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Effective Supervision and the Evolving Financial Services Industry

by Jerry L. Jordan

Technology, market consolidation, international competition, and new legislation are changing the face of the financial services industry. How are the agencies responsible for ensuring the safety and soundness of our financial system responding? Jerry L. Jordan is president and chief executive officer of the Federal Reserve Bank of Cleveland. This *Commentary* is adapted from his keynote address to the 111th Annual Meeting of the Ohio Bankers Association on May 31, 2001.

When I was still in graduate school, more than 35 years ago, it would have been hard to persuade me that I would be approaching the end of my career before we started to think seriously about the post-Glass-Steagall banking environment. By the mid-1980s, when I worked for a commercial bank on the West Coast, I had become sufficiently discouraged by the slow pace of banking reform that I thought I was making a joke when I would say, "The Berlin Wall will probably come down before Glass-Steagall!" Gramm-Leach-Bliley was signed on November 12, 1999. I had been hoping it would be signed three days earlier on November 9, which would have made it exactly on the tenth anniversary of the collapse of the Berlin Wall!

Bankers are no doubt still assessing the opportunities and strategic implications of Gramm-Leach-Bliley and the implementing regulations. At the same time, they are still digesting the impact of the Internet and wireless technology, ongoing bank mergers, and new financial products.

Banking regulators and supervisors, for our part, are pondering the implications as well. We know the system of supervision and regulation must be modernized to keep pace with a dynamic financial services industry.

To begin to do that, we need to address two basic questions. First, what public purpose do supervision and regulation ultimately serve? Second, apart from legislation, what forces are driving change in the financial services industry? We must answer these questions to anticipate how the system of supervision and regulation must change, so that these activities can accomplish their public purpose within the new financial landscape.

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Supervision and Regulation Are Different

Before we try to answer those questions, it is important to distinguish between supervision and regulation. These two words are often used interchangeably, or in conjunction with one another, to imply that both relate to the same concept or process. That can't be further from the truth. And, while we're distinguishing between the two, it might also be helpful to reverse the order and refer to these concepts as "regulation and supervision," since, as a practical matter, one typically follows the other.

Regulation refers to the rules or procedures that are designed to govern an industry's behavior. It is the prescriptions or boundaries imposed on the industry by legislators and regulatory bodies in an effort to "direct" it.

Regulation takes place in a political context—democracies often use legislation to encourage the things society as a whole likes (such as economic development) and discourage the things it doesn't (thus, the sin tax). As globalization and technology advance, financial institutions become an easy target for additional regulation; new regulations might be seen as a way of thwarting money laundering, achieving community development goals, or channeling credit to needy borrowers, for example. Such uses are often a temptation that leads regulation away from its true mission—to help establish the boundaries within which an industry can operate.

Supervision, on the other hand, is the monitoring or oversight function that takes place after the regulations have been passed. It ensures, among other things, that activities are conducted in accordance with those regulations. Bank supervision also involves assessing risk-management practices, helping boards and management make informed decisions, and, most recently, spreading best practices of the industry.

While the distinction between regulation and supervision may not always be clear, what is clear is that the system is changing. Regulatory and supervisory agencies have begun and will continue to rely more heavily on supervision, and less on regulation, to ensure the safety and soundness of our financial system.

What Are Regulation and Supervision Supposed to Accomplish?

Academics sometimes ask whether there is any legitimate purpose behind banking regulation and supervision. That may seem an abstract question, but even people who prefer a more Hayekian market economy—without even such regulations as legal tender laws—must agree

that we certainly don't have such a system now. There are a number of roles society has determined it wants an official, governmental institution to perform. These include traditional central banking functions, such as providing a standard of value and ensuring an effective payments system, as well as providing a safety net under the operations of depository institutions.

Assigning these functions to a governmental agency has two related consequences that are important here. The first is that these activities can easily end up hiding subsidies that distort markets. It may be possible to create a fairly priced deposit insurance program or to properly apportion the costs of providing an efficient payments system, but it is nontrivial in the best of times, even without political interference. So the pricing and distribution of governmental functions can act as a distortion. But something else happens once the government takes responsibility for the program: moral hazard. The mere fact that we have a central bank that serves as a lender of last resort and a guarantor of large-value, real-time payments, and the FDIC providing deposit insurance, creates moral hazard.

Incentives are misaligned. The price of risk taking becomes too cheap. This creates the need to rebalance the incentives, and that is the mission of regulation and supervision. As Alan Greenspan put it recently, "public policy should attempt to simulate, in so far as possible, what markets alone might do, or at least to create market-style incentives."[1]

By implication, then, supervision is not meant to replace the judgment of a bank's management or substitute for its board of directors. The goal is *not* to make supervisors responsible for the safety and soundness of banks. It is to return that responsibility to the banks and enable them to shoulder it: to get the invisible hand back in the game, so to speak. In this environment, the role of bank supervisors would at least be minimized. Given the presence of the federal safety net, supervisors would remain in the picture to provide general oversight of the banking industry; to ensure that risk-management systems are in place and effective; and, where possible, to share their experiences in supervising a broad range of entities to communicate what has generally worked well, and what has generally not worked well.

