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Safety, Soundness, and Self-regulation

Presentation by

Preston Martin

Vice Chairman

Board of Governors of the Federal Reserve System

to the

American Bankers Association

Annual Convention

New Orleans, Louisiana

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In our time it has become fashionable to emphasize the stresses and strains in our society and almost embarrassing to suggest publicly that adjustment and evolution might possibly turn out well. Of course it is necessary to recognize our problems and our perils--much of today's economic landscape is terra incognita. For our society as a whole, our institutions and our markets -- and for banking specifically, your competitors and even your products -- are transformed, not just changed. Yet it is a sign of the fundamental soundness of our financial system that while individual institutions have suffered, the system and the economy as a whole have remained healthy. That is not to say that we should not be concerned or lessen our vigilance. What do we really know about the risk potential inherent in swaps, options, standbys, indexes, options on indexes, backups, and all of the other innovations of those bright MBAs? It seems almost impossible to draw a firm line between prudent, yet high-return, investments and speculation.

My argument is with a superficial idea of our age: that only a tragic, pessimistic view of events is "serious" and "analytical". Instead let us keep in mind the risks we run but recognize that financial institutions in most instances have made some necessary adjustments which have turned out well. We are not always truly in crisis -- at times we are simply witnessing the end of "closed systems" in a deregulated, global environment. The financial industry is serving its publics better with a diversity of products and better rates of return. Certainly numbers of banks and thrifts have failed. But, in most cases, failed banks have reopened under new management or have become branches of other banks and are continuing to serve their communities.

One effect of disinflation, deposit deregulation, diversification, and even deflation in commodities, farm land, some housing, and some foreign assets is the recognition that you, and we, need to focus attention and resources on asset quality. I know, "they were all good loans when we made them". Let me suggest that the three Rs today for asset portfolio management are review, review, and re-review. I submit that the price of market change is not reregulation. Rather it is improved governmental supervision and more effective management, including some form of self-regulation.

I am very much aware that the banking industry has taken considerable steps to improve the quality of its loan and asset portfolios. I observe with satisfaction changed thinking in 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. But, while our concern is mainly with the industry as a whole, bank management and director responsibility is with the individual institution. To place the burden where it belongs, bank management and directors are ultimately responsible for ensuring strong profits, good asset quality, and sound operations. I would emphasize that responsibility in today's environment, in which insurance coverage for directors is not always easily available. In addition to an effective system of internal controls, you should look to your internal auditor and your CPA firm who are in a strategic position to render you assistance in your evaluation of procedures, policies, and objectives which lead to high quality assets.

I recognize that banking is not the securities business nor the accounting profession. The culture of the industry, its competitiveness, and the basic requirement of customer confidentiality make banking unique. However, I think the time has come to marshal private resources as well as governmental ones to arrest the erosion in public confidence which newspapers and pollsters have noted. Other industries have found that the exchange of information about good practices, risk controls, workable remedies to problem situations, and even codes of ethics, can coalesce to form a structure to educate the public and the slow learners in management.

Banking will continue to evolve swiftly in a regulatory environment which has shifted away to some degree from the premise that government has all of the answers. Our society has rediscovered the efficiencies of the market. Neither excessive risk-taking nor undue timidity are rewarded for very long. We need to balance these two opposing forces. Reasonable innovation, risk-taking, and growth need to be encouraged without fear that minor disturbances will lead to a public cry that the sky is falling. On the other hand, we should strive for a stronger, self-reliant system, which is less dependent upon the safety net and which recognizes that confidence in the banking system is the industry's most valuable asset. Market forces ultimately impose a discipline on economic activities. However, we cannot rely on the marketplace alone to balance the competing factors of risk and reward. Indeed, our current banking statutes and policies recognize that no such single-minded reliance is possible, particularly should confidence in the banking system falter.

We are seeing the distinctions between banks, investment firms and businesses blur. While these will always be, in my opinion, separate institutions, at the edges there has been, and will continue to be, intense competition. The entry into banking activities of retailers, Wall Street, and insurance firms has affected gross margins as new financial instruments are developed to attract consumers. Obviously, the public has benefitted from competitive forces, but the responsibility government officials have over banks, thrifts, and other financial institutions requires us to examine more carefully what changed circumstances portend for capital adequacy and liquidity. In today's environment, 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 efforts with regard to potential conflicts of interest, market concentration, financial disclosure, or consumer protection, but to reallocate priorities in your and our review processes.

