For Release on Delivery
11:00 a.m. P.D.T. (2:00 p.m. E.D.T.)
Thursday, May 30, 1985

Thrift Industry Challenges: What Self-regulation Has to Offer

Presentation by

Preston Martin

Vice Chairman

Board of Governors of the Federal Reserve System

to the

U.S. League of Savings Institutions

Conference of the Committee on Larger Institutions

Rancho Mirage, California

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It's a pleasure to be here with you today. I can say without contradiction that this is a period of unique challenge for your industry and for banking and thrift regulators, and I would like to focus my remarks on the new approaches these times call for from both regulators and management. It has been alleged that our financial institutional setbacks are almost wholly a function of deregulation. You know that is a half truth at best. Financial losses have occurred for a number of reasons including disinflation, management errors, and certain regulatory constraints. Market forces are unleashed: they cannot be recontained. Financial institution management must widen and refine its offering of services. Some of these will be costly in a profit center sense.

Management cannot lose sight of its most basic objective, long-run profitability, in its effort to diversify its "products" or its willingness to undergo short-term operating losses. Moreover, bankers and thrift institution managers have to seek profitability and growth in an economy in which disinflation appears here to stay for the foreseeable future. Technological change is growing at an increasing rate, forcing financiers to invest very substantial funds into systems for which the return on investment is uncertain.

One effect of disinflation, deposit deregulation, diversification, and even deflation--in commodities, energy assets, some housing values, foreign assets, and farm land--is perception of asset quality. Old views are challenged. In addition, today's economic expansion has bypassed whole regions and industries here and abroad. I would submit that the price of market change is not reregulation--rather it is more effective management and superior government supervision.

Let me turn to the governmental examiners and supervisors who, on the one side, cannot afford to reduce the consideration of the safety and integrity of each institution. A subset of governmental objectives, an important one, is the responsibility of the banking and thrift agencies, particularly the Federal Reserve, for the integrity of the whole of "banking" or of payments system institutions. Forms of organizations are growing more complex with affiliates, subsidiaries, and joint ventures. As your asset structure becomes more diversified, it is imperative that the examination approach allocate more resources toward measuring and analyzing the quality of assets and somewhat less toward the most technical aspects of compliance. This is not to slight potential conflicts of interest, market concentration, financial disclosure, or consumer protection, but to reallocate priorities in your and our review process.

The most encouraging sign I have seen, is greatly enhanced management focus on the vital documentation of policies and controls in credit extension and asset acquisition, and on the "three Rs"--review, review, and review. I observe with satisfaction changed thinking in thrift risk management; the designation of a more senior executive, a senior management group, and a board committee to control the review of credit decisions. This particular function is so important that we, and you, must carefully analyze those controls. Your internal auditor and your CPA firm are in a strategic position to help, on a periodic basis, by your insistence on an evaluation of procedures, policies, and objectives which lead to quality of assets.

Today's dynamic environment demands greater regulatory focus upon quality control, not replacing increased roles played by senior management, internal auditors, and CPAs. How will these supervisory roles be accomplished? First, there must be an increase in the number of qualified, experienced auditors and supervisory examiners, and an accentuation of the use of information management techniques to delimit the scope of examinations to those areas of particular risk in the institution being examined. Secondly, the accounting profession is compelled to assume a more quality asset-testing role, one which will give top management better information as to high relative risks within an audited institution.

Risk exposure has gone so far that the control augmentations I have enumerated may not suffice, however. I am advocating that both the banking and the thrift industry and their regulators seriously consider the feasibility of some form of "peer review" or self-regulation. It is time that all of us consider how the known short-run trends in risk-taking--known, that is, to the management within the banking industry and within the thrift industry--can be delved into to accomplish a new quality of risk management.

I believe there have been substantially salutary effects from self-regulation employed in the securities industry, the CPA profession, and the nuclear power industry. Although each is structured differently, there is clear benefit by drawing from knowledge within those industries. Let us take a closer look at the securities industry, the New York Stock Exchange, and the National Association of Securities Dealers (NASD) in regard to self-regulation.

A primary function of the New York Stock Exchange, in addition to providing a marketplace, is surveillance and regulation of member organizations. This self-regulation has two purposes: (1) to make sure that Exchange members financially and operationally fulfill their obligations to each other and to customers; and (2) to uphold standards of quality service to investors.

While the Exchange maintains a system for regulation and monitoring its member organizations, the process of self-regulation begins with the members themselves. It is the members, through the governing machinery of the Exchange, who impose rules of conduct upon themselves. The Exchange then publishes the standards and requires member organizations to apply them.

Self-regulation is administered by a professional staff at the Exchange. Rules are adopted by the Exchange's governing board, comprised of 10 representatives of the securities industry, 10 repre-

representatives of the public, a full-time president, and a full-time chairman. A special surveillance committee of the Exchange's Board of Directors keeps watch on any troublesome situation and helps devise remedies. Any firm showing danger signs based upon criteria of the Exchange is reported to this committee which monitors the situation until corrected. The committee includes six securities industry representatives, including two directors who have intimate knowledge of brokerage management, and two public directors. The Chairman of the Exchange serves as a member.

