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# **The Future of Banking Supervision**

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## **Introduction**

I'm very pleased to participate in this Conference on Bank Auditing and Regulatory Compliance. As my remarks this morning will indicate, I believe that in the years ahead, auditors will be playing an ever-increasing role in the financial system and in ensuring the well-being of banks and the financial system. This will happen not because of new legislation or regulations, but because market participants and banking officials need information about financial institutions that is accurate, timely, and comprehensive. Bank auditors, whether working within or outside these firms, have the expertise and incentives to play key roles in the information production process.

While it is obvious that the financial system's structure and products are changing rapidly and that they will continue to do so, we can't predict exactly how, or at what pace, the financial structure will evolve or the time line along which it will occur. Nor can we foresee what the most efficient form of financial structure will be. We do know that financial institutions will continue their trend toward becoming more similar, as the restraints of the current regulatory system are removed or more completely outflanked by less-regulated -- or unregulated -- competitors. Banking companies are already combining securities, insurance, underwriting, and venture capital activities with traditional banking products.

The future of banking reminds me of what I heard said about Niagara Falls. Five miles above the falls and five miles below the falls, the Niagara River is calm, but in between there is a transition that involves great turbulence. Bankers think of themselves as being above the falls, and they know the necessity of getting below the falls. However, few have volunteered to ride in the barrel during the transition.

My remarks this morning, will elaborate on the role of market forces in the evolution of the financial services industry, paying particular attention to the roles of information and auditing. The goal of banking supervisors should be to assist, rather than resist, market discipline. The inevitability of greater reliance on market participants' judgments, rather than on regulators' judgments, comes from the fact that it is now impossible for any individual or supervisory agency to fully comprehend the real-time risk profile of a diverse and complex financial institution. Consequently, it is essential that we enlist the collective knowledge of many market participants to evaluate an institution's risk-bearing capabilities and to exert discipline on its business practices.

In the future, the job of banking supervisors will be to ensure that markets are working effectively, rather than to supplant markets. Banking supervisors will pay somewhat more attention to the functioning of the financial system as a whole, and somewhat less attention to the operation of individual institutions. That premise underlies much of my thinking and several of my suggestions about the future of banking supervision.

Even though the financial system is evolving and the day-to-day activities of bank supervisors are changing, the *basic goals* of banking supervision will remain constant. The challenge ahead is to find ways that banking supervision be modified so that its enduring goals are more fully achieved with less cost to banks, to their customers, and to the taxpayers.

I will emphasize two goals: enhancing the efficiency and competitiveness of the financial system, and protecting the economy and taxpayers from systemic risk and consequent deposit insurance fund losses. We might quibble about the wording, and I readily admit that other goals are important (such as protecting consumers against fraud, deception, and illegal discrimination).

Nevertheless, these two categories of goals capture the essence of the objectives that supervisors will aim to meet as the environment around them changes.

## **Enhancing the Efficiency and Competitiveness of the Financial System**

In the past, legislation and regulations have defined banking as we know it. The National Bank Act, the Federal Reserve Act, and the Glass-Steagall Act have defined *what* a banking organization is permitted and forbidden to do. The McFadden Act, the Douglas amendment, and other legislation have determined the *place* of business and defined the *corporate form* required to do it. The national and state banking authorities, deposit insurance agencies, and Federal Reserve System have defined *how* to do it. Banking supervisors and examiners have tried to *ensure* that it was done that way.

Twenty-five years ago, if you asked bankers what business they were in, they would say they provided payments and saving products, as well as loans, for their business and household customers. When you ask bankers today, they say they are using asset allocation and risk management tools to address their customers' needs. Economists would say that the banking business has not really changed, because banks still operate to reduce information and transaction costs through financial intermediation and risk-bearing services.

Historically, the regulatory framework segmented the financial industry into three major groupings: (1) depository institutions, (2) securities underwriting and sales, and (3) insurance underwriting and sales. Each major group was further subdivided in ways with which we are all familiar.

