

**Remarks by  
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**The Banking Industry Looks Ahead**

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## Banks are Special

- (1) Transmission mechanism M.P.
- (2) Temporal aspects of balance sheet - funding credits relatively l/t with short-term liabilities - can be inherently unstable if not managed well
- (3) Major conduit of private savings to private investment; need to be trusted, secure to ensure economic growth

## Why do we supervise and regulate?

- (1) to ensure safety and soundness of financial institutions - prevent sources of systemic risk or burdens associated w/losses that must be covered by federal safety net
- (2) to promote an efficient and effective banking system that finances economic growth, impartially allocates credit, and meets the needs of customers and communities banks serve.

## Current Health of Banks

- (1) After a very rough period in early 90's New England broad banking (banks and thrifts) seen very positive. About 1/3 fewer banks and thrifts as a result of failures, forced consolidations, and

new mergers, but remaining organizations are quite healthy. Top 12 bank and thrift holding companies (better than 60% of 1st District asset base) all are strongly capitalized, have low levels of N.P.A. , high ROAA and efficiency ratios

- (2) This picture is a reflection of nationwide banking health
- (3) Can never afford to be complacent; arguably the late 80's banking excesses were a direct reflection of supervisory laxity, especially in the fact of heavy concentrations of real estate lending of one sort or the other; however, must always be reviewing how we supervise to ensure it is as effective (and least burdensome) as possible
- (4) In that regard, over the past two or three years we've had a bit of time to reflect--not fighting the continual fires of bank failures, though certainly the spate of bank mergers has presented a few challenges - our reflections have included the various ways the banking industry has and will change, its new lines of businesses, the impact of technological change and the highly competitive arena in which banks operate - our aim is to be more efficient, more flexible, and more effective in both how we supervise banking organizations and how we regulate them

## Supervision Changes

- (1) Changes in the banking industry have concentrated assets and transaction levels among fewer players, heightened the complexity of those transactions and the linkages among players and increased the potential that an individual disturbance may be transmitted more broadly. Systemic problems may be less probable because of sophisticated risk management techniques, but if they occur, the likelihood is they will move faster, and hit harder than ever before
  
- (2) Supervisors recognize this; they also recognize that the traditional methods of verifying the condition an the institution at a point in time by reconciling accounts, testing transactions and performing ratio analyses, focused as it was on a similar process no matter how different the banks risk profile, simply isn't good enough. We need to change
  
- (3) Major changes - 5 major areas
  - a) Risk Management Processes - Evaluate processes for controlling risks to determine the institutions capability to handle both its current profile, and future risk exposures-- formal rating to risk management in the examination

- b) Customized Profile - More customized focus of the exam to the particular risk profile of the institution; this accomplished through increased pre-exam planning
  
- c) More use of technology - examining agencies are working on developing a new common workstation which will be used to download and analyze data - should reduce on-site time and focus more attention on identifying and evaluating risks - new technology also improves off-site surveillance and should give us the ability once the glitches are worked out to tailor information we collect from the organization, and to make greater use of internal risk models and risk management reports.
  
- d) Greater commitment to Cooperation - The advent of interstate banking to its fullest extent is scheduled for early 1997. We at the Federal Reserve are working hard to make this as smooth a transition as possible from both an operational and supervisory point of view. On the supervisory side, we've been working with the CSBS and other Federal Regulators on a supervisory protocol that would reduce regulatory duplication to a minimum even when multiple states are involved. We are also using technology to more effectively communicate among federal and state supervisors to improve coordination and reduce duplication of efforts. The intent here is to achieve a

seamless supervisory process that will, we hope, continue to make the state banking charter viable in an interstate environment.

- e) Reliance on Market Discipline. Finally, we realize we as examiners must rely on the increasing sophistication of bank management, and on the discipline inherent in the markets, as the final bulwark in ensuring bank health. To that end, we first have focused considerable effort on disseminating instructions, policy statements and examination manuals aimed at defining sound practices for bankers concerned about controlling risks. One recent example of this guidance is the Federal Reserve's supervisory letter and manual on managing risks related to trading activities, which has been well received; these activities will continue. Second, to ensure market discipline we are emphasizing an increased level of disclosure by banking institutions not just focused narrowly on their financial conditions at a point in time but also on management's philosophy for managing and controlling risk. We have done much to improve disclosures for derivatives and market risks, and will continue to urge better and more broadly-based disclosures. This improved transparency enhances market discipline and rewards prudent management.

## Regulation

- (1) But many would argue that the problem with U.S. bank oversight lies not so much in the examination process, but more in the amount of regulatory overhead, bureaucracy, and sheer inertia.
- (2) Here we're making significant change as well - guided by four major principles

Well run bank holding companies that meet objective criteria related to their financial health should be able to expect prompt action on expansion proposals

Application process should focus on specific transactions and not be used to comprehensively evaluate and address supervisory and compliance issues

BHCs should be able to conduct nonbanking activities to the fullest allowed under BHC Act and should not be constrained by supervisory restrictions that do not apply to insured banks

Finally, market place evolution, especially in nonbanking activities and in way products and services are bundled for consumers, should be recognized and accommodated with minimal burden

- (3) Two proposals - August 23, 1996 proposal Reg Y and earlier Section 20 proposals
  
- (4) Changes in three areas - the application process, the kind and level of allowable nonbanking activities, and the Board's tying rules

Application process: for qualifying BHC's and "qualifying transactions" i.e., BHC's with composite 2 exam ratings, satisfactory management and good CRA ratings and transactions that aggregate less than 35% of assets and meet DOJ horizontal merger guidelines and interstate banking and home country supervision standards--only 15 - day notice req'd

This would have applied to 50% of applications in 1995 and reduced time from 35 days to 15

Public comment changes - System takes seriously useful information provided by public comment, but we need to restrict the use of comments received after the comment period is over, and allow Reserve Banks greater authority to act on cases that have been commented on, particularly as they may involve individual consumer complaints and repeat comments with no supporting evidence

Non-banking activities - proposal includes streamlining application process, eliminating restrictions on non-banking activities (including expanding the so-called laundry list) and eliminating restrictions that would not apply to an insured bank conducting the same activity; many restrictions are proposed to be removed or made less binding, in particular limitations on revenues for Section 20 subsidiaries and related firewalls, limitations on investment advisory activities, limitations on reliance from data processing and management activities, etc. etc; also 10 new activities are added to the laundry list and others have expanded scope; finally, approvals which used to lapse if activity not begun within a year now would remain in force if all is well with BHC - no need for piecemeal filings

Tying - significant changes - will eliminate its regulatory extension of the tying rules to BHCs and nonbanking subs - will allow BHCs to offer packaged banking services without eliminating the protection of the anti trust laws

In sum

- After fighting fires of the banking crises of the early 90's, bank supervisors are focused on improving their own operations

- The banking system is healthy, but we cannot afford to be too sanguine about risks -- they are there and we have to devise ways to address them
- At the same time, the industry is evolving rapidly, competition is keen, and nonbank providers of services continue to make inroads. Regulatory processes have got to recognize this and continually seek ways to be less burdensome and more effective
- I also believe that sooner or later Glass Steagall will explicitly or implicitly cease to exist, and we in the supervisory and regulatory community need to be ready to deal with multi-faceted financial services organizations, some portions of which still are subject to the Federal safety net.
- Thus, the changes in supervisory and regulatory approach I've mentioned have got to be seen as only the tip of the iceberg. Much more will need to be thought about, but I think the most important message is that we're committed to making these processes as effective and efficient as possible.