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Remarks by

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Good morning. It is once again a pleasure to attend the CSBS conference and to have the opportunity to share thoughts with you about how events are changing the manner in which we supervise and regulate banks. This past year was another great year for the banking industry in terms of profitability and overall financial strength, and state-chartered banks were no exception. At the end of 1995, more than 70 percent of all U.S. commercial banks were state chartered, and they held a larger share of the industry's assets (44 percent) than at any time in the past 20 years. Moreover, I understand that the state-federal protocol, a framework that should go far to strengthen cooperation between state and federal agencies, has now been endorsed by the state banking departments, the Federal Reserve, and the FDIC.

As state bank supervisors, we can take some comfort and perhaps satisfaction from these accomplishments. However, those of us who are not so new to the business know that neither bankers nor bank supervisors can afford to be complacent. The banking system and banking laws and regulations are changing, driven in large part by new technologies. These changes present challenges to bankers, to bank supervisors, and -- as much as ever before -- to the future attractiveness of a state charter. Those of us who believe strongly in the merits of a dual banking system need to take these challenges seriously and work together to ensure that the system remains strong.

Advances in technology and deregulation are expanding both the range of products banks offer and the scope of their markets. Moreover, with the advent of true interstate banking and branching, the geographic markets in which banks can operate will also be expanded. As a central bank governor, I view these changes as beneficial to the U.S. economy and to the overall efficiency of our financial markets. In many respects, they are long past due. However, these changes and perhaps more to come can also have profound implications for the way we supervise and regulate banks.

New products and competition

It seems that whenever I talk about challenges facing the U.S. banking system, the list includes an ever-increasing level of competition between and among banks of different sizes and types. Then there is also competition from mutual funds and other nonbank providers of financial services. Banking must be a great business, with so many institutions wanting to get into it. That pattern of growing competition apparently reflects the underlying nature of financial markets in this country, as technology and the shift toward a service economy permits or requires more companies to compete with banks.

Despite the consolidation occurring within the U.S. banking system, the competitive pressures facing the industry are as strong as ever, with no meaningful let-up in sight. The shrinkage has reduced the number of separate banking organizations by roughly one-third since 1985, but has still left nearly 8,000 separate banking organizations alive and well and has permitted the industry's assets to climb to $4.3 trillion. Moreover, even the number of branch offices continues to increase, to say nothing of ATMs and forays by some institutions into retail electronic banking.

Fortunately, though, the discussion at both the federal and state levels has now turned to ways the banking system can fight back through expanded powers and fewer geographic and other regulatory constraints. Through all this change and consolidation, community banks -- I hasten to add -- have remained highly profitable and viable competitors. I believe they can remain competitive in the face of changing technology and regulations to the extent they are able to accurately gauge and develop their market and product niche.

The new product areas that banks are pursuing, particularly insurance and securities sales, are hardly new or emerging markets that are short on competition. Although banking organizations should have the opportunity to offer these financial products, I hope they enter the markets carefully and with an adequate recognition of the underlying risks. While growth of Section 20 companies has allowed some large institutions to expand their corporate underwriting business domestically, for most institutions the new insurance and securities activities have involved essentially a broker's role. As such, they have helped banks boost their noninterest revenues with relatively little apparent risk.

The greatest risk to banks from these products may come, however, not from the more traditional credit or even market risks, especially if they maintain a broker role. Rather, banks may face new forms of business or reputational risk if their customers experience losses on these new products. Even if the banker fully informs the customer of the risks and the noninsured status of the investment at the time of sale, only time will tell whether bank customers will hold a grudge when markets turn south. In this sense, enforcing regulatory standards for disclosure seems fully consistent with promoting bank safety and soundness.

Last year I spoke with you about technology and banking markets, largely in the context of derivative instruments and their effect on regulatory capital standards. Derivatives remain concentrated among a relatively small number of large money center institutions. Indeed, the number of banks (563) reporting derivative instruments in their bank call reports at the end of last year was lower than at any time in the past five years. Nevertheless, the dramatic growth in the volume of these instruments and of the technology and innovation they represent are significantly affecting bank management practices. They are, in turn, also affecting the supervisory practices of the Federal Reserve.

Many of you may know of the decision last December by the Basle Committee on Banking Supervision to use a bank's internal value-at-risk models in determining regulatory capital requirements for trading activities. However, before permitting an institution to use its VAR models, regulators will need to confirm that the bank's risk measurement, management, and control process meets certain quantitative and qualitative standards.

