Remarks by

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I am pleased to appear before you today. In an attempt to contribute something relevant to this gathering of professional banking law practitioners, I will be discussing two broad topics: 1) issues related to merger and acquisition applications, and 2) the regulators' increased emphasis on the supervision of risk management. Because I want to focus on these issues and their implications for regulation, and because of time constraints, I will not be discussing specific legislative proposals in my formal remarks. I do, however, wish to make the point that the exceptionally fine performance of the banking sector over the last few years, and the admirable manner in which banks have emerged from the dark times of the late 1980s and early 1990s, provides the perfect backdrop in which to accomplish important legislative change. It is especially important for the industry, its supervisors, and its legislators to resolve important issues concerning structure and oversight of the financial services sector -- and to do so now, during the good times.

Without commenting on any particular Congressional or regulatory initiatives, let me say that legislative changes should constitute an integrated whole. As I have said before, either each part will work well or none of it will. In particular, it is important to settle first the structure of the financial services sector -- including the issue of expanded banking activities -- and then decide if we need to redesign the regulatory apparatus, and if so, how. Supervision and regulation should be responsive to the needs of efficiency and innovation within the financial system, not the other way around.

With that caveat behind us, let me proceed to discuss what I regard as two of the most important emerging regulatory trends in banking, both from the point of view of the industry and its legal advisors, as well as those who would regulate it.

The Wave of Mergers

First, let's discuss the wave of mergers that have swept the industry. The year 1995 can truly be termed the "year of the big deal" -- and the first part of 1996 is not far behind. Merger activity in 1995 represented about five times the aggregate deal value or aggregate asset value of the 1994 acquisitions. Total assets of acquired institutions in 1995 approached one-half trillion dollars! Let me hasten to add that, in discussing these mergers, my comments are meant to apply not only to combinations involving huge institutions but also to mergers between smaller banking companies focussed on smaller markets.

On its surface, a series of large mergers seems like a natural reaction to the easing of interstate barriers and the continued corporate desire to realize whatever consolidation economies there are to be had. But the political reaction to a series of large mergers is another thing entirely. I, for one, have no worry over the merger wave, in and of itself. Mergers should be evaluated on a case by case basis -- on their individual economic merits and on their compliance with the laws of the land.

Under the Bank Holding Company Act and the Bank Merger Act, virtually all significant bank mergers and acquisitions must be approved, or denied, by the

Federal Reserve. As you know, in reaching such decisions we must consider three broad criteria: safety and soundness, competition, and the convenience and needs of the local communities served, including the CRA performance records of the institutions involved. In the late 1980s and early 1990s, safety and soundness issues often dominated, but in recent years, convenience and needs concerns have greatly increased in importance. Today, my guess is that convenience and needs issues are the most frequently discussed, and certainly the most frequently protested aspects of merger applications that come before the Board. Protests come in many guises. Some are clearly frivolous, some are meant to advance self-serving interests. But increasingly, some protests are serious and sophisticated, and they require careful legal and economic analysis.

Several developments in the CRA arena stand out for special mention. In particular, community groups increasingly question the effect of branch closures on access to banking services in low- to moderate-income areas. Also, during the last several years, the results of fair lending investigations conducted by the Department of Justice, along with examinations conducted by federal regulators, have been scrutinized by the Board in a number of applications. Most recently, the effects on minorities of a loan pricing policy -- commonly called "overages" -- has been highlighted. Finally, as the new CRA regulation takes effect, we can expect greater emphasis to be placed on lending results within a bank's assessment area.

For acquisition-minded banks, I suggest that close attention be given to CRA matters prior to the application process. Carefully and dispassionately analyze your record and be proactive in correcting weaknesses. Articulate your rationale for any proposed branch closures. Investigate alternatives to brick and mortar branches that would enable you to continue to meet the community's credit needs. With respect to fair lending, recognize where and to whom you lend, and where and to whom you are not lending. Conduct a dispassionate review of your HMDA data and ensure that your data are accurate. Taking steps such as these will help to move applications along if questions are raised, and may help to eliminate problems before they arise.

