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Remarks by

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Good morning. In all my 35 years in the private sector as a banker, I never saw myself keynoting an ABA Conference on Regulatory Compliance. But, after six years on the job at the Fed, I am reconciled to my new role as a regulator. I try always to be a reasonable one and avoid, to the extent possible, adding to an already suffocating burden of regulation on banks. But the Congress in its wisdom often overdoes its legislative act and imposes unnecessary, rigid, restraints on regulators' ability to use their judgment.

In our report to Congress in 1992, the Exam Council attempted to catalog and define the burden on banking organizations. We have also attempted to rewrite some of the regulations to simplify language and ease the burden. But in spite of our efforts, the implementation of FDICIA has added significantly to regulatory burden.

One way to reduce burden would be to eliminate overlapping and redundant supervision of banks by federal regulators. It was in pursuit of that goal that the Treasury proposed last fall to collapse four regulatory entities -- the OCC, the Fed, the OTS and the FDIC -- into one new Federal Banking Commission.

As you know, we at the Federal Reserve support the concept of consolidation but could not support the idea of a single agency. For a time we engaged in a public debate with Treasury. But in February both agencies recognized that we needed to compromise, and the decision was taken to sit down together and work out the differences. Our discussions with the Treasury led to a mutual accommodation involving significant compromise by

both sides, but which also creates a considerably streamlined structure; which will work well; which meets many of the primary concerns of both the Treasury and the Fed; and also addresses some of the principal concerns of banks about regulatory overlap and overkill.

The principles we have incorporated in the agreement are as follows:

- First -- A continuing participation by the Federal Reserve in the regulation and supervision of the largest banking organizations, recognizing the important role the Fed must play in maintaining the integrity of the payment system, the operation of the window as the lender of last resort and maintaining the stability of the financial system.
- Second -- Reduction in the number of federal regulators in the interest of economy of operation, standardization in rule-making and statute implementation and elimination of redundant examinations by multiple agencies.
- Third -- Preservation of the dual banking system and the distinction between a federal and a state charter. This system, in place since 1863, has served the country well.
- Fourth -- Preservation for commercial banks of the right of choice of a federal regulator.
- Fifth -- Avoiding, if at all possible, imposing any additional cost burden on the banks as a consequence of this regulatory restructuring.

In my opinion, we succeeded in incorporating all of these principles. We will be able to present to the Congress a proposal which both the Treasury and the Federal Reserve can enthusiastically support. I think the banks, the Congress, the Administration and the Federal Reserve are all anxious to move toward reform in this area. Unfortunately the complexity of the legislation necessary to implement these reforms made the drafting process a longer one than we had anticipated. In view of the heavy legislative calendar, we decided to wait until the new Congress meets in 1995 to present our proposal. It will undoubtedly require extensive hearings in both Houses. It is, in our judgment, better to give it the full time frame of a Congress rather than try to squeeze it into the final few months of an election year agenda already loaded with health care, welfare reform, interstate branching, community development banking, and increasing attention to derivatives.

I want to turn now to another topic, since I am not able to share with you at this point the details of our regulatory reorganization proposal, beyond what I have already said.

The subject of derivatives is being discussed currently in an overheated environment created by recent market volatility, one or two sizable accidents, and media treatment which has created an aura of mystery and danger. Those factors have stimulated the usual reaction of Congress which is to want to regulate everything that moves.

Some would like us to believe that derivatives are a new phenomenon -- in fact, so new, so complicated and so dangerous that no one presently living can possibly understand them, let

alone know how to manage them. Not so! Derivatives have been around for a long time and have been used primarily to contain risk by providing a way to hedge price volatility, primarily in commodities but also in financial instruments. Futures and options contracts are veterans of generations of use in the commodities markets, and short positions, puts and calls have been factors in financial markets as well.

To be sure, these instruments have not always been used solely on defense or to minimize risk. By their very nature, they can also be used for speculative purposes. But, then, what financial instrument cannot be used for speculation? In the most simplistic illustration, it can be argued that a person buying a share of stock expecting the price of that share to go up while it is held, is speculating. If the price goes up, there is a profit; if it goes down, there is a loss. And, if the company invested in fails, the investor loses everything. The size of the bet only makes it more dramatic, but it doesn't change the fundamental elements of the transaction.

The complexity of certain of the newer, more exotic derivative instruments may make their operation more difficult to understand, particularly under varying degrees of volatility in the markets. To try to understand these new instruments, very sophisticated mathematical models have been designed to simulate the behavior of markets and of market instruments during episodes of volatility which are usually triggered by wide swings in interest rates.

During the recent episodes, some of the models failed to provide the guide to safe harbor because they assumed narrower

swings in interest rates than actually took place. Should we be concerned because of the magnitude of the losses incurred by investors in the Granite Funds or by Procter & Gamble? I think not!

