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Remarks by

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I am pleased to be here with you today to discuss challenges facing depository institutions, especially at a time when the industry is doing so well. The last time I addressed this group, which was in 1992, things were not going quite as well. Indeed, at that time many financial institutions were in trouble as a result of the previous recession and the problems caused by declining commercial real estate markets. In 1991 and 1992, we were still seeing more than 120 bank failures each year, and even that was a sharp improvement over the several preceding years.

Today, two years later, it is in many ways a different world. The economy is much stronger now, growing at a pace that continues to surprise many analysts, and the industry is doing well. Nearly two-thirds of the nation's banks reported earnings of more than 1 percent on assets for the first half of the year, while only 4 percent of banks reported losses. That 4 percent is the smallest loss share since 1980. Asset quality also continues to improve, and only 11 commercial banks have failed so far this year. Although regulators always seem to want more capital, I think we can -- in general -- be pleased with current industry capital ratios. The industry's risk-based capital ratio of 13.2 percent is well above the regulatory minimum for being "well capitalized". By one measure -- equity to assets -- capital ratios are the highest since the mid-1960s.

Community banks, in particular, have done well and by many measures continue to lead the industry. Profits have been strong this year, with an average return on assets of about 1.1 percent for first half of 1994. Although some of the nation's largest institutions are now reporting even more impressive returns, it is community banks that have demonstrated the greater consistency of earnings year after year.

When we last met, I spoke about the economy, the FDIC Improvement Act, and regulatory burden. With the economy now much stronger and FDICIA largely implemented, I want to talk today about other matters: the challenge of technology, the changing structure of the banking system, and the importance of carefully managing the core banking business. Although I won't speak at length about it today, I hope the banking industry and regulators will continue to focus on reducing regulatory burden as we face these developing challenges. Without continuing attention to this subject, we run the risk of losing ground and charges of regulatory "piling on" will be well deserved.

Challenge 1: Technology and Financial Innovation

Advances in technology and financial capabilities have created exciting opportunities, including the ability to offer new products and services to customers. You have new banking products to offer, such as mutual funds, some kinds of annuity products, debit cards and point-of-sale services. You also have a host of new or enhanced financial instruments to manage your risks and returns. In many cases, the new products provide access to markets that banks, especially smaller ones, have not been able to serve in the past. Even for those products and services that are simply new versions of traditional bank products, many have appeared particularly attractive because of their potential to generate fee income.

Some institutions have used these opportunities to diversify and innovate their product lines, while others have taken a more cautious approach and remained focused on more traditional lines of business. Neither strategy is inherently right or wrong, and both

present opportunities and risks. The benefit to a bank from offering new products will depend on the nature of the customer base, specific perceived opportunities, and the ability and expertise of management and the board of directors to operate and manage the new products, along with the associated risks. If nothing else, the history of banking in this country certainly demonstrates that there is no "one-size fits all" model for a successful financial institution.

It also seems clear, however, that conditions are changing -- perhaps more so than at any time in decades. Change creates opportunity, of course, but managing change is a challenge. From the Federal Reserve's perspective, we want to ensure that banks offer new products only when they understand these products and can adequately explain the risks to their customers. Such full and clear communication not only builds customer relations and goodwill, but also serves to minimize problems and misunderstandings that can jeopardize customer relationships and reduce the franchise value of a community bank. In the long run, banks serve customers best -- and gain community trust -- by helping customers make prudent and informed decisions. In this connection, it is disappointing that surveys and various spot checks continue to show that some customers are not being informed of the risks in uninsured products. I would stress that permitting poor sales practices can be short-sighted. At best, customer goodwill can be lost and, at worst, litigation or even unwanted legislation can result.

