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**Positioning Financial Institutions for Turbulent Times: What Lies Ahead  
Rethinking Bank Regulation in an Era of Change**

Thank-you for inviting me to this conference. It looks like you have an excellent program. It's a pleasure to be here in Iowa.

The Chicago Fed has longstanding ties with the Iowa banking community. As many of you know, three of the nine directors on our board must be bankers—one each from a small bank, a medium-sized one, and a large bank. Frequently, the community banker seat on our board has been filled by an Iowa director. Arnie Schultz, who's chairman and president of Grundy National Bank in Grundy Center, currently fills that seat. Iowa's also represented by Tom Dorr, who's president and CEO of Dorr's Pine Grove Farm in Marcus. Tom, by the way, is on the state board of regents that oversees this university as well as Iowa State and the University of Northern Iowa. In fact, Tom is chair of the regent's banking committee. Both Arnie and Tom provide terrific insight about the Iowa economy. They've even taken the time to help us get a first-hand look at developments in the state. Last September we took advantage of Arnie and Tom's local contacts to help us arrange for our board of directors to meet in Ames, and visit at Iowa State University where we had a chance to hear about some of the latest advances in agriculture.

To start off, I'd like to provide some brief background on the Fed as a reminder. Our mission, of course, is to foster a safe and sound financial system and a healthy, growing economy with stable prices. More specifically, we formulate monetary policy...We supervise and regulate banks and bank holding companies...And we provide financial services to banks and the U.S. government. The Chicago Fed carries out these activities in a five-state region. That's most of Illinois, Indiana, Michigan, Wisconsin, and all of Iowa. We have offices throughout the District, including one in Des Moines, to carry out these activities. We also have a head office in Chicago, branch in Detroit, offices in Milwaukee and Indianapolis, and a new facility in Peoria, Illinois.

Today I'd like to focus on the many changes taking place in the banking sector and how the Fed is responding to these changes. These are turbulent times as noted in the title of the conference. I won't belabor the point. I think we can all accept that as a given. But it's also undeniable that bankers are doing quite well, in the Midwest and across the nation. Last year banks nationally recorded an ROA of 1.14 percent. Banks did well in the Midwest too, with an ROA of 1.02 percent. And banks in Iowa did even better last year, with an ROA of 1.21 percent. It looks as though banks continued to do well in the first quarter of this year judging from preliminary figures.

So what's the problem? It's not so much today's environment, although banks do face significant challenges. It's tomorrow's environment...the competitive challenges bankers will be facing in the not-so-distant future.

Banks are facing crucial business decisions...decisions that could determine their ultimate survival. They need to decide their product mix...should they focus on the wholesale market, the retail market, the middle-market, or be an even more specialized niche provider? They need to decide how to distribute services...the choices include brick and mortar, ATMs, or the latest hot button issue—electronic distribution. And they need to decide on a strategy. Do they go it alone? Merge? Buy other banks? Form strategic alliances with non-bank partners? Or sell now and maximize shareholder wealth?

Bankers need to determine what they do best to make these decisions. And they need to evaluate their competitors in the same way. Of course, sometimes it's hard to define who a competitor is...a local bank, a telephone company, an insurance company, a Big 3 automaker, or even a well-known, very large software company.

Perhaps the most important question for any banker is: What does the customer want? That, of course, is the bottom line.

Further complicating the lives of bankers is consolidation. There's a lot of competition now, no doubt. We've gone from about 15,000 banks in 1980 to roughly 10,000 last year. More than 6000 healthy banks have been merged or acquired since 1980. And the share of assets controlled by the largest 100 banks has increased from about 30 percent to roughly 50 percent. All this may seem to indicate that larger banks are in the middle of a feeding frenzy.

But it's not that simple. Yes, deposits are more concentrated. And about one-fourth of domestic deposits nationwide are held by out-of-state banks. But a closer look at the numbers reveals a more complex situation. For example, more than 3000 new banks have started since 1980—that's about half the number that merged and were acquired during that time. Many of these start-ups are smaller banks that have been successful in serving niches in the market such as small businesses.

That's an indication that well-run community banks will continue to be a vital segment of the banking industry. They're close to their customers. They know their markets. They innovate. And they compete successfully.