That decision to use models, albeit with strings attached, reflects the growing complexity of certain bank activities and the improved risk management techniques that banks are developing to manage the related risks. It also reflects a recognition by regulators that our approach toward capital standards can help to promote safety and soundness in different ways -- not only by requiring an adequate amount of capital, but also by providing bankers with added incentives to develop and maintain sound risk management and control procedures in their daily operations.

I believe we should take that approach more often, as we consider future amendments to our regulatory capital requirements. While the current risk-based capital standard has served us well, it should be viewed as the minimum standard it was originally intended to be and not used to address all financial and nonfinancial risks. Bankers are innovative and can usually find exceptions or variations to specific situations addressed by capital requirements.

Rather than continue to fine tune or materially redesign supervisory measures of risk, we should rely more on the ability of institutions to demonstrate why their current capital ratios are adequate. That approach would be less intrusive, while spurring bankers to conscientiously consider and analyze their unique risks profiles and capital requirements. Concentration risk, for example, is a risk not easily quantified, but is one that most bankers -- particularly community bankers -- recognize as very relevant to their activities. Rather than providing a safe regulatory harbor, this approach forces bankers to assess their risks.

Evolving management and supervisory techniques

The Federal Reserve, and indeed all of the federal banking agencies, are placing more emphasis on a bank's *risk management and control processes and procedures*, while still performing loan-by-loan reviews and other so-called "transaction testing" to make sure the procedures have been implemented. This emphasis on risk management is particularly important at the largest institutions because of the volume and pace of transactions and the importance of trading, derivatives, and asset securitization activities.

For such institutions, supervisors clearly recognize that they cannot rely on a snapshot of the bank's condition at a particular time because its risk profile can change so very quickly. Rather than determine the "answer" on a given date, we want to assure ourselves that the bank has adequate procedures in place to maintain asset quality, adhere to established trading limits, and so forth long after we leave the bank. While this shift in supervisory focus will be much less pronounced at smaller banks, it will extend to some degree to all institutions supervised by the Federal Reserve.

In order to accommodate this shift, the Federal Reserve will be implementing a variety of procedural changes designed to make the examination process more effective, as well as less burdensome to banks. These changes should provide examiners with more flexibility to tailor individual examinations to a bank's particular circumstances and to devote examiner resources to areas considered most important to the institution's earnings and capital. The changes range from allowing examiners-in-charge more time to plan examinations to making greater use of statistical sampling techniques and computer technology.

Pre-planning and "scoping". Providing examiners with sufficient time to pre-plan an examination has always been important, but has not always received the attention it deserves. Under a more tailored, risk-focused examination, adequate prior planning becomes essential. In doing this, examiners review earlier supervisory reports and conclusions, internal reports of bank management, public documents, analyst reports, and other information to determine which risks are likely to be most relevant to the institution. They are also expected to keep abreast of developments between examinations, especially for larger institutions, and to meet or otherwise discuss matters with management, as necessary. As an aside, in the context of technology, I would note the growing number of banking organizations that are placing their quarterly statements and other reports on the World Wide Web.

Certainly credit risk has been and remains the dominant risk for virtually all banks, but market risk and other risks -- even reputational risk -- should not be overlooked. After assessing the level and relative importance of various risks, it is important that examiners determine more precisely which activities will be reviewed, how they will be evaluated, and why other activities will be given less attention. These decisions should be based on the examiner's earlier review and on relevant discussions with other supervisors and with internal and external auditors about how our collective resources should be allocated. These decisions should be documented. This revised approach should give examiners more flexibility to make judgements than they might have had before.

This "focus on risk" is only one of a number of initiatives the Federal Reserve is undertaking to improve the effectiveness and efficiency of its supervision. Moreover, while there has been a fair amount of publicity given to risk management, I believe its significance can be easily overstated. For the vast majority of U.S. banking institutions, the basic structure of the examination approach may not materially change, although bankers hopefully will perceive the process to be more efficient and less intrusive than it has been in the past.

Workstations and information requests. As the World Wide Web, pentium computers, and real-time information systems are becoming commonplace and as banks are looking everywhere to cut costs, bank supervisors need to conduct examinations in ways that are less disruptive to banks. In conducting our work, we need to be sensitive to the many demands placed on bankers as they deal with change and with high levels of competition. While we should expect them to cooperate fully, we should try to minimize the interruptions we create.