In addition to opportunities to offer new products, bankers also face a wide array of new and sometimes very complex investment opportunities. Spurred in large part by the securitization of mortgage loans, the sometimes dizzying range of alternatives includes

structured notes, CMOs with high-risk characteristics, and other similar instruments. Given the growth of derivative and complex cash market instruments generally, it is not surprising that some of these instruments are appearing at smaller institutions. In many cases, that's fine. The instruments offer advantages over other investments, and can present acceptable risks to the bank. That said, some -- including many mortgage-backed instruments -- can involve complex embedded options or other characteristics that make their market behavior difficult to determine. In turn, their value may be more volatile than more traditional bank investments. Obviously, banks have a great deal of experience managing these risks in mortgage loans, but the complex structure of some mortgage-backed instruments can, quite frankly, present a very different challenge.

The complex price behavior of these instruments means that, more than ever, a bank's management must understand fully the risks involved in the instruments it owns. In this regard, having a formal and established process for reviewing new investment instruments and informing your directors of the risks is essential, or at least a very, very good idea. The magnitude -- and sometimes the nature -- of the risks associated with novel instruments is frequently unclear, and indeed can be quite complex to most ordinary mortals. As a result, it is a common mistake -- and often a formula for losses -- to invest in products before implementing adequate internal controls and risk measurement systems.

Structured notes provide ample illustration of this point. Many were designed to provide attractive yields under then-current conditions, but have delivered significant market losses when those conditions changed. In August of this year, the Federal Reserve issued guidance on structured notes to banks and examiners. In essence, that guidance

recognizes that these instruments may offer certain advantages over other investments, but also indicates that they may be inappropriate for many depository institutions. By focusing only on low credit risk and favorable current yields, some institutions may be overlooking the instrument's market and liquidity risks. As always, management needs to understand the risks inherent in the instruments they hold, and manage those risks accordingly.

I hasten to point out that, at least so far, the Federal Reserve has not seen evidence to suggest that structured notes present a threat to the banking system, despite all the attention they have received and the problems they have caused for some banks. Structured notes have, like many bank investments, declined in value as market rates have increased. The point is that because of their complex nature, structured notes -- as much or more so than other instruments -- must be carefully evaluated before they are purchased.

As examiners from the Federal Reserve -- and, I would expect, examiners from all of the agencies -- review banks in the future, you can expect them to devote somewhat more attention to risk management. They will focus on key elements of the risk management process: active involvement by bank directors and management; the presence of clear policies, limits and authorizations; a process for thoroughly reviewing new products; an effective risk management system including adequate measurement and reporting of the bank's risks; and of course effective internal controls and procedures.

History suggests that active involvement by directors is critical to sound banking. Since year-end 1993, for example, the market value of the industry's investment securities has declined by \$24 billion, or about 3 percent. Such relative declines would be highly unwelcome news to directors who were not aware of the risks and who did not

understand the nature of the bank's investments. Such results should lead boards to make sure that they fully understand market risks of the instruments they hold, and the effect interest rates can have on the liquidity position of the bank.

Circumstances like this help to highlight the importance of evaluating market risk under a range of market conditions along with possible effects on bank capital and liquidity. By understanding the conditions that can produce significant losses, a bank's directors and management can better determine their appetite for risk and, if necessary, take steps to modify the bank's position. This leads me to stress testing. Such testing doesn't need to be rocket science. Evaluating the circumstances under which a transaction could go wrong is something bankers have always done in one form or another. The level of complexity and the degree of quantitative sophistication required for adequate stress testing should be determined case-by-case and on the basis of the investments held.

To be sure, quantitative skills are becoming a more important component of sound management. Prudent bankers simply must be able to measure the risks incurred. Nonetheless, for most products, some very meaningful stress testing can be done even without complex tools. Alternatively, it may be possible to work with brokers or other third parties to obtain relevant information, which when complete and well-documented, can provide a reasonable sense of the vulnerability to stress conditions. Many of you may already look at your holdings in this way, and I suspect many others of you will be doing so in the near future. While it may seem daunting now, I've learned that one should never underestimate a banker's ability to adapt.

