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# CHALLENGES OF CHANGE

Remarks by

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## Introduction

It is a distinct pleasure to have the privilege of meeting with you today to discuss the challenge of change in our banking and financial system. It is clear that we are entering--indeed it is probably more accurate to say we are in--a period of accelerating change and, therefore, a period of great challenge for both bank managers and bank regulators. It seems that nearly every day a new financial instrument is created, a new banking service introduced, a new technology unveiled, or a new regulatory loophole discovered. Ours is a world of credit cards one day, debit cards the next; automated teller machines one day, home banking the following; interest rate futures one day, options on interest rate futures another day; nonbank banks one day, nonthrift thrifts the next. I need not document all these changes to you, for you and your banks are the agents, promoters, originators, and beneficiaries of many of the changes. My intention is simply to illustrate the magnitude of the challenges and to point out the two-sided nature of change--it presents both positive opportunities and new potential risks. It is incumbent upon us, therefore, to promote change in a constructive, not a bewildering, fashion.

These changes are of paramount importance because of the crucial role played by banks and other depository institutions in our financial system. Depository institutions perform a number of unique and critical functions with national and global implications. Among other things, depository institutions administer the payments mechanism through the issuance of transaction accounts to corporations and individuals, serve as key providers of credit to individuals and businesses, and act as the vehicle through which the effects of monetary policy are transmitted to the economy. Given the profound importance of each of these functions, we have a special responsibility to act wisely in the face of change. All of our decisions, good and bad, will be magnified.

The unprecedented pace and magnitude of change in the banking industry require a flexible and responsive regulatory structure. Recent history suggests that the marketplace changes faster than the laws that attempt to regulate it. (De facto interstate banking is just one outstanding example.) If this lesson carries through to the future, it is imperative that regulators and depository institution managers work together to shape laws and regulations that will make sense in the face of the changes to come in the industry. If not, unnecessary resources will be expended, as they are now, to find loopholes in archaic laws.

Before discussing some of the critical challenges we face, I would like to share what I believe are the major objectives of our banking system. After all, our approach to change should be guided by a clear vision of our objectives. As regulators, we often express our objectives in terms of a banking system that is competitive, innovative and efficient, and safe and sound. It seems to me that bankers also share the same objectives. What differences exist are likely to be differences of approach, not substance.

As we face the challenges ahead, it is important for bankers and regulators to understand each other's concerns and perspectives. Bankers have increasingly come to understand that market and technological changes, the development of new products and services, and the rescission of obsolete or unnecessary regulations can open new opportunities to better serve their customers and communities and, thereby, enhance their opportunities for growth and improved profitability. For this reason, bank managers have begun to seek greater freedom to manage and respond to change in ways that maximize reliance on free markets. Regulators, on the other hand, are sensitive to the possibility that along with change, innovation and new opportunities can go new types and levels of risk exposure for banking organizations.

The critical test for both sides, bankers and regulators, is to strike the proper balance among the sometimes competing objectives I outlined above. In general, I believe that the most effective means of achieving the objectives--competition, innovation and efficiency, and safety and soundness--is to allow the creative energies that abound in the marketplace to operate freely. That means that, as regulators, our job is to facilitate change, not to hinder it. Likewise, our responsibility is to administer a system of incentives and constraints designed to promote prudence and discipline, not to decide on how individual banks respond to the system of incentives and constraints. That responsibility lies in the hands of management and the directors themselves.

The regulator's ultimate concern, of course, is the safety and soundness of the banking and payments system. Only by understanding the dynamic environment in which depository institutions operate--and the opportunities and risks that can accompany change--can regulators carry out this critical responsibility in a way that benefits all sectors and participants in our complex and growing economy.

## Some Specific Challenges

I would now like to discuss some of the major changes and developments over the last several years--and some possible prospective changes--that have complicated and will, no doubt, continue to complicate the task of both managing banking organizations as well as supervising them. The principal developments that I would like to address may be subsumed under the following categories: i) economic/financial, ii) technological, iii) regulatory/competitive and iv) public confidence.