Turning now to the analysis of competitive issues, I would first emphasize that the policies and procedures used by the Fed have remained remarkably, and I think quite appropriately, stable. But as the forces of consolidation, nonbank financial service providers, technological change, globalization, and, hopefully, continued deregulation transform the banking environment, it may be that we will need to adjust how we analyze competition. On the one hand, most of the forces affecting banking seem to result in increased actual and potential competition for banks. Thus, it seems quite likely that many mergers that might have caused competitive concern five years ago, or even today, will not raise concerns in the future. Indeed, I would say that the recognition of such pro-competitive market developments has been a clear trend in Board decisions over recent years.

On the other hand, the vast majority of households and small businesses continue to receive their financial services primarily from insured depository institutions, and especially commercial banks, located in local markets. Thus, when considering the potential effects of in-market mergers we should perhaps pay particular attention to the impacts on households and small businesses. Indeed, as each of you knows, small business lending is the primary focus of the analysis of competition done by the Department of Justice. In late 1992, the Board asked its staff to begin examining, on an experimental basis, the possible competitive effects of proposed mergers on small business lending. While this experiment is on-going, the Fed staff has continued to base its recommendations to the Board on staff's normal analysis of the "cluster" of banking services as proxied by total deposits.

The bottom line is that the Board's approach to the analysis of the competitive effects of bank acquisitions is being reexamined. Whether our approach will change in significant ways, I cannot say. But some reexamination was signaled in the Board's order on the Wells Fargo/First Interstate acquisition proposal. In that case, the Board continued to analyze the effects of the acquisition on competition in the cluster of banking products and services and that analysis indicated that divestitures were needed. But the Board specified in its order that, in judging whether the proposed divestitures were adequate, the Board considered the effect of the divestitures on competition in small business lending, small agricultural lending, and some other services. The Board also indicated

that it paid attention to the size and quality of the divested offices. In particular, Wells ultimately committed to divest offices to purchasers that would make small business loans, small agricultural loans, and middle-market loans in all of the markets where there were potential problems. Wells also committed that its divestitures would be consistent with Justice Department merger guidelines. Again, I cannot tell you whether this slight shift in emphasis foreshadows formal changes in the Board's method of analysis, but it is clear that the competitive implications of bank acquisitions will be an on-going concern for the Board, and for applicants' legal advisors as well.

The Revolution in Risk Measurement and Management

Let me turn now to another important trend in the business of banking, and one that has special implications for the supervision of banking. I am referring to the virtual revolution in risk technology, which is transforming the banking business -- especially at our larger institutions.

Technological and financial innovation is creating new ways for banks to measure, manage, price, and take on risk. With the help of these new technologies, financial theory is now being applied routinely to unbundle the risks embodied in traditional financial products so that these risks can be repackaged and transferred to institutions and individuals most willing and able to accept them. Indeed, advances in risk technology not only are transforming traditional banking products and delivery systems but are creating whole new classes of financial instruments. Developments in the management of market risk have been

particularly noteworthy, where innovation in the control of foreign exchange risk and interest rate risk has given rise to significant growth in the trading and derivative activities of large commercial banks.

Innovation in the credit activities of big banks is also well underway. Credit risk has always been the most important risk to commercial banks and, of course, the primary source of earnings. It has also been a difficult risk for bankers to measure and control. Still, technological innovation is providing for improved loan analysis and more accurate internal credit risk ratings, which in turn facilitate more efficient loan pricing and internal capital allocation relative to risk. Several large banks are devoting resources to identifying correlations among default risks, so that their credit risks can be diversified more effectively and managed on a portfolio basis. We are also seeing several large institutions selling the first "credit derivatives" -- financial instruments devoted explicitly to the transference of credit risk.

Loan securitization is especially worthy of attention since it is becoming more common and involving more kinds of bank assets. Currently, there are more than $200 billion in outstanding loan-backed securities sponsored by banks. Today, banks securitize a wide variety of bank loans, including short term commercial loans, first and second mortgages, credit card receivables and lease receivables. The number and type of securitized assets is sure to keep growing. For example, we expect to see further evolution in the nascent market for the securitization of small business loans.

Supervisors face important challenges in keeping up with this rapid pace of change in the financial services industry. To remain effective, we must adapt our procedures to recognize and accommodate this change and to take advantage in supervision of the advances in risk measurement and risk management technology.

