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"RETHINKING BANK REGULATION AND SUPERVISION"

by

Edward W. Kelley, Jr.

Member

Board of Governors of the Federal Reserve System

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It is a pleasure to be here today. The theme for this year's conference, rethinking bank regulation, is quite timely. With the banking industry's strong capital condition, and profitability at record levels, it is a good time to look ahead and consider the future without the distractions of a current crisis. As with many things in life it is always useful to take a step back and rethink what we are doing. It is especially useful at times like this when much is changing in the financial services sector.

To guide our thoughts in rethinking bank regulation, we need to ensure that we take a systematic, well targeted approach by focusing on the Why, the What, and the How of regulation. In short, we must: (a) review **why** we regulate banks and financial institutions in the first place; (b) take stock of **what** we are supervising -- that is how banks, and the environment in which they operate are changing; (c) reassess whether our original reasons for regulating banks still apply; and, (d) examine **how** we are supervising banks today and **how** best to supervise them in the future.

It seems necessary to discuss each of these questions to develop a coherent picture of where bank regulation and supervision is heading and the direction it should take -- in short, to answer the question "What should regulators do?". I will address each of these topics in turn, but will focus mainly on the last issue: how to best supervise banks today and tomorrow.

Why we regulate banks.

Considering the first question: "Why do we regulate and supervise banks?", there are two primary reasons:

1) To ensure the safety and soundness of financial institutions so that they do not become a source of systemic risk, pose a threat to the payment system, or burden taxpayers with losses arising from the federal safety net; and,

2) To promote an efficient and effective banking system that finances economic growth, impartially allocates credit, and meets the needs of the customers and communities banks serve.

Balancing the goals of ensuring safety and soundness and facilitating market efficiency and effectiveness has always posed challenges. Today, supervisors face increasing pressures in this balancing act given the fast pace of change in technology, financial products and management techniques --

changes that are significantly affecting the way supervisory strategies are achieved.

What we supervise - Changes underway in the industry.

The litany of technological and financial innovations that are transforming the financial services industry is well known. Advances in telecommunications and computer technology have provided banks new and more efficient opportunities to expand regionally, nationally and globally. At the same time, and driven largely by the same phenomena, financial innovations have enabled banks to fine tune and expand product lines and activities, allowing for a more targeted response to customer tastes and needs. Delivery mechanisms are being dramatically transformed from banking through the internet to redesigned branch offices offering a full array of banking, brokerage, and insurance products. Without today's computer technology banks could not offer these products or keep pace with the increasing volumes of financial transactions in both wholesale and retail markets.

The forces of technology and financial innovation are also changing the structure of the industry and the way it is being managed. The recent wave of mergers among larger organizations has been, in part, driven by the industry's belief that technology can be exploited to achieve scale economies. Smaller organizations also are successfully using technology to improve their efficiency and ability to compete in their chosen markets. While technology and financial innovation have increased the range and complexity of financial products, they have also provided advances in the techniques used to identify, manage, and control risks. These techniques range from sophisticated value-at-risk models used at large trading organizations to credit risk scoring models used to evaluate and track asset quality.

Reassessing whether our original reasons for regulating banks still apply

Do these changes in the industry undermine the traditional policy objectives we initially laid out of promoting a sound, responsible, and responsive banking system? Certainly not. Indeed, they intensify the need for an active supervisory and regulatory process.

Advances in risk management certainly help in reducing potential systemic disruptions. However, given the dramatic increase in the volume of financial transactions over the past several years, the concentration of these transactions among a relatively small number of institutions, and the increasing complexity of many new financial instruments, some have argued that heightened linkages among national and international markets may have increased the potential that an individual disturbance may be transmitted more broadly, causing systemic difficulties. While innovations have provided new opportunities to operate efficiently and to manage and control risk, they have also created the potential for organizations to accumulate sizable losses over a short period of time. The Barings incident is perhaps the most notable. Clearly, the need remains for regulators to ensure that institutions are operating soundly and that potential systemic disturbances are met with appropriate regulatory responses.

Overall, the need for supervision and regulation to ensure that banks operate safely and soundly is increasing, not diminishing. But, in pursuing this goal of ensuring safety and soundness it is also important that supervisors continue to promote an effective and responsive banking system that efficiently finances economic growth. To do so in an era of change, supervision and regulation must change as well.

How supervision and regulation are changing.

While the original objectives remain appropriate, the manner in which supervisors achieve them is changing both to accommodate industry evolution and to improve their own efficiencies by making better use of available technology. Traditionally, supervisors have sought to achieve their goals by imposing regulations, providing guidance, verifying bank activities, and requiring or prodding the industry to make greater disclosures. Each element remains important and is still evolving.

The nature of regulation is undergoing significant change. Traditionally, regulations were strict prescriptions of rules with black and white standards such as the maximum amount of loans to one borrower or lists of permissible investments. While certain maximums, minimums, and laundry lists remain necessary in many cases, they are becoming less effective. In the past, supervisors and institutions often controlled risk by focusing on particular products or activities where the risk was generally concentrated. For example, market risk is generally associated with trading activities while credit risk is concentrated in loan underwriting. However, recent advances that allow risks to be separated from products and activities, and then reassembled in other forms, have made product or activity-based rules less effective. Derivative instruments can be effectively used to mitigate the market risks of traditional trading instruments but, at the same time, can involve significant credit risks that may not have been present before.