To carry out these responsibilities, the Exchange uses a broad range of techniques. These include: (1) computer analysis of financial and operating reports from the brokerage firms; (2) routine annual examination; (3) surprise field visits by Exchange examiners to check on sales practices as well as finances and operations; (4) audits by independent public accountants; and (5) monitoring by coordinators who have information concerning every member.

The Exchange Constitution and rules authorize a wide range of penalties for organizations and individuals that violate their provisions. These penalties range from censures, fines, and temporary suspension of employment to expulsion from the Exchange community which is tantamount to being permanently barred from the securities industry. The enforcement department investigates and reviews each report and if formal disciplinary action is warranted, brings charges before an Exchange hearing panel which has power to issue a verdict and impose a sentence. Hearing panel decisions may be appealed to the Exchange's

Board of Directors, to the Securities and Exchange Commission, and ultimately to the federal courts.

The 1975 amendments to the Securities and Exchange Act considerably enlarged the SEC's role of oversight, while still leaving the bulk of day-to-day regulation and surveillance in the hands of the industry. While the New York Stock Exchange serves as the primary regulator for its members, it does not do the job alone. The Exchange works closely with organizations which provide a self-regulatory framework for other parts of the securities industry and with the clearing corporations that clear and settle transactions among brokers. All the data in the FOCUS reports and in the many other financial and operating documents filed with the Exchange, are simultaneously available to the federal regulators, who are also kept fully informed of disciplinary actions.

NASD is the self-regulatory organization of the securities industry responsible for the regulation of the over-the-counter securities market. NASD endeavors to satisfy its responsibilities through enforcement of the provisions of the federal securities laws as well as its broader ethical rules of conduct which obligate members to observe high standards of quality service. Membership totals 4,900, more akin to the size of our banking and thrift industries.

A Board of Governors is the controlling body of NASD and determines policy on a national scale. The membership has been divided into 13 districts with representation on the Board based roughly on the number of members in each district.

The Board of Governors consists of 31 members, 21 of whom are elected by the membership; 9 governors are elected by the Board, 3 represent NASDAQ companies, 2 insurance companies, 1 an investment company, and 3 represent professions relating to the securities industry, such as accounting, business, education, and law. The president of NASD serves as a continuing member of the Board.

Working directly with the Board are various special committees which are appointed by the Chairman of the Board to study special areas of NASD activity and to advise the Board. Some of these committees are composed exclusively of members of the Board while others include non-Board members who are specialists in the particular areas assigned to them.

NASD fulfills its self-regulatory responsibilities by means of an integrated plan involving a nationwide field inspection program carried out by the 13 district offices and supported by the executive office. The purpose of this program is to ascertain member compliance with NASD rules, federal securities laws and the rules and regulations thereunder, and other applicable rules and regulations including the rules of the Municipal Securities Rulemaking Board with respect to members' municipal securities activities.

Enforcement proceedings may take place through the district committee, as well as the imposition of penalties. NASD rules also provide for an appeal process to NASD's Board of Governors as well as to the SEC, and, if required, to the federal courts. The SEC receives a copy of every decision rendered by a district committee and they call up for review any disciplinary action taken by NASD. SEC also reviews annually NASD's assessment schedule to determine whether it is fair and equitable.

We can learn considerably from these experiences and structures within the securities industry. Although peer review in the securities industry is quite advanced, it provides a good starting point and the following ideas.

The main objective of self-regulation in banking and thrift would be the maintenance of high standards of quality control within the key areas of lending, investing, and funding to insure the public of the safety and soundness of the system.

Under the auspices of a board of directors, representing the broad segments of banking or thrifts, and the public, objective standards of quality would be assembled for use in the measurement of reviewed institutions. Board members would serve for rotating terms to insure fresh ideas and broad representation.

Because of the issues of competition and conflicts of interest, it would be advisable that an independent staff of reviewers, perhaps on loan from industry firms in part, conduct the detail of the reviews. However, the completion and issuance of reports would occur through subcommittees of the board of directors. Such subcommittees could be established based on size and type of institutions. Also, the extent and timing of reviews would be based upon risk factors and past experience.

Although participation in such a program could at first be voluntary, the industry may see benefit in the long run in a mandatory requirement, in order to complement reliance of government regulators with the results of peer review. Coordination with the regulators, confidentiality, and the subject of sanctions will also need to be debated.

I think that the necessity of better, more effective supervision in today's high-risk, high-exposure financial world demands serious consideration of ways to draw on industry knowledge in measuring the quality of assets in commercial banking and in the thrift industry. We have arrived at a crossroads in the banking and thrift business, which faces a future considerably different from the past. New techniques are therefore required to insure stability on the path to 21st century banking. The challenges and opportunities confronting thrifts will continue to increase, and thrifts' managements are and will be stepping up to greater leadership roles in maintaining safety and soundness in the changing banking and thrift industries. Today's higher-risk thrift institution requires new approaches by the examiners. Industry self-interest, I would submit, also necessitates your involvement in self-regulation and other solutions.