



Remarks by Vice Chairman Roger W. Ferguson, Jr.

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Community and Regional Banks: Increasing Complexity and Risk-Management Needs

Good morning. I am pleased to join you today. Though I am not here to discuss financial and economic literacy, I would be remiss if I did not commend the North Carolina Bankers Association for sponsoring Camp Challenge, your summer camping and financial literacy program.

A forum like this provides an opportunity to discuss the evolving nature of community and regional banking, the traditional strengths of such banks, which many of you represent, and the challenges you face, day to day, in managing them in an era of rapid change. More and more, it seems clear that future success will depend on your continuing to use some of banking's traditional advantages as well as on your ensuring that key aspects of risk management effectively address the new complexities of your business. In short, community bankers must remain cognizant of the traditional means by which they have controlled and managed risks, continuing to do well what has been effective in the past, and invest both resources and effort in understanding and managing new features of the regional and community banking landscape.

Role of Regional and Community Banks in Our Economy

It's useful for a moment to consider the importance of community and regional banking in this country. Although a small number of the largest banks in the country control the majority of the nation's deposits and banking assets, regional and community banks remain vital to our economy. Time and time again, we have seen the larger banking organizations concentrating resources in a given market segment, reducing their efforts in others, even sometimes pulling out of communities that don't easily fit into their plans. As a result, in many parts of the country, regional and community banks are the dominant financial institutions actively serving the local trade area. But even where they are not the dominant players in a market, smaller banking organizations are traditionally very effective competitors. One enabling factor, to be sure, is that regional and community banks are quick to embrace the benefits brought about by technological change. However, a truly key competitive advantage, which smaller banks continually seek to leverage, is their personal contact with their customers. Successful community bankers affirmatively seek to be seen as neighbors and supporters of their depositors and borrowers. It is in large measure through such contact and personal knowledge of customers and community that successful bankers, small or large, maintain a significant presence in the market and demonstrate commitment to their communities. Indeed, time after time we have seen that community banks have gained market share when large banks entered their market by acquisition; anecdotal evidence indicates that the gains have gone to existing community bankers and de novo entrants, both faring well in competition with their large out-of-market rival.

Moreover, regional and community banks are bankers to many small businesses. More than 99 percent of all employers in this country are classified as "small businesses." Small businesses as a group employ fully one-half of all private-sector workers and provide the lion's share of net new jobs in the economy. With small businesses as primary commercial customers, regional and community banks have long been, and will continue to be, an element of strength in our economy. Consequently, the safe and sound operation of regional and community banks must be ensured. At the same time, these banking organizations must be encouraged to be innovative in meeting the needs of their customers.

The competitive advantages of smaller institutions are not without accompanying benefits for the management of traditional risks in the banking business. The management of credit risk, historically the most significant exposure of banks, is the obvious case in point. Personal knowledge of customers--their character, opportunities, competence, resources, and capacity for repayment--not only is the competitive "leg up" in establishing a sound and mutually profitable credit relationship, it also helps a successful community banker in setting the baseline for serving the customer (and the bank) by gauging the appropriate extent and the terms of that relationship. Misfortune will occur sometimes, and business conditions will periodically weaken, as those events have occurred routinely in the past. But no one in the community--customer or bank--is served by the extension of credit that would be judged unsound in the light of the customer's capacity to perform when that credit was granted.

Increasing Complexity of Regional and Community Banks

Traditionally, smaller banking organizations have been regarded as subject primarily to credit risk, although interest, funding, and operational risks have also been major areas of concern. Increasingly, however, liquidity and market risks have grown in significance as regional and community banks have gained greater access to less traditional sources of funds. Competing alternatives to core deposits in the 1990s led many regional and community banks, even the smallest institutions, to rely increasingly on intermediary sources, such as deposit brokers, the Internet, and other automated service providers, to raise funding to support asset growth and meet loan demand. Deposits gathered from such sources, even those not explicitly "brokered," can be less stable than traditional core deposits, since the depositors typically lack any other customer relationship with the institution and could shift funds to a different bank or investment in search of a higher return. In addition, many regional and community banks today rely more heavily than in the past on wholesale borrowings from financial intermediaries, including other commercial banks and securities firms, to supply portions of their funding mix.

