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SUPERVISING THE NATION'S FINANCIAL INSTITUTIONS - CHALLENGES AND RESPONSES

Presentation by

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to the

American Bankers Association

Conference on Safety and Soundness

Mayflower Hotel

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Deregulation of banks, thrifts, and other financial institutions has brought a cornucopia of services for corporate and individual consumers and a bushel basket of challenges and headaches for bankers and for government officials who are charged with supervising banks and bank holding companies. Business now has cash management services, commercial paper, and even some aspects of investment banking; government has electronic payments, bookentry, and other services; and households have insurance, discount brokerage, an impressive array of savings instruments, and credit availability once only the prerogative of the wealthy. The entry into banking of retailers, Wall Street, and insurance firms from outside the banking industry has blurred industry lines and affected gross margins. The public benefits when pricing for services more nearly reflects market forces, but the responsible governmental officials should be alert to the altered profitability of competing institutions and what that portends for adequacy of capital and of liquidity.

Narrower margins in financial services have pushed management to seek volume on the one hand and, on the other, riskier assets, which have the appearance or the potential of filling the profitability gap. Take discount brokerage. Is this service likely to develop an adequate return on needed investment or is it rather a low return or no return means to hold or expand market share? Or take a non-bank bank. When it is difficult to make a marginal, but full service branch profitable, how do you earn on a costly to establish limited facility? Limited in service to squeeze through the loophole, and expensive to establish in another state, the non-bank bank is as costly as a World War II beachhead on an enemy island. It may take a touch of genius to make a non-bank bank profitable on a cost accounting basis.

And, 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 to achieve limited interstate banking.

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. Just as some U.S. manufacturers are virtually drowning in a flood of imports, U.S. bankers find their markets undercut by the price competition from foreign-based lenders. Technological change is also increasing at an apparently 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, housing values, foreign assets, and farm land--is on perceptions of asset quality. Old views are challenged. In addition, today's economic expansion has bypassed whole regions and industries here and abroad. Foreign competition has driven some U.S. industries and certain U.S. agriculture down to depression levels. Maintaining loan portfolio quality is thus complicated not only by internal factors to the banking industry but also by forces exogeneous to the lending process.

It is therefore not hyperbole to characterize these times as revolutionary for banking. Success, even survival, depends upon adherence to the classic virtues, upon quality assurance structures and upon the integrity of the management by objective process. Beware the executive who says, "I'm not a banker anymore, I'm a manager!" Or even worse, "I'm an information manager!"

Unqualified growth as management by objective, "M.B.O.", overemphasized by any institution is the leading indicator of future failure. Obsession with growth as virtually the sole objective expressed at all levels of management is impossible to reconcile with high quality assurance. Growthmanship makes monitoring and control down the line impossible. Management must 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 commercial bank management with regard to the need for a more senior executive, for a senior management group, and for board committees to control the review of credit decisions. This particular function is so important that we, and you, must more carefully analyze those controls. Your internal auditor and your

CPA firm are in a strategic position to do that, on a periodic basis, by the evaluation of procedures, policies, and objectives which lead to quality of assets.

These are a few of the challenges to management. Let me turn now to the governmental examiners and supervisors who, on the other side, cannot afford to reduce their consideration of the safety and soundness of the financial system and of the integrity of each institution. A subset of governmental objectives, an important one, is the responsibility of the banking 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 and subsidiaries and joint ventures. As the institutional asset structure becomes more diversified, it is imperative that the examination process 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 abandon the review of potential conflicts of interest, tendencies toward market concentration, financial disclosure, consumer protection, and other public concerns, but rather to suggest additions to the review process.

Today's dynamic environment demands greater focus upon controls. We see increased roles to be 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 bank auditors and supervisory examiners, and an accentuation of the use of information management techniques to delimit the scope of examinations and to flush out those areas of particular risk in the institution being examined. Secondly, the accounting profession is compelled to assume a more "examinational" role, one which emphasizes high relative risks within an audited institution.

Yet the control augmentations I have enumerated may not suffice. I want to raise the radical notion that it is time for the industry and regulatory bodies, both federal and state, to investigate with seriousness the feasibility of some kind of "peer review" or self governance. 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 sourced, delved into in the examination and the CPA auditing process, to accomplish a new quality of supervision. As a first step, let us today look at peer review techniques in two of the most highly controversial business areas: peer review in the accounting profession, and peer review in the nuclear power industry.