Those who invest in hedge funds like Granite are well-heeled speculators, willing to take very significant risks in pursuit of higher than usual profits. Where the minimum investment is \$250 thousand or even as much as \$1 million, are we really concerned that some of the rich high-rollers lose a bundle in the course of a market adjustment? Well, I, for one, have not shed any tears. And, my protective instincts are not stirred by the plaintive cries of "foul" from a giant manufacturer which walked eagerly into a highly speculative transaction with a huge bet and stayed with it while the market piled on the losses. By the same token, is anyone really concerned about the roulette player at Las Vegas who loses the farm? No! And, there is no evidence that gullible widows and orphans are playing the derivatives market unless they are very rich widows and orphans who should know what they are doing. And, in that case, who cares.

Much of the current rhetoric urging legislation to regulate derivatives and their use focuses on threats to the safety and soundness of banks. Some argue that proprietary trading in derivative instruments is extraordinarily risky and, therefore, inappropriate for banks with insured deposits. But, making term loans to businesses is probably the riskiest business of banks, and we don't give that a second thought.

A simple but useful definition of banking is that the banker essentially manages financial risks for his depositors. His job

is to manage risk not avoid it. It is certainly reasonable to assume that exotic, or at least exotically named derivatives are riskier than single-family mortgage loans. But does it follow that they are, therefore, unmanageable and should be prohibited to banks? Or, even more ridiculous, that the only ones who understand derivatives are Member of Congress who can set the world right by yet another legislative adventure in micro-managing the banking system?

Let's be realistic. Derivatives are not new. They are not mysterious. And, if managed properly, like any risk, they are not particularly dangerous. An Indianapolis 500 race car is not in and of itself a dangerous vehicle. It is only dangerous and life threatening in the hands of an ordinary driver. And, in that analogy lies the answer to the question of what to do about derivatives.

I am convinced that with full disclosure by banks of their derivatives activities and exposure, trained examiners will be able to assess the risk inherent in the activity and then make an informed judgment whether the risk management process in the bank is adequate to protect against a disastrous loss that would threaten depositors and shareholders. A satisfactory risk management system for a trading bank must include:

1. A position monitoring and reporting system capable of keeping management absolutely current with market developments and the bank's position.
2. Stop-loss disciplines to automatically trigger close-out of deteriorating positions.

3. Exposure limits for each category of risk undertaken and these should be specifically known to and approved by the board of directors.
4. Credit policies and procedures for adequate assessment of counter-party credit risk.
5. Authority to make exceptions to position limits and stop-loss procedures vested in senior management officials who are not responsible for the profitability of the trading operations.
6. Market models used for designing investment and trading strategies must enable management to "stress test" the bank's position to identify emerging problems in a changing market.
7. And, finally, management, both top management and trading management, should have a thorough understanding of the instruments and how they are being used and trading management should be experienced in trading in volatile as well as stable markets.

If examiners have enough information disclosed to them to make an accurate assessment of the degree of risk undertaken by a bank, they should then be able to judge the ability of a given institution to handle that risk and take whatever steps are needed to adjust individual institutions to their risk tolerance.

Legislation would inevitably try to set standards or parameters for the industry which ignore individual differences among institutions. On the other hand, with disclosure and trained examiners, the supervisors will be able to recognize

individual capacities and permit broader range for those who are qualified and restrict participation for the amateurs.

I am sure you sense my aversion to legislated regulation when good supervision can do a better job. I only hope that we can persuade Congress not to jump in, at least until there is a better reason to do so.

I want now to turn to another regulatory issue which is a potential source of real trouble to banks, but which we may have an opportunity to deal with more rationally. Banks are being beset by efforts to transform the Community Reinvestment Act -- CRA -- into a system of mandatory credit and resource allocation with cease and desist orders and civil money penalties as the price of noncompliance. This re-invention of CRA was undertaken in response to a Presidential request to re-vamp CRA regulations to eliminate unnecessary paperwork and to put more emphasis on lending in minority and low- and moderate-income neighborhoods. Those are certainly admirable goals enthusiastically embraced by all of us who believe in CRA as sound public policy and who have recognized that its enforcement in the recent past has often concentrated more on form than substance.

But, oh my!, the proposal recently out for public comment, which was drafted by the regulatory agencies, has little relation to the President's request for reduced record keeping since it suggested new reporting requirements on banks which would add tremendously to regulatory burden. In addition, it proposed standards for bank lending and branch locations which were blatant attempts to allocate credit and resources. Congress in its wisdom over the years has assiduously avoided credit

allocation, even in fervent pursuit of its most cherished causes. The recent proposal was an outright administrative contravention of the historic intent of Congress. One might also argue successfully that since the Community Reinvestment Act does not provide for the imposition of fines or other punitive measures for noncompliance, inclusion of such measures in the current proposal is without foundation in statute.

Putting more definition into compliance standards for CRA is certainly desirable. It would help bankers manage the compliance of their organizations and it would help examiners to have better defined standards for compliance examinations. I would contend, however, that both of those desirable goals can be achieved by less draconian measures than those recently proposed.