Challenge 2: Changing Structure of Financial System

A second challenge is that presented by the structure of the banking and financial system. Here again, technology and financial innovations have played important roles, along with other forces that have altered the financial landscape and required banks of all sizes to improve their competitiveness and overall efficiency. These forces have changed what a bank is and does. They have led to significant consolidation within the banking industry and have increased the importance of non-bank institutions. During the past decade, many of you have seen dramatic changes in your own institutions -- as well as your competitors -- as ownership changed and new competition appeared. That pattern is simply a continuation of factors that first affected bigger banks, as large corporations turned directly to capital markets and as brokerage houses began to offer deposit-like instruments to customers. Coping with these changes was difficult for some large banks, but they adjusted. Smaller banks are vitally important to their communities and, as such, are well situated to compete successfully.

The recent passage of the interstate banking legislation will create opportunities and challenges for community banks. While the new law may make it easier for new competitors to enter the market, dealing with competition is nothing new to most of you. Like most major changes, interstate banking should lead to a reassessment of activities and competitive strengths and a focus on ways to improve. Undoubtedly, it will also create some dislocations and undesired pressures. Eventually, however, these changes should lead to a stronger and healthier banking system that can compete effectively and with less risk to the federal safety net. Ultimately, it is the reduction of risk in the industry that will most

effectively deflect increased regulation and perhaps create opportunities to reduce the scope of current regulations. As you well know, to succeed in this environment there must be an opportunity to compete without an ever-growing burden from government regulations. This in turn requires a demonstration that your banks are well-managed and meeting community needs. I can appreciate that your job is not an easy one.

In meeting these challenges, the key for community banks may not necessarily lie in new product initiatives, but instead in a clearer and simpler approach: using local presence and small-bank service to full advantage. This has historically been the strength of the community bank. Looking forward, this community bank advantage should remain formidable. Demand for traditional services by smaller businesses and by households will not disappear, and neither will the community bank niche in the market. Smaller banks have repeatedly demonstrated their ability to survive and prosper in the face of change, including increased competition from large banks. Research at the Federal Reserve, for example, indicates that even in major metropolitan areas, community banks can consistently outperform much larger competitors. Technological change may augment this community-bank advantage by making products, services, and capabilities available to smaller banks at lower costs. Simply look at what affordable personal computers have done to help manage business better.

Challenge 3: Taking Care of the Core Business

There is no shortage of pressures brought about by new technologies and competition. But perhaps the most important task ahead, even with these changes, is to take

care of basic business. On this point, I may be preaching to the choir; nevertheless, it always seems to be a message worth repeating, since it is mistakes on the basics that have caused industry problems time and again. First among these basics is not to sacrifice lending standards for short-term gains. The credit crunch of the early 1990s was a problem, of course, and the business of banking is to lend. But lending must be done prudently, with the expectation of being repaid as agreed.

The Federal Reserve's latest surveys of senior lending officers indicate that lending standards have begun to ease. That pattern is not yet disturbing, because conditions are generally good and standards in some cases may have been too high. The industry also seems well-capitalized and well-reserved. However, asset quality remains the principal risk to most banks and the one we must all watch most carefully.

Looking after core business also means conducting business in appropriate ways, consistent with sound practice and supervisory standards as well as existing law. Most recently, there has been a proposal to change regulatory standards for the Community Reinvestment Act. The new proposed standards are oriented to results, especially in the area of lending, and less on process or form. The proposal involves a larger role for examiner judgment, to take proper account of the "context" of a bank's market and circumstances. I will admit to having some reservations about the proposal and its potential for regulatory burden, but I encourage you to read the proposal and look forward to reviewing your comments on the issue.

Conclusion

The best response by community banks to these challenges seems to be pretty clear. Technology and legislation may be important challenges, but small banks have historically shown much resilience and an ability to adapt. The greatest challenge, and the key point, is to do core banking business well.

This is, indeed, a period of change. The greatest risk in coping with that change, though, may come from pursuing new product and investment activities that are not fully understood. I believe community banks will continue to thrive in the years ahead by focusing on the principles that have served this industry well. Thank you.