It may be particularly difficult for supervisors to be very demanding when the industry is reporting strong asset quality and posting record earnings year-after-year. Claims of regulatory burden always get an audience, whether the claims are justified or not. After all, who needs meddlesome bank supervisors when times are so good? Although we know conditions will change and that we should remain vigilant at all times, supervisors should genuinely search for better ways to do our jobs -- not just to avoid criticism -- but because it is the right thing to do.

In both the planning and onsite examination process, we can make greater use of available technology to improve efficiency and reduce supervisory costs and burdens without sacrificing the quality of work. One example is to pursue opportunities to download selected information from a bank's computers onto examiner PCs. At that point, examiners can analyze some of the bank's exposures, identify concentrations and other characteristics of the bank's loan portfolio, and perform other statistical and financial analyses.

Such a process should permit examiners to reduce materially the amount of time they spend on manual operations and should enable them to spend more time identifying and evaluating risks. A Federal Reserve workstation that would perform these functions is being tested now in cooperation with the FDIC and several state banking departments. Using such systems should also cut significantly into the time examiners spend during onsite examinations. That, in turn, should allow us to use examiner resources more efficiently and also make bankers more satisfied with the process.

Another way to reduce the burden of examinations is to request information as much as possible in a format "friendlier" to the internal information systems of a bank. We should all strive to construct first-day letters and other information requests in a format that is as similar as possible to the bank's management reports. While there are limitations to our flexibility, at the Federal Reserve we are committed to working closely with other supervisors and the banks in structuring our requests so that they are more accommodative to readily available information.

Interstate banking and branching

I cannot address this audience without taking the opportunity to discuss interstate banking and the critical importance in this environment of supervisory coordination. This situation fits Benjamin Franklin's statement to a tee, "If we don't hang together, we will surely hang separately." As I said in my opening remarks, the state banking system is today both competitive and strong. We are surely aware, though, of the serious potential threat to the future of the dual banking system. For many small banks, we may see relatively little effect from the new interstate branching law. But for large state-chartered banks, the removal of interstate barriers could be revolutionary. It is important to the future of the dual banking system that we coordinate our supervisory and regulatory regimes to create a virtually seamless process.

I believe the state and federal banking agencies have worked well in the past to minimize conflicts and duplication in our oversight activities, although more can always be done. In the current environment, though, it seems more important than ever that we work hard to "get it right."

In an effort to coordinate policies, the Federal Reserve, the FDIC, and representatives of the CSBS and several state banking departments have formed in the past year a State-Federal Working Group to create such a seamless system. Their efforts build upon the protocol agreed to unanimously last year by your state banking departments that was also directed at supervising state chartered banks with operations in more than one state. These agreements among states and between state and federal supervisors represent the kind of cooperation we all need in order to make the process work.

The dual banking system has provided many benefits to our economy, and banks that operate interstate should have the option of a state charter. In this spirit, the development of the state-federal protocol and its related model cooperative agreement represent an important step toward improving coordination in the supervision of state chartered banks and reducing the regulatory burden on them. As such, this document should complement nicely the CSBS protocol endorsed last year that set out a cooperative framework for home and host state supervisors.

The Federal Reserve is strongly supportive of these types of efforts and looks forward to other ways in which state and federal supervisors can work together to make the supervisory and examination process more efficient and effective, more risk-focused, and more burden sensitive. I can tell you with confidence that the Federal Reserve recognizes the benefits of close and cooperative working arrangements at both the federal and state levels.

As we all know, though, the "devil is in the details" and the "proof is in the pudding." We need to remain united in working through the specific procedures discussed in other sessions of this conference and, very importantly, must also remain committed to implementing these agreements day-by-day.

Conclusion

In closing, I would suggest that these could be either the best of times or the worst of times for the dual banking system. Economic conditions for banks are good, and bank supervisors are working diligently to reduce unnecessary costs to ourselves and the banking system. Moreover, as it evolves in the coming years, interstate banking and branching should provide new opportunities and markets for many institutions and new challenges to supervisors. As supervisors, we have done and are doing much to streamline our activities and to make the supervisory process more efficient. Ultimately, though, the U.S. Congress must also do its part if the industry is to expand further its product lines and enjoy the benefits of less regulation.

In the months and years to come, it is critical that state bank supervisors at both state and federal levels work closely to carry the concept of seamless supervision to fruition. Next year will provide a critical test of our determination and ability to do that. By next year's conference we may begin to see the results.