The most sensitive nerve-ends in that proposal related to the imposition of quantitative market share standards for CRA lending; a requirement that banks have branches which are readily accessible to customers in low- and moderate-income neighborhoods; and the possible imposition of cease and desist orders and civil money penalties for banks found to be substantially not in compliance.

The quantitative lending test based on market share was clearly intended to allocate credit and is highly questionable from a public policy point of view. Perhaps equally important, the scramble to make loans in a defined market in order to reach market-share compliance requirements could result in safety and soundness problems. After all, the classic way to move market share is to offer a better deal. In marketing loans, unless I have missed something in a long banking career, a better deal

means any or all of the following: lower interest rates, better terms, or relaxed credit standards. Any one of those, carried to an extreme could create safety and soundness problems. A combination of all three is a sure formula for disaster.

There is already anecdotal evidence from one or two metropolitan areas that banks are paying bounties to anyone who refers a successful minority or low- or moderate-income loan applicant. In anticipation of the proposed regulation being adopted finally, banks are apparently already playing the numbers game to get loans on the books. If that sort of behavior is widespread, I smell real trouble down the road.

The proposed imposition of an obligation that banks have branches readily accessible to low- and moderate-income customers is certainly an attempt to allocate bank resources and has a questionable relationship to the extension of credit. Modern lending techniques do not require a branch facility either to solicit business, take applications or service the customer. Automated teller machines provide access to cash and deposit facilities which are probably more efficient than a branch from the customer's point of view in any case. A standard of convenience and need related to branch location is a reversion to standards of 25 years ago. Technology has made those standards completely obsolete. Most banks today are shrinking their branch networks, not in abandonment of markets, but because there are other more efficient ways to distribute services than through brick and mortar branches.

The proposed imposition of punitive measures for substantial noncompliance raises legal questions since the Community

Reinvestment Act itself contains no provision for noncompliance penalties other than the implied authority for regulators to turn down applications from institutions with unsatisfactory CRA records. It seems obvious that the inclusion of cease and desist and civil money penalty authority in the proposal was designed to force the proposed allocation of credit and resources in furtherance of social engineering goals.

As a matter of public policy, I have grave concerns over that course of action. The purposes for which CRA was enacted are eminently sound. Banks do have a moral obligation to meet the credit needs of the communities in which they operate. Over the years since CRA enactment, the Federal Reserve has developed programs and conferences and publications designed to encourage banks to take an aggressive stance in community lending. The Federal Reserve emphasis has been that it can be good, profitable business when done the right way and the incentive ought to be profitable opportunity rather than avoidance of costly penalties. I think our approach has worked. Banks all over the country have sponsored programs of lending that have channeled billions of dollars into cities like New York, Philadelphia, Boston, Pittsburgh, Los Angeles, Denver, Atlanta, Dallas, Houston and many others. In addition, banks in smaller cities and rural areas have learned how to meet the specialized needs of their communities with safe and sound lending programs. It has always seemed to me that positive incentives like profitability and economic development are better than fear of retribution and fines.

But the news isn't all bad. Thanks to the over 2,000 comments the agencies received, we have a solid basis for substantially revising the proposal in an attempt to eliminate the worst aspects and achieve the President's original objectives of more lending and less paperwork. We are working to find ways to encourage more lending without allocating credit and resources and I hope we can avoid any onerous new reporting requirements. There is a serious legal question raised by the proposed imposition of cease and desist orders and civil money penalties. To my way of thinking, the best way to deal with that is simply to drop it.

A new CRA proposal probably merits another round of public comment and I hope the agencies will all agree to that. Better to take a little longer with this project and get it right this time.

There are, of course, other regulatory issues in which we all have an interest. FAS 115 and its impact on portfolio management and regulatory capital is an important issue. The purists would argue that changes to capital as a result of mark to market exercises should be reflected in calculations of regulatory capital with the attendant risk of triggering prompt corrective action even though the losses posted are unrealized. My own view is that a bank is a going concern and unrealized mark to market losses and gains should not be posted to the capital account for regulatory purposes.

Interstate branching, which will be in conference, raises a host of regulatory compliance issues which very well might delay final action long enough for the bill to die with this Congress

in December. I hope not, but there are so many technicalities it may simply be impossible to deal with all of them in conference.

Regulatory compliance is tough now and it will probably get tougher. Congress likes to legislate and increasingly banks offer an opportunity for them to micro-manage by statute. Also, at a time of fiscal constraint at the federal level, the credit capacity of the banking system offers a convenient mechanism to finance social programs. The capital of bank shareholders is substituted for public funds.

I wish I could offer a brighter outlook for the future. I cannot. The danger, as yet unrecognized in Congress, is that the burden of regulation will suffocate the banking industry by putting it at such a competitive disadvantage to other providers of financial services that it cannot survive.

Thank you for your attention. I would be glad to try to answer your questions.

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