Indeed, regional and community banks have relied increasingly on the liability side of the balance sheet for funds management. Most observers, for example, have been unaware of how successful community and regional bankers have been at directly raising uninsured deposits in their local markets when loan demands have exceeded core deposit growth. In the latter half of the past decade, the uninsured deposits at these banks grew more rapidly than those at larger banks. To be sure, large time deposits cost more than insured deposits, but community banks have maintained their profits and returns on equity.

The creativity that community banks have shown in supplementing their core deposits--deposits that have grown less rapidly as attractive substitutes became available for their customers--has once again surprised those that believe smaller banks can no longer compete in modern financial markets. Such ingenuity in funding supplements their creativity in maintaining and increasing their loan base in the competition with their larger rivals.

This ingenuity also increases the need for closer management of funding at the same time that regional and community banks' investment portfolios have become more complex, with holdings of instruments that are in some cases longer-dated or have more options, than traditional bank investments. Even in terms of the capital base, the widespread use of trust-preferred securities has introduced additional complexity to regional and community bank holding company balance sheets.

The expanded use and acceptance of asset-backed securities have also enabled regional and community banks to take advantage of what we, only a few years ago, considered, to be "large bank" opportunities to originate and sell large volumes of mortgages and other consumer loans, either directly to purchasing intermediaries or indirectly through a securitization vehicle. To be sure, the sale and securitization of assets give rise to varying types and degrees of risk to the originating institution. Typically the risk of credit losses from the underlying assets is divided variously among the parties to the transaction, including investors, guarantors, and the originating institution itself. In many cases, the originating institution retains significant credit exposure through the credit enhancements that it provides. These enhancements constitute contractual obligations to protect investors who have purchased the securities generated by the transaction from incurring credit losses.

These contractual recourse exposures, as you well know, are addressed in the agencies' risk-based capital standards, including an interagency rule implemented in January of this year that establishes a concentration limit and imposes a dollar-for-dollar capital charge on certain residual interests. But it may be less well known that banks that engage in securitization activities need to be wary of taking any action, such as providing post-sale support to a securitization in excess of any contractual obligation, that would suggest it has implicit recourse exposure to losses beyond the contractually stated amount. Banking organizations that are deemed to be providing implicit recourse are required, in general terms, to treat the entire outstanding amount of assets sold as though it remained on the books for risk-based capital purposes.

Finally, numerous third-party vendors and service providers today offer regional and community banks more and more products and financial services--delivered through traditional channels as well as the Internet--so that banks, in turn, can meet the increasingly sophisticated needs and demands of their customers. As a consequence, many smaller banking organizations face additional complexities in their business and new or heightened exposures attendant to the on- or off-balance-sheet assets and liabilities, and revenues and operating costs, associated with these arrangements.

New funding sources and activities are critical in carrying on the traditional community banking business and in profitably serving customers. But the Federal Reserve has supervisory responsibilities, and I would be remiss if I did not note that the development of these new sources is a mixed blessing. New funding sources, while enabling community banks to meet loan demand, challenge the institutions to manage the potential volatility and price sensitivity of these funds. The increased complexity of investment portfolios and off-balance-sheet activity similarly subjects institutions to increased liquidity and market risk. The issuance of trust preferred stock through pooled securities has enhanced the access of smaller banking organizations to capital, though it leverages common equity of the parent company and, in some cases, puts pressure on insured subsidiaries to support the increased cash-flow requirements of these instruments. Reliance on large time deposits requires that offering rates remain competitive with the market, creating interest-rate risk that must be

managed. Securitization activity, as noted above, can provide a hugely significant alternative funding for, even to some smaller banking organizations, but it entails certain recourse obligations and exposures and may involve additional liquidity, market, and reputational risks. The use of third-party vendors and service providers, while expanding the menu of fee-based products and services that can be offered by regional and community banks, presents numerous challenges, particularly in terms of operational risks.