Economic and Financial Environment

Economic and financial developments shape the environment in which banking organizations operate, and have a major impact on the financial health and stability of the banking system. Since the early 1970s, the U.S. economy has experienced two severe recessions and has, at various times, been subject to significant financial pressures stemming from high and volatile interest rates. Since the early 1980s, these developments have led to an increase in business failures and problem loans. Particular sectors such as agriculture, energy, commercial real estate, heavy equipment and manufacturing have been especially hard hit. Moreover, many firms have taken on increasingly high levels of debt which has weakened their ability to withstand unanticipated shocks. These developments, combined with overly rapid growth and, in some cases, a deterioration in credit standards and controls, have resulted in a significant increase in bank failures which reached a post-depression high of 79 in 1984. In addition to the increase in the number of bank failures, we have also seen serious earnings and asset quality problems in some of our nation's larger institutions.

While I believe our economy has returned to a long-run path of sound, sustainable growth, the volatility and uncertainty of the 1970s and early 80s have left a legacy of troubled loans in some depository institutions. This situation has been exacerbated by the strains experienced by farmers and certain manufacturing firms whose financial health has been further hurt in recent years by the continuing high exchange value of the dollar. Clearly, the events of the last several years underscore the critical importance of asset quality and the need for senior management and directors to establish sound lending standards and internal controls for limiting bank exposure to credit risks. This is especially true during economic recessions, but even in a dynamic and growing economy some sectors, such as is presently the case in the oil and gas industry, will be experiencing difficulties or adjustment problems that require vigilance on the part of both bank managers and bank supervisors.

Events of the last several years also highlight the critical responsibility of bank managers and senior financial officers to ensure that their institutions maintain a strong financial profile in order to withstand unanticipated shocks and strains. In this regard, adequate capital and liquidity, and a balance sheet that is resistant, or, at least, not unduly exposed to interest rate risk, are of paramount importance. We regulators have traditionally been extremely concerned about the maintenance of adequate capital in banking organizations and, in particular, about the decline in capital levels that characterized many of our larger institutions in the 1970s and early 80s. As most of you know, the Federal banking agencies have established capital guidelines or regulations specifying acceptable minimum capital ratios. No one, of course, has yet devised a scientific method for determining what is the right amount of capital for all organizations under all conditions, and some of us--here I include myself--are not overly enthusiastic about fostering a proliferation of supervisory rules that tend to be somewhat arbitrary and, at times, inflexible. However, as I have suggested, it is incumbent upon <u>bank management</u> to ensure that strong capital positions are maintained over time, and the Federal Reserve's capital guidelines program was, in part, a regulatory response to the failure of some banking organizations to prevent the decline in their capital ratios to very low levels.

Within recent years, the capital ratios of many banking organizations have increased significantly. In attempting to raise capital ratios and satisfy supervisory capital requirements, however, it is, of course, essential that bank managers avoid steps that may actually increase risk exposure, reduce liquidity, or undercut the intent of the banking agencies' capital adequacy programs. For example, a reduction of low-risk, money market assets in order to generate a higher capital-to-total assets ratio may do little to reduce risks and may actually weaken an institution's overall liquidity. In a similar vein, the assumption of excessive contingent liabilities and arrangements to move significant credit risks off the balance sheet, while minimizing the adverse impact on capital-to-assets ratios, likewise does little to strengthen an organization's capital adequacy or its overall financial condition. Indeed, the issue of the rapid growth of off-balance sheet activities and risks is of concern to all regulators and represents an area in which bank managers must sharpen their understanding of and control over risk-taking. In the first instance, it is the responsibility of each bank to control its own risk--this, in my view, is preferable to the imposition of restrictive and inflexible rules which should only constitute a last resort for bank regulators.

While we have experienced a good deal of volatility and uncertainty in recent years, one development, in particular, augurs extremely well for the growth and overall stability of our economy. I am referring to the significant decline in the rate of inflation from the double-digit levels of a few years back, which placed the economy on a more firm footing for future growth. However, this favorable development has placed considerable pressure on some borrowers who, during the period of rapid inflation, incurred debt with the expectation that their loans could readily be repaid with depreciated dollars. The transition from an inflationary to a more stable economic environment can indeed place strains on certain borrowers and, in turn, affect their ability to repay their debts. However, the long-run benefits to the economy of a more stable price level are immense, and I can assure you that the Federal Reserve is committed to continuing the progress that has thus far been achieved in reducing the rate of inflation.