In the accounting profession, the American Institute of Certified Public Accountants, in its SEC Practice Section, has designated a Public Oversight Board (POB). Its board members are drawn from industry leadership--for example, Arthur M. Wood, former chairman and CEO of Sears--from government and from academic accountancy; the SEC Practice Section's Executive Committee has membership from a wide variety of firms in the accounting profession, and it utilizes a small permanent staff.

Between 100 and 200 firms are reviewed each year, on a three-year cycle. The imposition of sanctions by one or another of the POB has been notable by its absence, and the Congressional hearings before the Dingell Subcommittee have recently reviewed this omission at some length. Nevertheless, the accounting profession should be commended for its voluntary effort conducted by a professional organization and aimed at improving the quality of the auditing process. The methodology includes establishing professional standards for quality control and testing each firm's compliance with those standards. The strength of peer review lies in its reach, at one time or another touching every major accounting firm. The tests must include review of the supervision and review of an audit engagement. How did the CPA conduct its audit? What asset tests were performed? The exit conference following a peer review provides the opportunity for the firm under scrutiny and the POB reviewer to exchange ideas, particularly those stemming from the successful auditing done by competing firms.

Despite the failures in auditing which have been widely discussed, I believe that peer review in the accounting profession has had a widespread salutary effect upon practices and upon quality control in that profession; that is, the more numerous audit "successes." The question naturally springs to my mind as to how such a process might be applicable to banking.

Admittedly, the answer is not clear. Would the banking industry voluntarily set up a board to do its own reviews, limited, say, to quality control in the lending process or asset acquisition of a given banking institution? Would any commercial bank voluntarily submit itself to the review of any of its practices or results by a group made up in the fashion of the POB ? Obviously, the intrusion of competitive factors and the confidentiality of information must be considered, as must qualitative differences between quality control in bank lending as compared to quality control in accounting procedures. But, could a board be set up voluntarily which would serve as a source of information to governmental supervisors when they set up of the scope of their own examinations of banking firms?

However, banking is an art, a management process, not a profession. Let us turn, therefore, to a controversial management operating area, one which has been subject to the extremes of criticism and praise over the past six years; namely, the nuclear electric utility industry. This industry maintains the Institute of Nuclear Power Operations (INPO) to promote improved safety and reliability in the operation of controversial nuclear plants. INPO does not aspire to the governmental review and oversight of the U.S. Nuclear Regulatory Commission (NRC). However, INPO has a record of accomplishment as a self-regulatory, virtually a peer review, process. Indeed, INPO has gone a step further in receiving the endowment of the industry of authority to bring pressure for change upon individual members at individual plants. The eight members of the INPO steering committee represent nuclear electric utilities from each region of the country. Its board of directors is likewise composed of utility executives, as is the president of the Institute. An advisory council of professionals from outside the industry draws from academe, science, industry, and the health professions. INPO's objectives embrace items which are, of course, not strictly comparable to the banking industry, but its mission encourages excellence, promotes the exchange of information and good practices among its members and, indeed, provides guidance for members' use in training and operations. The emphasis is to "assist member utilities in implementing their own improvements rather than attempting to preempt their management responsibility."*

A further activity is the Institute's analysis of nuclear power plant events, whether those occur in the construction, testing, or operation of nuclear plants. The information and conclusions derived from such an analysis are disseminated to members and participants. Perhaps more interesting is that onsite reviews of member institution plants are conducted and, in those reviews, corrective actions are stimulated as part of an ongoing evaluation program.

While such details of the POB and the Institute of Nuclear Power Operations peer review would have to be studied, 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 through an approach similar to the POB.

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* Institutional Plan for the Institute of Nuclear Power Operations, May 1983, page 4.

I have cited two instances of favorable experience in self-regulation among the many with which we are all familiar in order to suggest some methods by which the present state of supervision of banking could be improved through efforts of the industry itself--the banking and the thrift industry--and of the several professional organizations which serve them.

We have arrived at a crossroads in the banking 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 banks will continue to increase, and bankers will be expected to step up to greater leadership roles in maintaining safety and soundness in the changing banking industry. Today's high-risk banking requires new approaches by the examiners. Industry self-interest, I would submit, also necessitates your involvement in self-regulatory and other solutions.