Risk Management

Banking is a highly leveraged and often relatively low-margin business. The loss from a single significant credit relationship or a material breakdown in controls can offset the gain on many other transactions. Losses stemming from a concentration of sources--related borrowers or activities--can threaten the viability of the bank. Bank managers as well as supervisors need to remember, therefore, that the benefits of the new developments mentioned above--access to funding alternatives, potentially higher-margin investments and activities--are counterbalanced in part by higher risks associated with increasing complexity. Successful risk management today implies some additional cost and investment to ensure that systems for measuring, monitoring, and controlling risk are fully capable of addressing the new complexity of regional and community banks. A key advantage of smaller banking organizations in managing credit risk--close knowledge of their customers' prospects and capacity to service debt--is less relevant in addressing many of the new risks they face. Many of these new risks are market-driven or entail complexities with which the bank has little experience. Indeed, I urge community and regional bankers to recognize that the same market realities that created the need to adopt new funding sources and activities also require that these banks invest in appropriate new risk-management techniques. I realize that these often look like pure cost increases, but I assure you that they go hand in hand with the new activities and will ensure the continued ability of community and regional banks to successfully adapt to changing markets.

Indeed, the traditional characteristics of many small and even regional institutions--including local ownership and control by interested and involved individuals, a limited span of relatively simple operations, and effective management-- still can be relied on to ensure that new risks are properly identified and effectively managed.

The need for traditional prudential policies will not be obviated by new risk-management techniques. Federal Reserve examiners will continue to look at four key components of risk-management systems in evaluating the management of supervised institutions. These components are:

- the effective identification, monitoring, and reporting of risks,
- the sufficiency of policies and limits for controlling those risks,
- the adequacy of internal controls ensuring adherence to approved limits, and
- active oversight of these processes by directors and senior managers.

These four elements, taken together, provide a widely applicable framework for assessing risk management, though the detailed components of risk management can vary considerably among institutions. For example, when a bank's exposures to credit, market, and operations risk are routine, well understood, and limited in their dimensions, fairly simple risk-management processes can suffice. More complex assets, liabilities, and business activities, however, will demand more elaborate processes and internal controls. And concentrated exposures of any kind, whether to credit or to funding risks, need to be identified and made subject to well-considered and reasonable limits. Whatever the

complexity and design of the processes, however, the four core elements are interdependent. As a consequence, each of the four components must be comprehensively addressed for the entire system to be effective.

Effective risk-management processes are also a strong deterrent to fraud. Irrespective of the level of risk inherent in bank activities, we must remember the fact that banks, particularly those with less robust risk-management and internal controls, are highly susceptible to customer or insider fraud and to mismanagement or, occasionally, insider abuse. More often than not, it is the failure or absence of basic internal controls and risk-management processes that permits such losses, or fails to bring them to light before serious damage results.

A sound and comprehensive internal control system is based on the core principle of separation of duties and naturally includes a fully effective audit program. But--importantly--it also encompasses ongoing procedures for the independent reconciliation and certification of bank records to ensure that basic controls are functioning effectively.

Conclusion

In closing, I emphasize the need for risk-management processes in community and regional banks to advance sufficiently to meet the risk-management challenges of the banks' current environment. Though often those challenges might be met by adapting sound practices long pursued in the organization, for an increasing number of banks, new systems and procedures may be needed to keep pace with the more-complex risks associated with an evolving or a growing business. As bankers, bank supervisors, and policymakers, we should strive to work together to ensure that those risk-management processes are sufficiently robust and that they have been tested to ensure their effectiveness.

A final word may be in order after so much discussion of the need to adopt more-sophisticated risk management at community banks. You have no doubt heard about the changes in capital processes being discussed in Basel by the supervisors of the major industrial countries. These changes are being proposed mainly for the large, complex, internationally active banking organizations of the world, whose operations and business needs have developed beyond the intended reach of the current capital requirements. However, the capital and regulatory structures being developed in Basel will not affect the rules under which most, if not all, of the banks in this room will operate. Indeed, for most banks in this country, Basel II will have virtually no effect.

I want to thank the North Carolina Bankers' Association for the opportunity to speak to you today.

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