Technological Change

Another major factor affecting the environment in which banks must operate is the speed and nature of technological change. The combination of traditional banking services with new telecommunications, electronic data processing, and funds transfer technologies has created new products and services, and has diminished the importance of geographic barriers in the provision of banking services. It is, of course, impossible to say where this technological revolution will lead. What is clear, however, is that these changes will create new product opportunities, new ways for banks to serve their customers, new forums in which depository institutions will have to compete, and continued pressure to eliminate outmoded regulations that tend to inhibit constructive responses to market forces. Managers of depository institutions must understand the nature of technological change, how this change will affect the evolving needs of their customers, and the implications of the acquisition of new technologies for expense control and overall profitability.

Regulatory/Competitive Environment

A hallmark of the last several years has been the growing trend toward deregulation of our banking and financial system. We are indeed in the midst of a rapidly changing regulatory and legislative environment that has already greatly altered, and will continue to alter, many of the ground rules that have affected the performance of depository institutions since the 1930s. This, as I have already suggested, has ushered in many new opportunities and challenges.

Deregulation means many things to many people, but generally the term refers to the lifting of interest rate ceilings, the expansion of asset powers and other permissible activities, and the dismantling, however fitful and gradual, of geographic barriers to deposit-taking. In addition, I would point to another element of deregulation that, while it has perhaps achieved less publicity, is in my view no less important. That is, the commitment on the part of regulators to periodically review their regulations and supervisory policies to eliminate any unnecessary or obsolete restrictions that do not have a clear and demonstrable safety and soundness rationale.

Interest rate deregulation gained impetus in the late 1970s as inflationary expectations and financial uncertainties drove open market rates above the deposit rate ceilings applicable to regulated depository institutions. As you were no doubt painfully aware at the time, banks and other depository institutions suffered significant deposit outflows resulting from the ability of money market mutual funds to pay market rates and offer checking accounts, unencumbered by rate ceilings and reserve requirements. The phase-out of rate ceilings begun in 1978, broadened and enacted into law in 1980 in the Monetary Control Act, and, subsequently, administered by the Depository Institutions Deregulation Committee, is now virtually complete. Depository institutions can now compete more fairly among themselves and with other financial service companies for the funds of depositors and savers. While this has raised the cost of funds for some smaller institutions, it has also improved their access to consumer deposits that were flowing to the money market funds or other financial intermediaries.

By improving the competitive fund-raising position of depository institutions, rate deregulation has provided many benefits and has lessened the likelihood that institutions will experience the liquidity pressures and deposit outflows associated with disintermediation. However, there clearly are costs and risks that have accompanied the lifting of rate ceilings. Depository institutions' liability structures have become more rate sensitive, and this can place severe pressure on spreads and margins when interest rates increase. Moreover, competitive pressures, combined with overly exuberant growth plans, have induced some institutions to pay excessive rates for funds, and, in turn, to make high risk, high yielding loans and investments in order to cover their costs. Thus, the competitive opportunities opened up by interest rate deregulation have also exposed depository institutions to the potential risks associated with increased funding costs, asset/liability mismatches and the tendency to seek higher yields through the assumption of excessive risks. Bank managers, in such an environment, must closely monitor the maturity, cost and rate sensitivity of their liabilities, and ensure that the risk and reward relationship inherent in their loan and investment portfolios is kept within reasonable and prudent limits.

The phase-in of deposit rate deregulation has highlighted the importance of providing depository institutions with greater powers and freedom on the asset side of the balance sheet. This has been particularly evident in the case of thrift institutions who have experienced the severe, and often fatal, consequences of funding relatively low-yielding, fixed-rate mortgages with deposits carrying higher market rates of interest. Thrifts, of course, have had their asset powers broadened considerably by the Monetary Control Act and the Garn-St. Germain Act, and depository institutions in general have been given greater loan pricing freedom by the repeal or liberalization of usury statutes. Further, depository institutions of all types have continually developed new products, services and delivery systems to better meet the needs of their customers.