Although the environment has been changing somewhat during the last few years, our nation's basic regulatory framework does not recognize that commercial banks are greatly affected by the competition they face from firms in the other regulatory boxes. Nevertheless, depository institutions, securities firms, and insurance companies all cater to the financial needs of the same customers. Financial engineers can now decompose and recombine financial risks faced by businesses, households, and governments in ways that make it impossible to maintain separate regulatory compartments. The highly fragmented regulatory structure of the twentieth century's financial services industry simply will not serve the needs of the twenty-first century marketplace. So, even though by law and by tradition the term "bank" has a distinct meaning, future supervision must acknowledge that all financial institutions are basically in the same business and deserve to be treated accordingly.

### *Removing Barriers*

The first step necessary to achieve full parity among intermediaries is to remove or ease the restrictions on the lines of financial business that banks can enter. A *minimum* step would be to improve the *method* of product regulation. Banking companies should not be required to get permission from regulators before doing something new. Rather, they should notify authorities of their intentions. If regulators want to prevent the action, the burden should be on them to intervene in a *timely* way to demonstrate that the costs exceed the benefits. [Jerry: Be prepared to answer the question of who bears the cost if regulators' objections are not timely.]

Unfortunately, the 1930s' regulatory approach to banking required companies to ask permission whenever they wanted to change what they were doing. Banks needed permission to branch, to merge, to form a holding company, and to acquire a subsidiary or affiliate or even

open or move an ATM. The underlying philosophy has been: Prove to the authorities that you should be allowed to do this.

I have a philosophical objection to this approach. It places power outside the constitutional checks and balances among the legislative, executive, and judicial branches. Constitutionally, as I understand it, government is supposed to bear the burden of proof if private citizens are to be constrained from following the dictates of self-interest. Banking regulation forces private citizens--in this case, bankers-- to bear the burden of proving that they should be permitted to act in their own self-interest.

The *ideal* response to the first need would be to remove legislative barriers to structural change in the industry so that market forces could determine the most efficient configuration of the financial industry. In addition, by attaching sunset provisions to both legislation and regulations, we would reduce the likelihood that restrictions will apply beyond their useful economic life.

### ***Supervisory Methods***

Even as we press for fundamental reforms, we should strive to improve our *method* of supervision so as to reduce the regulatory burden.

There was a time when bank examination essentially was in the spirit of financial cops who sought to catch banks doing something wrong and issue citations. That era has now passed and what we call “value-added supervision” has taken its place. Value-added supervision seeks to protect the public interest with a minimum cost to banking. The responsibility of the financial supervisors in the broadest sense is to ensure that financial intermediaries are safe, sound, efficient, and honest. The goal of every on-site or off-site examination should be to leave the financial intermediary a stronger and healthier place.

Value-added supervision includes two broad initiatives -- increased responsiveness to the needs and concerns of banks, and an array of educational efforts. Increased responsiveness promotes a working relationship with bankers that is based on collaboration rather than confrontation.

The Federal Reserve System is developing Examiner Workstation -- which uses Windows-based software that allows examiners to download loan, investment, and earnings information from a bank's computer system before and during an examination, and to electronically manipulate and analyze those files. This eliminates the laborious preparation of reports and helps examiners identify areas of highest risk *before* arriving on site, so that their efforts can be advantageously focused. The Workstation should increase efficiency and reduce examiner disruption of bank activity.

Value-added supervision also eases asset quality determination by placing greater reliance on banks' own internal systems of loan quality review and reporting, after supervisors verify the adequacy of the internal loan review systems. Similarly, once supervisors confirm that banks have strong internal controls and internal audit systems, there is less need for examiners to review for compliance with various laws and regulations.

The philosophy behind value-added supervision is that it is less costly to prevent problems than it is to fix problems after the fact. Advocating the internal use of high-quality risk management systems is one way to do that.