Overall, more flexibility is required in regulatory approaches. Regulations must be prescribed to address safety and soundness concerns but cannot be so specific or narrow that they interfere with the process of innovation. An example of such flexible rulemaking was the safety and soundness standards the banking agencies adopted in response to Section 132 of FDICIA. That section required regulators to prescribe standards in areas such as loan documentation, internal controls, and compensation -- just to name a few. Such standards could have been specified using regulator imposed laundry lists and requirements. However, the banking agencies adopted an approach that set broad standards for what constituted safe and sound practice, leaving the specifics of how that standard should be achieved to the bank. Not only does that approach recognize the impracticality of imposing singular standards on the diverse array of products offered by the more than 9,000 banks in this country, it also allows banks to adjust their practices to fit the changing nature of their products and activities.

Regulators should also be alert for ways to make their rules more compatible with sound, internally developed practices in risk management in order to reduce burden and to improve the effectiveness of their regulations. One way we are trying to do this is in our proposed capital standards for market risk in a bank's trading activities. These new standards will permit large trading banks to use their internal "value-at-risk" models to calculate their future capital requirements for market risk, subject to examiner oversight and a few regulatory constraints.

Through their evaluations of many institutions, regulators are in a unique position to identify and promote sound practices within the industry and are offering their guidance more than they have in the past. In earlier years, supervisors used guidance for relatively narrow purposes -- typically to advise examiners or bankers on interpretations of existing regulations or procedures for compliance. Today, guidance is moving away from narrow, compliance oriented details toward the identification and dissemination of sound practices for the various activities banks conduct.

Please note my emphasis on "sound", not "best", practices. Sound practices reflect those minimum principles to be employed to ensure that the activity is conducted prudently. Best practice, in my view, can and does occur in institutions of every size, shape and level of sophistication, but supervisors should focus on sound practices and leave the determination of what is "best" to the judgement of individual institutions.

Since 1993, the U.S. banking agencies have issued a series of instructions, policy statements, and examination manuals stressing the importance of managing all risks posed by the institution's activities. One example of this guidance is the Federal Reserve's supervisory letter and manual on managing the risks related to trading activities, which were well received by banks, auditing firms, and others. I believe the dissemination of this type of guidance is a good example of supervisors adding value and we expect to continue to emphasize this approach in the future.

Although regulations and guidance are important, the cornerstone to the bank supervisory process is the verification of prudent practices and financial condition through on-site examinations, coupled with off-site surveillance. Traditionally, on site examinations have focused on compliance issues and verifying the condition of the institution at a point in time by reconciling accounts, testing individual transactions and performing ratio analysis. The examination process has also tended to involve very similar procedures regardless of the bank's unique mix of activities and risk profile. This process is changing.

First, examiners are placing more emphasis on evaluating the soundness of a bank's process for managing and controlling risks. Although they must still reconcile and test certain transactions, single point-in-time assessments of financial condition or compliance status are becoming less effective indicators of an institution's *future* risk exposures and compliance. Testing the soundness of the institution's risk management and internal control processes provides greater assurance of an institution's soundness on an ongoing basis.

The Federal Reserve's recent decision to assign a formal rating to risk management in our examination reports reflects the importance we place on sound management and adequate internal controls. For state member banks and bank holding companies, this rating is given significant weight when determining the rating for management under our bank and bank holding company rating systems. While supervisors have long reviewed internal controls during examinations, the process of developing formal ratings increases the focus on risk management and highlights both the quantitative and qualitative aspects of a bank's system for identifying, measuring, monitoring, and controlling its risks.

Second, to improve the examination process, the Federal Reserve and other banking agencies are emphasizing more pre-visitation planning in order to better identify those areas of the bank's activities that pose the greatest risk. In other words, the examination scope now has a more customized focus.

Third, supervisors are making greater use of computer technology in the examination process such as the use of automated systems that permit examiners to download data from a bank's computer, analyze portfolios on their personal computers, and identify concentrations and other characteristics within the bank's loan portfolio. As a result, examiners should be able to reduce materially the amount of time they spend on manual operations and should be able to devote more time to identifying and evaluating risks.

This combination of focusing on the management process, planning examinations better, and using automation more effectively should reduce the amount of time examiners spend on-site performing clerical activities, and increase the time they have to evaluate risk.

Supplementing the on-site examination process are surveillance activities, which traditionally have involved standardized ratios and screens that rely on regulatory reporting. However, those screens are sometimes not flexible or comprehensive enough to provide a true profile of the bank's risk -- so they also need to improve. One enhancement is to tailor the information we collect to the bank's activities, including making greater use of internal management reports and the results of internal risk models. In recent years, supervisors have expanded the focus from internal loan classification reports to the results of banks' sophisticated internal models and other risk management reports. Such changes merely reflect the evolving nature of bank activities and the improved procedures banks have for measuring those activities.

As with examinations, disclosure practices of the past also focused narrowly on the financial condition of the institution at a point in time, using conventional accounting and regulatory measures. Today, however, disclosures are expanding to include a description not only of the level of risk taken by the company but also of management's philosophy for managing and controlling risk. This improved transparency enhances market discipline and rewards prudent management. We have already done much to improve disclosures for derivatives and market risks, and we will continue to urge better and more broadly based disclosure on all of an institution's major activities and exposures.

Conclusion

In conclusion, I believe the traditional public policy goals of regulation are still appropriate, but changes in the structure and activities of financial institutions require that we rethink the way supervisors accomplish these tasks. Just as banks must adapt and change in response to the competitive landscape around them, regulators must also periodically reassess and, when necessary, restructure their activities to accommodate change. Our supervisory procedures have and are changing to recognize new technologies and techniques that are transforming the banking industry. Like the industry we need to rethink how best to do our job on an ongoing basis. Thank you.