Despite the degree of deregulation that has already occurred, changing market conditions, the advent of new technologies, intensifying competition among various types of financial institutions, and the existence of loopholes in the present regulatory framework, continue to underscore the pressing need for a thorough reevaluation and clarification of what powers banking and other depository institutions should be allowed to exercise. Consistent with its safety and soundness concerns and public policy as reflected in existing statutes, the Federal Reserve Board has acted where appropriate to expand the "laundry list" of activities that are permissible for bank holding companies. For example, within the last few years, the Board has allowed holding companies to provide discount brokerage services, to act as futures commission merchants and to arrange equity financing for commercial real estate. The Board has also taken steps, consistent with existing law, to streamline and reduce the burden associated with the process of applying to make acquisitions and to conduct new activities.

Ultimately, of course, the Congress--not the regulators or the courts--must determine what powers depository institutions may exercise and, therefore, what is the proper line of demarcation between banking and other forms of commercial activity. In so doing, Congress will have to consider the changing environment, and weigh the opportunities and benefits associated with new powers for depository institutions against the potential risks involved. The Federal Reserve has supported an expansion of certain powers for depository institutions--such as the underwriting of municipal revenue bonds and mortgage backed securities, the sponsoring and distribution of mutual funds, and certain insurance and real estate brokerage activities--while ensuring an adequate regulatory and supervisory framework and maintaining the basic separation of banking and commerce. I personally agree that depository institutions can be given additional freedom and latitude to respond to market forces and customer needs, without compromising our concerns over safety and soundness.

The advent of interstate banking poses another challenge to bank managers. As an economist, I see great benefits from the removal of restrictions on entry into new markets. Enhanced competition will benefit bank borrowers and other customers, and the greater diversification that depository institutions will be able to achieve should, other things equal, help to lower banking risks. Both bank managers and regulators, however, need to be sure that geographic expansion is supported by adequate financial and managerial resources and strong capital positions. There is, of course, already a considerable amount of interstate banking in the provision of most bank services, except for the taking of deposits, and even in this latter area, funds transfer technologies and the activities of money brokers have begun to diminish the importance of geographic restrictions.

A number of states have already enacted, or are in the process of considering, statutes that allow the acquisition of in-state banks by out-of-state institutions, although in many cases the potential acquirers are limited to institutions located in specified geographic regions. While regional pacts may play a role as a transitional mechanism to full interstate banking, such arrangements should not be used to protect the market positions of dominant regional organizations or indefinitely restrict entry into regional banking markets. In the case of those states that have opted for regional arrangements, the Federal Reserve supports a national trigger that would at some future point allow full interstate banking, with appropriate safeguards to preclude undue concentration of resources on a national basis and within individual states.

In my view, a national approach to interstate banking will maximize the number of potential bidders and entrants, broaden the opportunities for those organizations that wish to be acquired and strengthen competition in the banking system. I do not believe that small banks will disappear or that the total number of banking organizations will decline to the extent predicted by some forecasters. It is clear, however, that in such an environment bank managers will be forced to sharpen their skills, better understand and respond to their customers' needs, and adapt to change. Indeed, the common thread running through all of the developments I have mentioned is the prospect for intensified competition among depository institutions and between depository institutions and other financial services companies. I believe this point is critical and must be stressed: bank managers must innovate and respond to change in a way that serves their customers and assures their profitability, while avoiding unsafe and unsound practices and undue risk-taking. The job of managing and regulating financial institutions is becoming increasingly complex, and both bankers and bank regulators will be critically tested in the years ahead.