It strikes me that auditors should have a natural affinity for the concept of value-added supervision. Auditors, whether internal or external to the firm, are paid to provide bank management (internal audit) and/or the public (external audit) with information and advice that

adds value to the firm and protects the interests of investors and customers. Each group that receives information wants it to be timely, accurate, and germane to its interests. They want to understand the risks faced by the banking organization, how those risks are being managed, and what residual exposures remain. They want to know if they should alter their behavior in some ways that will either strengthen the organization's performance or reduce their exposure. And, it seems to me, the stakeholders also want to know about best practices within the industry.

Auditors routinely provide these services for financial institutions.

### ***Derivatives and Risk Management***

In recent years, auditors and examiners have encountered new challenges in dealing with derivative products and the associated risk-measurement tools. Derivatives are innovations that, like atomic energy and genetic engineering, can be intended for good but have ill effects through mismanagement. Both auditors and supervisors want bank managers to employ financial innovations appropriately, and to ensure that fundamental questions are being addressed inside the banking organization.

Bank examiners could themselves directly evaluate the bank's risk assessment models, procedures, and controls. But by properly structuring incentives within the bank, supervisors could rely more on internal auditors. Of course, banking supervisors will want evidence that a bank's internal auditors are informed, educated, and permitted to play an independent and influential role in evaluating the organization's risk-management tools and adherence to the bank's own policies. In Ronald Reagan's phrase about arms control, "Trust, but verify."

The technological advances that spawned derivatives are now being used to aggregate risks across all lines of business and activity. From a supervision perspective, these initiatives are applauded. Corresponding to this change is an explicit focus by the supervisory agencies on

the risk-management process, particularly regarding oversight by directors and senior management, adequacy of policy procedures and limits on risky activities, MIS measurements, and adequacy of internal controls.

Given the dynamic nature of the market, it becomes much more important for supervisors and auditors to ensure that risk-management systems are adequate and that risk is properly identified, measured, and controlled on an ongoing basis. This area of self-governance offers the greatest opportunity to reduce regulatory burdens while achieving the goals of supervision and regulation.

### ***Making Greater Use of Market Forces***

The concept of market forces supervising an industry sounds like an oxymoron. Some might think regulation has to be carried out by a government agency. I don't agree. Under the right circumstances, market forces can provide very powerful and efficient incentives for appropriate behavior. Banking supervision should rely as much as possible on public disclosure, market forces, and positive incentives rather than on permission, denial, and instruction.

Because of the rapid pace of financial innovation, the increasing complexity of the global payments system, and the kinds of instruments being used for risk management, it makes enormous sense to broaden the scope of involvement of the many market participants who have a clear self-interest in rewarding and disciplining financial institutions. For market forces to be effective, ample information about the assets, liabilities, and practices of banks must be disclosed to the public. Furthermore, there must be credible assurance that the information released is accurate and complete.

## **Protecting the Economy and Taxpayers**

### ***A Few Words about Systemic Risk***

Banking supervisors have traditionally attempted to protect the safety and soundness of the entire financial system by ensuring the viability of each bank, or at least the viability of the largest and most complex banking organizations. During the 1980s, the expression “too big to fail” became part of the supervisors’ jargon. We all recognize that as financial institutions become larger, as financial markets become more global, and as new financial products make it possible for institutions to incur massive losses in a very short time span, it becomes ever more difficult for supervisors to feel secure about preventing the problems within one institution from spilling over into the broader marketplace. Supervisors care deeply about these potential events because their occurrence can cause disruptions in real economic activity and serious losses of wealth.

An alternative approach that seems more manageable and less intrusive is to require sufficient capitalization and collateralization and to limit interbank exposures. This idea was recently suggested by Tom Hoenig, president of the Federal Reserve Bank of Kansas City. Hoenig’s approach could enhance the prospect that the failure of even the largest financial organization would not cause unacceptable degrees of disruption to the financial system or the economy. In such a world, regulators would impose far fewer restrictions, if any, on companies engaging in risky activities. Bank stockholders and other claimants, knowing to whom and by how much their bank is exposed to other banks, would exert greater pressure on management for prudent behavior. This approach would also reduce the resources needed for examination, the costs that banks incur from examination, and most important, the restrictions on market-driven innovations by large institutions.