Today's dynamic environment demands greater regulatory focus upon quality control, demanding increased roles from senior management, internal auditors, and CPAs. There must be an increase in the number of qualified, experienced auditors and supervisory examiners. Information management techniques need to be accentuated to delimit the scope of examinations to areas of particular risk. Also, the accounting profession needs to assume more of a quality asset-testing role, one which will give top management better information as to relative risks and as to risk control procedures within an audited institution.

As you know, we have recently adopted new policies to help both you and us -- the regulated and the regulators -- to evaluate risk. The experience of recent years compels us to increase our surveillance in order to anticipate problems at an earlier stage, improving the chances for recovery. The effects of two recessions, disinflation, increased competition, inadequately reviewed business judgment, and, in a few cases, misuse of the public trust, demand increased vigilance. In general, we intend to increase the frequency of our examinations and correct weaknesses through more frequent and clearer communication with bank management and the directors who are responsible for the activities of their institutions. We are also looking into other areas of supervision: upgrading our coordination of efforts with other banking supervisory agencies, both state and federal, to improve efficiency; sharpening our analytic approach to deal with issues such as bank holding company funding and liquidity, and risk and leverage considerations in nonbank activities; and improving examiner training.

I deliberately link the thoughts of examination and responsibility because while we supervise over 6,200 bank holding companies and 1,100 state-chartered banks, the responsibility for those individual institutions rests with bank management. This is a fundamental principle which often seems forgotten in a era of increased reliance on outside examinations. The public turns to the regulatory agencies demanding to know why we are not doing a better job of supervision. As I noted, we are taking steps in that direction. But our resources are not infinite nor do we want to impose an undue burden on the banking industry by determining the worth of every bank activity and decision.

Also, I argue that the accounting profession must assume a larger quality asset and quality control testing role, one which will give Boards of Directors, Board Committees and top management better information as to high relative risks, and asset concentration relative to internal controls within the audited institutions. In such an uncertain economy, risk exposure has gone so far that even the control augmentations that I have enumerated may not be sufficient. Thus I continue to advocate that the banking industry and the regulators seriously approach the feasibility of some supplementary form of self-regulation. It is time that all of us consider how the known, short-run trends in risk taking can be delved into to achieve a new quality of risk management and how the industry can better share vital information and analyses.

A key safety and soundness issue centers around the difference between preventing and detecting problems. Increasingly, examiners operate in a "detect" mode; problems are identified after the fact. How do we train examiners to keep abreast of new business areas where risk exposure is arising? In order to grow and to counter the pressures of narrowing margins or spreads, some financial organizations have increased their exposure to risk to reach for yield. Faced with increasing competition, even global competition, some have entered new fields or are accepting new and greater risks in their fundamental businesses to generate income. Others have greatly broadened the geographic base of their operations. This results in an environment of heavy competition, much uncertainty, and, in a few cases, outright failures. This situation accentuates the need to prevent problems, and the industry is in a position to contribute to that goal through the spread of good practices and control procedures.

We have seen recently where the problems of a few become the problems of the many and, as a result, questions arise as to the safety and soundness of the entire financial system. Public confidence is a major issue in the whole process and it behooves the industry to take action to instill confidence and gain control of its destiny. During recent scattered setbacks in a few institutions it has become more evident that efforts to obtain new powers need to be accompanied by industry initiatives that ensure those powers will be managed prudently.

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 to drawing from knowledge within those industries. As an example, look at the New York Stock Exchange, and to the accounting profession with regard to self-regulation.

While the Exchange maintains a system for regulating 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 representatives of the securities industry, the public, and its president and chairman. A special surveillance committee of the Exchange's Board of Directors keeps watch on any troublesome situation and helps devise remedies.

With regard to the public accounting profession, it has managed to maintain its independence and integrity through self-regulation. The methodology includes establishing professional standards for quality control, and testing each firm's compliance with those standards. The strength of this peer review process lies in its reach, at one time or another involving every major accounting firm.