Iowa community banks illustrate the point well. They're active and vital participants in the community. The response to the Great Flood of 1993 is a good example. Iowa banks lowered loan rates and deferred payments following the flood. Business failures in Iowa dropped by a third in 1993, despite the flood. That shows to me how closely Iowa banks work with their local business community. This type of partnership is good business...and good for the community.

So I feel confident that well-managed community banks will survive. In fact, I think they will continue to help set the standard for innovation in the banking sector. The caveat, of course, is that banks can't ignore the fundamental changes taking place. They need to adapt and innovate to survive.

That brings me to the point I'd like to emphasize today. It's essential that regulators recognize that bankers are facing some tough decisions. We need to ensure that we don't stifle bankers' ability to pursue the strategy of their choice. I don't mean to imply that we should abandon safety and soundness concerns. But I do think we need to fundamentally revisit how we try to achieve our goals. I'd like to briefly discuss six points that illustrate what we need to do and what we're already doing in this area.

Number one—We're working to take advantage of economic incentives and market forces in developing regulations. Using incentives that help match up the interests of bankers with the interests of the public, in cases where there might be a conflict, will foster a more efficient financial services industry. We all probably agree that the invisible hand of Adam Smith can't provide exclusive oversight of the banking sector. But we probably also agree that we should avoid the other extreme of heavy-handed regulation. That only stifles innovation and encourages banks to expend their resources on avoiding onerous regulations.

Let me give you an example of what I'm talking about. Regulators have been working on an approach for requiring banks to allocate capital for market risk. This directly affects only large banks. But many smaller banks are end-users of derivatives to hedge risk. And I think the regulatory approach is of interest to all banks.

The Fed, in conjunction with the leading foreign bank regulators and other U.S. regulators, has decided to use what's called an internal models approach. Banks can use their internal model as a basis to determine their market risk. This, in turn, determines how much capital should be allocated. The internal models idea is a positive step...it avoids a one-size-fits-all approach.

But there's an alternative approach I'd like to highlight. It's an idea that the Federal Reserve System and the Chicago Fed in particular have studied...it's called the pre-commitment approach. This approach would provide incentives for banks to allocate capital that's appropriate for their risk. Banks would commit to containing their cumulative losses in their trading portfolios below a certain level over a given period of time. Then they would set aside enough capital to cover the possible maximum loss. If the bank loses more than expected, it incurs a penalty.

The bank determines the risk of its portfolio and the corresponding appropriate level of capital. It has an economic incentive to make sure that it isn't taking on too much risk in relation to its capital commitment.

The New York Clearing House Association is organizing a pilot study of the pre-commitment approach, with the Fed's encouragement. A lot of work still needs to be done, but I'm excited about the possibilities. I think we should try to use similar approaches that take advantage of incentives whenever possible.

Number two—We need to move toward performance-based regulation and away from the permission and denial approach that's much more common today. Regulators traditionally have required banks to request permission when they want to innovate. But in today's fast-changing environment banks need to constantly innovate and change. Regulators must find ways to be more flexible while fulfilling their statutory responsibilities for fostering safety and soundness. A permission and denial approach will be increasingly costly and won't serve the public interest.

Instead, regulators should start rewarding banks that meet high standards of performance. Such banks should be given more latitude...they shouldn't require the same close supervision that's appropriate for banks whose performance is lacking.

Number three—We're increasing our focus on risk. In fact, the Fed and the other federal banking regulators are working on a proposal to modify the CAMEL (Capital, Asset Quality, Management, Earnings, Liquidity) rating system to more formally evaluate risk management. What we're finding is that a "snapshot" of a bank's loan portfolio isn't always enough. Things are changing too quickly. Focusing on risk management gives us a better idea of how a bank will do in the future...not just how it's doing right now.

I should say that focusing on risk is nothing new for the Fed. Our examiners have traditionally evaluated risk management. As you know, though, a lot of an examiner's time is spent reviewing individual transactions to determine a bank's risk exposure. In the future, we'll focus less on specific transactions and more on management and control processes. If we find problems with the risk management process, that will be a sign that we need to exercise greater oversight of that institution.