## Public Confidence

I would like to mention one other challenge that I believe bank managers face in light of recent developments in the banking industry. This relates to the public's perception of and confidence in the banking system. The increase in the number of bank and thrift institution failures, the notoriety associated with certain well-publicized examples of insider abuse, mismanagement and excessive risk-taking, and the extensive problems recently experienced by privately insured depository institutions have raised questions in some people's minds about the safety of financial institutions and the degree of prudence exercised by bank and thrift managers. The most egregious cases of mismanagement and insider abuse have, I believe, been quite limited--by far the overwhelming preponderance of bank managers are highly skilled and operate their institutions in full compliance with banking laws and prudent banking practice. Nonetheless, there is, I believe, a degree of public concern that the managers of some depository institutions may be inclined to take excessive risks with depositors' funds. This concern must be addressed by bank managers in a straightforward manner. The public must have complete confidence in the banking system, and the actions of bank managers must truly justify and reinforce this trust. Depository institutions operate to a large degree on public confidence, and bankers cannot hope to garner the support needed to continue the trend toward deregulation if the wisdom, prudence or legality of their actions is open to serious question.

## Responsibilities of Management and Directors

The responsibility to meet the challenges I have outlined lies squarely on bank management and boards of directors. As members of senior management, you must have a firm grasp of the nature and type of risks your organization has undertaken. This grasp must embrace not only the traditional risks associated with lending and investing, but also the exposure arising from off-balance sheet banking in the form, for example, of standby letters of credit, involvement in financial futures and interest rate swaps. The nature of risks is changing just as rapidly as the environment in which depository institutions are operating. In this connection, the introduction of any new product, service, or activity--whether or not it involves conventional extensions of credit--ought to require an assessment of all potential risks that could result from providing the service or engaging in the activity. Depository institutions must have systems and procedures in place to monitor and control risk-taking and to report operating results in a timely and clear manner to senior management. And, equally as important, boards of directors must play an active role in establishing policies and monitoring the compliance of senior management with the policies.

Notwithstanding the importance of general economic factors in affecting the health of financial institutions, the key determinants of a depository institution's financial condition are, in most cases, the skill and competence of the institution's management and the effectiveness of its directors. In my view, this is becoming increasingly evident in this period of rapid change, and the principle of management and director accountability will guide the actions of bank regulatory officials as they carry out their responsibilities for ensuring the safety and soundness of the banking system.

## Regulatory Challenges

This discussion leads me to the point of considering the challenges that face the depository institution regulators. Clearly, given the changes that are taking place, our jobs will be tougher too. On the one hand, as I have indicated, the supervisory and regulatory framework must provide an appropriate degree of freedom for bankers to innovate and compete. Trivial and stifling regulations should have no place in our complex banking and financial system. On the other hand, the pace of change and uncertainty that we are experiencing pose new risks that, if not properly controlled, can undermine the stability of our banking system and the strength of our economy.

We are continually reminded that overly rapid growth and overly aggressive or enthusiastic lending concentrated in certain sectors--such as characterized the REIT industry in the early 1970s or the oil and gas industry more recently--can seriously weaken loan portfolios and result in damage that requires many years to repair. This serves to reemphasize the critical importance of such fundamental principles of safety and soundness as proper credit evaluation, adequate portfolio diversification, and effective oversight by management and directors. The challenge to us as regulators, then, is to understand the nature of the changes that are taking place and to accommodate these changes while discharging our critical responsibilities for the safety and soundness of the banking system. To put it another way, we must not try to impede change or turn the clock back. Instead, we must be sensitive to the environment in which depository institutions must operate and provide freedom to innovate, while at the same time holding management accountable for monitoring and controlling their risk-taking activities. And, when necessary, we must step in, employing formal or informal enforcement actions, to prevent unsound practices, excessive risk-taking or violations of law.

The best way, in my view, to achieve a strong, competitive and innovative financial system is to have a legislative and regulatory framework that rests on three fundamental pillars or principles. First, we need a set of clear, rational laws establishing the types of activities that banking organizations may conduct and the geographic scope in which they can be conducted. This is the responsibility of Congress and, as I have suggested, there is room to broaden the permissible activities for depository institutions and provide more latitude to respond to market forces while paying due regard to safety and soundness considerations and the long-standing public policy of the separation of banking and commerce. Once the fundamental statutes and prudential rules have been established, trivial or niggling restrictions that have no real prudential rationale should be discarded.