What can we learn from these self-regulatory success stories that we can apply to the banking industry? I have argued for the need for a self-regulatory body or bodies in the banking industry that would interface with the regulators, possibly through the coordinating group of regulators, the Federal Financial Institutions Examination Council. There are numerous functions that could be carried out by the self-regulatory groups. I would like to mention a few that I feel require further consideration.

A banking principles board could be established to set standards for good business behavior, particularly in new business areas, and focusing on the off-balance sheet products such as interest rate swaps, letters of credit and so forth. The growth in asset-backed securities strongly suggests that the industry set its own standards and guidelines for securitized investments. Operating, valuation, validation, and insurance standards are needed. For mortgage-backed and chattel mortgage-backed securities what methods of analysis are most effective? Additionally a code of ethics could be established that would apply on an organization-wide basis to individual institutions. While many banks have a code of ethics, an issue to be addressed is what types of corporate culture and behavior encourage improprieties. This requires a commitment by senior management to establish a corporate climate that emphasizes ethical conduct.

A self-regulatory group may wish to consider a bank or banker accreditation program. Banks whose management choose to do so could be measured against a set of good practices standards. Individual banker accreditation, on the other hand, would involve formalizing an education process, particularly for young bankers, followed by certification tests. Such educational requirements might also call for a continuing education requirement.

Within the self-regulatory group or organization, a clearing-house could be established for the discussion of problem situations on a confidential basis. This would permit institutions with particular difficulties to have a forum to which they could go to discuss problems as they are arising and not after unfavorable results have occurred. Lessons about a "safety net" for liquidity situations is one example. This feature also would benefit bankers by making a source of information available against which to test their decisionmaking process.

An industry self-regulatory group could help establish business plans and strategic planning as necessary aids for banks and thrifts staying viable today. Long-range strategic planning provides the goals for the institution, the critical success factors, the action steps assigned by person and by completion date, and the critical assumptions underlying the goals and success factors. It is, in short, the plan or road map for the future of the institution--lacking this, we have seen institutions become sidetracked from their fields of expertise. Business plans are the outgrowth of the planning and research used for the strategic plan and are much more detailed. With the business plan addressing key areas--such as economic environment; growth, profitability, and net worth; continuity of management and directors; lending, investing, and funding activity and territory; interest rate risk management; and controls--financial institutions would have a management tool to measure quality performance against benchmarks and would be in a position to improve the direction of their business. The industry, as a whole, has many good examples to rely upon as a basis for setting standards for use by institutions of all types and sizes.

The establishment of good practices standards and a code of ethics require a mechanism that results in some form of enforcement. The self-regulatory body that would be established may be part of an existing trade organization or trade organizations, or it may be an independent entity, or it may occur originally as a spin-off of an existing organization. Bank accreditation reviews could be performed by the self-regulatory body itself, or by bank directors, bank general counsels, independent panels of bankers, or CPAs, who could report to the self-regulatory body or bodies.

Many may be skeptical of suggestions for a self-regulatory approach in the banking industry. In fact, we have already had favorable experience in industry efforts to reduce daylight overdrafts. I am also very pleased the American Bankers Association has established a commission on safety and soundness and that the commission is evaluating the feasibility of self-regulation in banking. I give my wholehearted support to this initiative.

Let's recognize that membership in the self-regulatory group would be on a voluntary basis. A prestigious certification would enhance a bank's public image as well as its credibility with its supervisory agency. Once established as a viable self-regulatory body, a standards board's certification could signal ethical and professional compliance to minimum banking principles, which federal and state examiners could consider in their examining process. In general, board certification would carry sufficient status so that membership would be in the best overall interests of a bank. The public would be assured that analytical techniques are being used to combat undue risks.

I believe that the necessity of 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 business, a business which faces a future considerably different from the past. New techniques are therefore required to ensure stability on the path to the future. The challenges and opportunities confronting banks will continue to increase and managements are and will be stepping up to greater leadership roles in maintaining safety and soundness in the changing banking industry. Today's higher risk financial institution requires new approaches by the examiners. However, regulators' efforts in requiring more capital, additional disclosures, risk-based deposit insurance, and so on, have limitations. Industry self-interest, I urge, necessitates bankers' involvement in self-regulation and other unprecedented solutions. Let us build upon the countless successes in the industry and put crisis management in its place -- a necessary but insufficient approach for a growing, healthy industry.