examines a given depository institution. In supervising a parent bank holding company, for example, the Federal Reserve relies principally on the evaluation of subsidiary banks or thrifts by that subsidiary's primary supervisor and does not attempt to re-examine the bank or thrift.

In evaluating credit risk, the principal risk to banks, the agencies have long had procedures designed to enhance consistency and increase cooperation across the agencies. For large, syndicated loans—those involving credits of more than \$20 million held by two or more banks—the agencies have the Shared National Credits Program in which supervisors from all banking agencies agree annually on a single evaluation that all examiners use whenever they encounter the credit. This program covers more than \$700 billion of unused commercial loan commitments and some \$400 billion of outstanding commercial loans of the U.S. banking system. The outstandings represent roughly one-third of all commercial loans booked in U.S. offices of commercial banks, including the U.S. branches and agencies of foreign banks. For many years, a similar process has also existed for evaluating the so-called “transfer risk” inherent in loans to borrowers in foreign countries that are not denominated in the borrower's local currency. Once a rating is determined for a specific country and for particular types of credit extensions to that country, examiners of all agencies treat the credit uniformly.

I do not mean to imply that there is no burden for those banking and thrift organizations dealing with more than one supervisor. One area, in particular, that can present difficulties in coordinating supervisory activities relates to larger and more complex banking organizations. These institutions are often characterized by multiple bank and nonbank subsidiaries that manage and control their consolidated activities through risk management and operating policies and procedures developed and monitored at the parent holding company level. Similarly, as bank activities and management practices have evolved in recent decades, these large financial institutions have structured their daily activities increasingly along product lines, with less regard to legal entities. For example, many large banking organizations control, hedge, and otherwise manage their investment securities and trading position across all of the subsidiary bank and nonbank entities on a consolidated basis.

The banking agencies recognize that these trends in management practices can increase the potential for overlapping supervisory efforts and have, accordingly, sought to minimize the overlap that might occur. In June 1993, the federal banking and thrift agencies adopted an interagency agreement under which they would coordinate the timing, planning, and scope of examinations and holding company inspections; conduct joint examinations or inspections, when necessary; hold joint meetings with bank and bank holding company management related to examination findings; and coordinate information requests and enforcement actions. This agreement delineated the supervisory responsibilities of each agency regarding particular entities within a consolidated organization. It also recognized that there are legitimate situations when an agency other than an entity's primary supervisor needs to participate in examinations or inspections in order to fulfill its regulatory responsibilities. While no panacea, it has helped to reduce the burden of multiple supervisors on banking organizations.

However, even if every banking and thrift organization were subject to the jurisdiction of only one agency, some of the inherent overlap in examiner duties would still occur simply because of the size and diversity of the institution's activities. The "overlap" would be less apparent to the institution because examiners would all be from the same agency, and any differences in supervisory judgments would be minimized. However, the number of inquiries and onsite visitations might not decline materially.

Even with one supervisor per organization, different laws and regulations apply to different elements of an institution, and its diverse activities often require examiners to have specialized expertise. Reviewing the adherence of a parent company to the provisions of the Bank Holding Company Act and its implementing regulations requires different skills than are necessary in reviewing the trading activities of a London subsidiary bank. More generally, at large organizations safety and soundness examinations require a large number of individuals with special expertise in such diverse areas as credit evaluations, with experts needed for each type of credit market; securities trading; foreign exchange; risk management; evaluation of credit and market risk models; and compliance with safety and soundness laws and regulations, such as lending to affiliates and loans to one borrower. To this list must be added specialty examinations for trust activities, CRA, and data processing.

Scheduling, training, and coordinating the personnel to conduct these varied activities throughout the organization and to communicate as necessary with each other would still be a complex task under a single agency. Moreover, some institutions—large and small—prefer that examiners not arrive simultaneously because of the demands that would place on their resources. Thus, as now, a single

regulatory agency would still spread out its examinations over time, either because of limitations of agency staff or because of the preferences of the institution.

Mr. Chairman, you asked about the Federal Financial Institutions Examination Council, established by the Congress in 1979 to provide a facility through which the agencies could address policy and operating differences, and thereby reduce the costs of their activities to the supervised institutions and to the public. The Council has been largely successful in this by providing a useful forum for both the principals and the staffs to discuss issues of common concern. It has facilitated consistency in regulations, accounting, and information collection. It has also devised ways to lessen regulatory burden and has sponsored extensive training and education for examiners and bankers. These are no small matters. However, candor requires that I report that some substantive and complex issues have proven to be difficult to resolve by the Council.

Outside of the Council framework, the three banking agencies have had success in developing guidelines to coordinate the planning, timing, and scope of examinations where multiple agencies are involved. Efforts continue to carry such guidelines further, particularly by working to implement the concept of unified examinations pursuant to section 305 of the Riegle Community Development and Regulatory Improvement Act of 1994. This legislation requires the federal banking agencies to implement a system by September 1996 that determines which one of them shall be the "lead" agency responsible for managing a unified examination of each banking organization.

Conclusion

In conclusion, the U.S. banking system today is extremely healthy and competitive in both its domestic and international operations. The degree of actual multiple supervision of banking organizations is less than a cursory review of statistics might suggest. In addition, federal bank supervisors, and the Congress, have made substantial progress in recent years in improving our supervisory policies and procedures for ensuring bank safety and soundness, and also in reducing regulatory burden, reducing supervisory overlap, and improving the consistency of our rules and regulations. While we can and should do more, and the agencies are working toward such improvements, modifications and reforms should be evaluated against certain principles. First among these is that changes in regulatory structure should follow and not precede adjustments to the basic structure of our insured depository system and the modernization of its activities. Choices made by the Congress on bank and thrift structure and authorized powers should be fundamental determinants of the regulatory structure. The Federal Reserve continues to encourage the Congress to take legislative actions needed to further the evolution of our banking and financial system.

I would be happy to answer any questions that you might have.

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