Second, greater freedom to innovate and compete and, therefore, greater freedom to assume risks implies the need for an effective program of prudential rules and supervisory oversight. As a quid pro quo for greater latitude, depository institutions should be required to maintain strong capital positions--that is, capital positions generally above regulatory minimums--and be subject to thorough on-site examinations and, when necessary, timely and effective supervisory enforcement actions. We at the Federal Reserve are actively engaged in exploring ways to strengthen the examination and enforcement processes. One area of particular interest to me is the communication between bank regulators and boards of directors. It is incumbent upon us as regulators to present clearly and candidly--without hedging and obfuscating--our assessment of your institution's financial condition. Only in this way, can we be justified in holding bank management and directors accountable for responding adequately to our supervisory criticisms and concerns.

In addition to capital adequacy guidelines and examination programs, regulators must establish other prudential rules that clearly delimit what is considered sound banking practice, without making these rules so detailed or inflexible as to unduly burden or impede the management process. Of course, regulators should not intrude in management's prerogatives so long as an institution is in sound condition and in compliance with the law; on the other hand, regulators cannot hesitate to step in to prevent insider abuse, unsafe practices or legal violations.

Given the rapidly changing environment we are in, regulators must continually consider new ways to discharge our responsibilities and promote the soundness of the banking system. One idea that warrants consideration is greater financial disclosure and reliance on market discipline in lieu of, or to supplement, regulatory fiat. Banks already disclose a good deal of information, and I know that some of you may feel that disclosure has already gone too far, that disclosed information may be misinterpreted and, therefore, that further disclosure could be detrimental to the banking system. On the other hand, to the extent that disclosure encourages customers to deal with the overwhelming preponderance of banks that are sound and well-managed, and to the extent that market forces can substitute for the rigidity often inherent in government rules and regulations, disclosure may hold out prospects for a more efficient and flexible regulatory system.

Another idea that merits careful consideration is the peer review concept put forward by Vice Chairman Preston Martin. Under a system of self-evaluation, bankers themselves could complement the supervisory efforts of the government by establishing a peer review process, identifying questionable banking practices, and encouraging management to take corrective action. Peer group review and evaluation could, of course, be a powerful tool to encourage sound banking practices, and this approach, too, could foster a regulatory environment that is more flexible and responsive to conditions in the banking system.

In addition, I believe that the supervisory process could benefit considerably from increased cooperation and communication between in-house auditors, external auditors and bank supervisors. Financial managers and in-house auditors play an important role in safeguarding assets, identifying potential risks, establishing financial and operating standards, developing internal systems and controls, and monitoring and reporting on risk-bearing activities. These functions are obviously of interest to the external auditors and are of critical concern to bank regulators. We as regulators should make every effort to foster an increased understanding of what constitutes appropriate standards in these areas and encourage in-house and external auditors to see that such standards are continually met.

The third major pillar of a sound banking system rests on the role played by management and the boards of directors. When all is said and done, it is clear that examiners cannot and should not oversee every action taken by bank management, and no regulatory system of written rules or restrictions can anticipate all of the adverse consequences or potential risks associated with new activities. For this reason, directors must establish prudent policies within the law and the guidelines established by the regulatory authorities. Moreover, directors, working with senior management, must also ensure that the depository institution at all times operates within the established policies.

In the end, greater management and director accountability must accompany the greater freedom afforded in a deregulated environment. Clearly, in light of the changes that are taking place, the days of protected markets, static technology and easy profits in the banking industry--if they ever did exist--are gone forever. Supervisors must identify problems and communicate their concerns clearly, and directors must recognize and carry out their responsibility to ensure that institutions are operated in full compliance with the law and sound banking practices. Despite the profound challenges we face, our financial system can thrive and grow stronger so long as we recognize both the risks as well as the opportunities inherent in a dynamic economy and a changing environment, and so long as both bankers and regulators are committed to carrying out the full range of their responsibilities. While our perspectives may differ, both the managers of depository institutions and the regulators share the common goal of an efficient, competitive, responsive and safe banking system.