So while we have no choice but to acknowledge that these distortions exist, we need to ensure that the product of these distortions (that is, bank supervisors) add value to the environment in which they've been inserted without mistakenly assuming responsibility for the safety and soundness of the industry.

Further, to fully understand the proper role of supervision, it is necessary to understand the nature of risk. Risk is like total matter and energy in the universe—it can be transferred and transformed, but it cannot be destroyed. Because risk can't be eliminated, it must be managed, and the business of banks and other financial intermediaries is to take on and manage risk.

But in the presence of distortions, banks do not take on the socially correct amount of risk. Such distortions end up creating the very problems they were designed to solve. With deposit insurance protecting them from the discipline of the debt market, savings and loan associations had the incentive in the 1980s to "go for broke." And, of course, many of them did just that—go broke—and they took a lot of taxpayers' money with them! The purpose of regulation and supervision is to see that the private costs and benefits of taking and managing risk don't deviate too far from the social costs and benefits. This is also the sole reason we have capital requirements—to prevent excessive leverage and the risk that would accompany it.

The Changing Financial Landscape

What forces are changing the financial industry? Most of the pressure creating the new financial landscape, of course, comes from technological advances and financial institutions themselves. Underlying trends in technology and finance were creating opportunities for financial institutions to innovate even before legislation and regulation formally recognized them. Insurance, investment and merchant banking, real estate brokerage, or even joint ventures with telecommunications firms have been interesting prospects for traditional bankers. The movement toward electronically initiated debits and credits certainly will continue, though whether the successor to the ATM will be a smart card, an Internet connection, or a wireless phone remains to be seen. This means we need new solutions to old problems—the successor to the guy riding shotgun on the Wells Fargo Stagecoach is now the biometrics expert or the encryption specialist.

Technology has also affected asset management. Banks have the ability to alter their balance sheets quickly as they buy, sell, and trade financial assets. The advent of round-the-world, round-the-clock markets in stocks, bonds, futures, and options makes it possible to alter a balance sheet in the blink of an eye.

It also means the ability to create, package, and distribute new financial products; so we see securitized loans, collateralized loan obligations, and credit derivatives. This enables banks to add value to their customers—to more finely craft products that have the risk and liquidity characteristics that lenders and borrowers want. It also allows banks to manage their portfolios more closely, laying off risk they choose not to hold and concentrating on the risks they have a comparative advantage in bearing.

This ability to manage risk more finely has the benefit of lowering the marginal cost of bearing risk. As a simple example, consider mortgage securitization—banks were able to diversify away their default risk on home mortgages by trading individual mortgages for collateralized mortgage obligations (CMOs) But the many CMO constructs also mean that investors can make some very complex and risky bets in the mortgage market. So an increased ability to manage risk is a two-edged sword: Mortgage holders can reduce their default risk, but with *misaligned* incentives—without supervision—it is now easier to take on too much risk.

Market consolidation is also a potent force changing the industry. Among banking companies, we see growing size, concentration, and complexity. Banks now spread across vast regions of the country (or around the world), engaging in wholesale, retail, and subprime lending, Internet banking, and trust services, funded by a broad array of deposit and nondeposit liabilities. And this is just "traditional" banking.

The financial holding company allows new combinations of financial services: banking and insurance, investment and commercial banking, mortgage banking, trusts, and annuities. Even the lines between banking and commerce blur.

Lastly, international competition provides an extra impetus for change—for large financial firms and bank supervisory agencies.

■ Less Regulation and a New Approach to Supervision

Gramm-Leach-Bliley was only one response to the changing marketplace. Recognizing that financial institutions have "gamed the system" to a certain extent and found ways around the once-relevant barriers erected in the 1930s, legislators finally removed many of these barriers to allow the financial industry to determine its own efficient topography within more general boundaries. A key element in eliminating these barriers is the movement in supervision away from a system of permission and denial toward a system of certification and notification. In the past, banks filed applications whenever they wanted to do something new, and the bank supervisor either approved or denied those applications. Now, once a financial holding company qualifies and continues to meet the qualifying criteria, they expand and tell the Fed afterward. The burden has shifted from banks proving themselves "worthy," to the supervisor intervening if risk-management systems appear inadequate.

Recognizing that financial services firms would increasingly be able to stay several jumps ahead of any command-and-control, permission-and-denial system, supervisory authorities know that a different approach is needed: To keep up with the marketplace, supervisors need flexibility. This awareness is reflected in the proposals for a revised Basel Capital Accord. While the revisions retain a revised "standardized approach" that updates the risk-buckets framework from the original 1988 accord, the heart of the proposal is the new internal ratings-based approach (IRB). This approach is meant to give banks the incentive to hold the appropriate amount of capital for the risk they actually bear. Regulations will no longer determine the correct amount of capital; rather, the appropriate level will be based upon the institution's internal risk ratings.