Capital adequacy policies provide just one example of how supervisory procedures must change, and are changing, to meet the challenges posed by financial innovation. Nearly a decade ago, banking supervisors sought to develop and promote capital standards that addressed changing practices within the banking system and that were more sensitive to a bank's risk profile. Significantly, the current risk-based capital standard that was adopted in 1988 (the Basle Accord) provided a mechanism for addressing the growing volume of off-balance sheet transactions. It also distinguished among very broad categories of credit risk in instruments booked on the balance sheet.

Clearly, the Basle Accord gave supervisors and the banking system a framework for evaluating capital adequacy that was more responsive to the level of credit risk than had previously existed in regulatory standards. Still, the current capital rules remain crude in many respects and may often not capture the true risks embodied in many new products including, as just one example, the complex tranches of loan securitizations.. Recognizing the need to keep pace with industry changes, supervisors have made efforts to ensure that the existing capital standards continue to evolve to meet changing needs. Nevertheless, a

caveat is in order. No matter how complex we make our rules, our formal capital standards will always do a less than perfect job of reflecting the riskiness of activities that bankers are actually undertaking.

It is for this reason that the Board of Governors continues to place emphasis on the supervision of the risk-taking process on a bank-by-bank basis, rather than the rote application of fixed capital rules that apply to all banks, regardless of the specifics of their circumstances. In other words, our philosophy is that we should strive to improve the supervision of banks by means other than adding to the burden of regulation. And this approach has the great advantage of being more forward looking rather than backward looking.

One way we intend to improve the supervisory process is to spend more time on the risk measurement and management procedures at banks. As you are aware, in late 1995 the Federal Reserve and the Comptroller separately announced major efforts to examine the risk management capabilities of the institutions we supervise. In the Federal Reserve's case, we intend to assign a formal rating to risk management in our examination reports. For state member banks and bank holding companies, this rating will be given significant weight when determining the rating for management under our bank "CAMEL" and bank holding company "BOPEC" rating systems.

Risk management examinations, of course, should focus not only on the risk models used by banks, but most importantly on the risk management processes being used, including the system of internal controls. This must

include careful attention not only to policies and procedures, but to ongoing assurance that these policies and procedures are being followed consistently by operating personnel. As certain recent events have reminded us, it does the bank no good to have a sophisticated loss probability model if the loan officer doesn't conduct a simple background check on the borrower. Value-at-Risk models are worthless if there is no monitoring of the actions of individual officers, such as traders, in a position to cause the bank harm.

But while risk control processes are at the heart of good risk management, it is the new computer-based methods for quantifying credit risk that are most intriguing. For example, one of the early steps banks took to introduce more precision into the measurement of credit risk was the process of grading loans, including newly originated credits, often on a 1 to 10 scale. Risk-grading is now common practice at the majority of the larger banks, and smaller institutions are beginning to utilize the practice as well. Importantly, some banks are going even further by attempting to estimate certain statistical measures of risk, including average historical losses and, most interestingly, loss variance on each grade of loan.

As banks become more proficient at developing statistically based measurements of credit risk, supervisors may become increasingly confident in what these measurements can tell us. It may become possible to incorporate these internal bank risk measurements into our regulatory and supervisory capital standards. This has occurred most recently with respect to capital requirements

for market risk. In January 1998, the "internal models" approach to setting capital for trading account activities will become effective at the largest, internationally active banks.

The computer-based measurement of credit risk is in its infancy, and it will likely be some time before it reaches the level of sophistication with which market risk is currently measured. But quantification of credit risk, and the use of these statistical measures within risk management, is here to stay. Risk quantification, increasingly, will become a fact of supervisory life.

The recently increased emphasis on supervisory review of risk management procedures is just being translated into examiner actions in the field. As is the case with banks' internal risk processes, the supervision of risk management can be expected to evolve. I urge you to familiarize yourselves with this evolution and, needless to say, advise and sensitize senior management on the issue.

In conclusion, I want to enthusiastically acknowledge the many positive contributions bank counsels make to the success of their institutions. Today, I've discussed two areas that are "front burner" with regulators, each of which calls for your attention. I know you will effectively provide that attention, to the benefit of the banking industry and the banking public.

Thank you.