Number four—We need to develop more efficient and effective exams. Things are changing, but I think it's safe to say that exams will remain the cornerstone of the supervisory process. We're trying to develop exams that are more effective and less burdensome to banks.

I think we'd all agree that we should try to reduce the burden of regulation. The trick, of course, is to reduce the regulatory burden and maintain high supervision standards. I don't think the two are mutually exclusive...they should work hand-in-hand. I spent a number of years in the private sector. I know that regulation can be burdensome. So I'm pleased to report that the Fed, and the Chicago Fed in particular, is actively involved in a number of projects to reduce the supervisory burden. Certainly, we can do more. But I think we've made progress.

As you may know, the Fed has adopted a program in which a larger portion of an exam will take place at a Reserve Bank office. The Chicago Fed was one of the leaders in the Fed System in developing and implementing this program. In fact, our Iowa examiners stationed in Des Moines were pioneers in the effort. I think it's a win-win situation for bankers and regulators. It reduces interference with your operations. It gives our examiners easier access to resources at our office. And it increases examiner productivity.

An increased use of technology has helped us in this effort. The Chicago Fed is playing a key role in one initiative to develop a new set of automated tools for examiners that can be used on a PC. This set of tools, called Examiner Workstation, is being developed in response to feedback from bankers and examiners. We're developing the tools in cooperation with the FDIC and a number of state banking regulators. These tools will enable examiners to receive data from banks in an electronic form before the exam. Examiners will be able to analyze the data in our building instead of your building. And they can focus on analysis instead of the time-consuming process of transcribing records. We're just starting to test these tools in the field as a first step in introducing them into the exam process.

Number five—We need to reduce duplication of effort. The Federal Reserve has already done a lot of work with the FDIC and state regulators to do so. State and federal regulators have formed a working group to focus on this issue. The group will build on work that's already been done... most notably an agreement by state regulators on how to handle banks operating in more than one state. Under the agreement, a single state regulator and a federal regulator will oversee such banks.

The Fed is also exploring ways to avoid duplicating the efforts of internal and external auditors. I think we should consider allowing banks to self-certify their compliance with certain rules and laws. Regulators would review a bank's process for ensuring self-compliance rather than check individual transactions.

And number six—We're taking advantage of a valuable resource—bankers. We need to encourage a strong and steady flow of communication. Regulators can't depend only on their own ideas...things are just too complicated and changing too quickly.

Now of course we're not in the business of making bankers happy. And we won't become a captive regulator. But we need to work together. Probably the last thing a banker wants to hear is "I'm from the Fed, and I want to help." Another way to put it, though, is "I'm from the Fed, and I'm here asking for your help." For me to do my job, I need to know about the challenges you face in your job. There will always be differences of opinion. But regulators need to be open to ideas and suggestions. We need to actively solicit your feedback and consider it carefully.

How do we encourage this interaction? One example is our plan to have more regulatory functions handled at our examination office in Des Moines. We're currently transferring trust and EDP functions, and we plan to transfer some application authority. We hope this will make it easier for Iowa bankers to work directly with our examiners in Des Moines and communicate their ideas to us. This should also help our examiners be more responsive to the unique concerns of Iowa bankers.

One other quick example in this area...The Chicago Fed recently held its annual conference on Bank Structure and Competition. Bankers, regulators, and academics all come together at the conference to discuss major public policy issues facing the banking industry. This year we tried something new...a roundtable session in which bankers were invited to sit down with senior officials from the Chicago Fed to discuss regulatory issues. We had a good turnout, interesting discussion, and heard some excellent ideas. As a first step in this process, I think it was a very successful start.

To sum up, you're facing increasing challenges. Community bankers have an established record for creativity and innovation...exactly what's needed to prosper in our turbulent times. The Federal Reserve needs to be as flexible as possible so you can meet those challenges. Regulators and bankers have common goals at the end of the day. We both want a safe and sound banking system. And we both want effective, thorough exams that are done quickly and efficiently. I think we've made a good start, although there's certainly much more to do. With your help...your feedback...your ideas, we can accomplish our mutual goals.

Thank you.