Although the IRB has generated the most discussion, the Basel proposal rests on what the Bank for International Settlements calls three pillars, which also represent a new approach to supervision. The first is the new minimum capital requirement, which, as I just noted, is preferably based on the bank's own internal risk-management system.

The second is the supervisory review process. Bank supervisors will evaluate the bank's own procedures for assigning risk ratings and, consequently, for deciding on the appropriate level of capitalization. Essentially, bank supervisors will be saying two things to bankers: Be sure you understand your risk, and be sure you are maintaining enough capital to protect yourself from that risk.

In this setting, supervisors can only add value through the review and validation of risk-management systems. We have an inkling of the future in the ways in which supervision has changed recently and in new programs that have tried to implement the new approach, such as the Federal Reserve Bank of Cleveland's "value-added supervision." This approach means that we want supervisors to view themselves more as agents who spread the best practices of financial and management systems, rather than financial cops. It means, in many cases, simply asking the right questions: What are your greatest exposures? Are you prepared for the financial equivalent of a hundred-year flood? What makes you so sure? How do you know you don't have your own version of Nick Leeson? Done properly, this encourages responsible behavior and aims at *preventing* the concentration of risks that leads to problems. And prevention is a keystone of the proposed new accord.

The third pillar is market discipline. Market discipline is essential, as it exerts pressures on management and shareholders to align risks with rewards. Of course, this third pillar is not well developed, and we do not yet have effective market discipline within the environment of misaligned incentives created by the safety net. Although it will never become a fully reliable substitute for the supervisory review process, it will be a source of independent information, and fuller disclosure should make markets more reliable as the outer rampart of a safe and sound financial system.

■ Challenges for Bank Supervisors and the Supervisory Process

Continued movement away from a permission-and-denial approach to one in which the risk-management system of the bank is assessed requires a closer focus on the incentives in the organization. That means a shift from detailed transactions testing and loan file review toward more review and validation of the systems an institution uses to identify and manage its risk.

Not so long ago, getting a snapshot of a bank's portfolio of loans and investments as well as its sources of funding might have given an examiner a good idea of how the bank was managed. Now, altering the composition of both the asset and liability sides of the balance sheet is so easy that such snapshots serve little purpose. In fact, even getting an unblurred snapshot at a point in time becomes increasing difficult, as both financial institutions and financial contracts grow in complexity.

Undoubtedly, the increasing fluidity of the financial industry has fundamental implications for bank supervisors and the skills required to be effective and to add value. The skills needed to determine whether a loan has proper documentation are not the same as those needed to assess the organizational architecture of the bank. Understanding how risk is managed at the firm and identifying which executives have the right to make key decisions—those who choose the risks that are taken, determine what the key performance measures are, and decide what the reward system is—are not trivial tasks and definitely require new, specialized skill sets to accomplish.

When you consider the fact that supervisors must also evaluate a firm's operational soundness and how this task has been complicated by technology, you realize the entire process is quite daunting. Add in the need to evaluate the effectiveness of market discipline and the need to rely on reports from different functional regulators, such as the SEC or insurance commissioners, and the challenge becomes greater still. In addition, different-sized organizations may have very different needs. The market discipline imposed by a small group of local stockholders may be no less effective than that imposed by specialists on the New York Stock Exchange or institutional investors, but supervisors must use different approaches when evaluating each form of market discipline.

Flexibility and adaptability are critical. Supervisors may well have a role in spreading best practices from large firms to small ones, or vice versa. But in the

end, the real test of bank supervisors is the amount of value added or, put quite simply, whether the bank was stronger when the supervisors left than when they arrived.

Conclusion

What else is in store for bankers and bank supervisors? An old adage says, “Nothing is constant but change,” and that is certainly the case for the financial services industry. But there is a major difference in the way change was once viewed: Rather than the change being “done to” the financial services industry, the financial services industry is in a position to “do the changing.”

Bankers are the ones who are dictating the change and shaping the landscape of the financial services industry. As a result, the system of supervision and regulation has to adapt, and has, in fact, been adapting. We are rapidly moving to an environment that relies less on rigid adherence to regulations and more on supervision that is flexible enough to let the industry grow as the industry sees fit, yet strategically involved to maintain the system’s safety and soundness. This new environment has been made more flexible as supervisory agencies have been given the latitude of interpretation to determine which activities are “financial in nature” or “complementary” in order to keep the powers of financial holding companies up to date.[2]

If we do our job well, future changes will be evolutionary, with less need for periodic “omnibus banking bills” such as Gramm-Leach-Bliley.

Footnotes

1. Alan Greenspan, “The Financial Safety Net,” remarks to the 37th annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 10, 2001.

2. The Gramm-Leach-Bliley Act granted joint powers to the Treasury Department and the Board of Governors of the Federal Reserve System to expand the list of permissible activities for financial holding companies and financial subsidiaries of banks deemed “financial in nature.” In addition, powers were granted to the Board of Governors alone to deem new activities “complementary” and therefore permissible for financial holding companies. See section 103 of the Gramm-Leach-Bliley Act adding sections 4(k)(1)(B) and 4(k)(2) to the Bank Holding Company Act.

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