### *The Safety Net*

This approach to systemic risk management requires a careful reexamination of the federal safety net placed underneath large, complex banks operating on the high wire. Deposit insurance exists to discourage depositors from withdrawing funds from their bank so rapidly that assets cannot readily be liquidated at par value. Moreover, the Federal Reserve's discount window facility offers a mechanism for providing liquidity to sound institutions that may have trouble funding themselves temporarily in the market. Because of the way deposit insurance premiums have been set, and the manner in which insolvent bank resolutions have been structured by the banking supervisors, the entire safety net at times may have encouraged bank managers to take on imprudent levels of risk. In effect, the safety net has encouraged the very same risky behavior it was designed to prevent.

In the wake of the 1980s' thrift industry crisis, Congress altered the framework within which banking supervisors could operate to resolve problems at troubled depositories. The changes were designed to minimize taxpayer risk. Yet, the deposit insurance system itself was not reformed. Deposit insurance introduces moral hazard and risk to the public purse, as has been amply demonstrated in the last two decades. We face three dilemmas: (1) how to respond to the problem of moral hazard, (2) how to avoid broadening the moral hazard problem as banks broaden their range of activities in a world where they are no longer confined to little boxes, and (3) how to avoid having our efforts to protect taxpayers impede the natural, market-driven evolution of the financial system.

Our current approach to the problem of moral hazard is to use supervision and regulation to promote safety and soundness. If we continue with this approach as banking organizations extend the range of their activities, we must either build firewalls to separate the traditional portion of the organization from its affiliates, or we must extend safety and soundness

supervision – and the associated regulatory costs -- to all of the affiliates. Neither option is attractive or even plausible.

An alternative approach was recently suggested by Tom Hoenig as part of the plan that I mentioned previously. Deposit insurance would be provided only to banks that limit themselves to traditional banking activities, and safety and soundness supervision would be continued for those banks. Banks that engage in riskier activities would forfeit access to the safety net. This approach would leave it to each bank to choose whether it prefers to participate in riskier activities or to have deposit insurance.

I am inclined to favor the Hoenig approach because it would continue insurance for most banks while not inhibiting the activities of banking organizations that want to broaden the scope or increase the riskiness of their activities. It seems to blend an increase in market freedom with political feasibility.

## **Conclusions**

I expect banking supervision to remain a challenging activity in the years ahead for several reasons. Apart from issues of safety and soundness and fraud, supervisors are expected to prevent problems that originate in one organization from spilling over into the broader financial markets. In other words, bankers are expected to look out for their individual interests, and supervisors are expected to look out for the public interest. This difference in perspective will not, and should not, change.

As banks continue to perform their traditional economic functions as risk managers and financial intermediaries, they will increasingly become more similar to their competitors in other financial services industries, and even to those in some nonfinancial industries. Electronic

banking, for example, not only holds out the promise of exciting new products for customers, but also could create unusual alliances among banks, computer software companies, and telecommunications firms. These new partnerships will certainly raise safety and soundness issues about the banking system. They are equally likely to pose interesting public policy issues about the design and operation of domestic and global payments systems. Even the role of central banks within payments systems needs to be assessed, since central banks typically authenticate certain types of transactions and assure their timeliness.

Because the financial system is changing, its supervision must change as well. Closer connections among firms in the financial intermediation, risk management, and payments businesses suggest that an umbrella supervisor of some sort will most likely be necessary to assess the condition of large, complex organizations and to safeguard the operation of the system as a whole. As my remarks this morning have surely indicated, however, I think the public's interest is best served by constructively capitalizing on the self-interest of market participants.

You may recall that at the beginning of my remarks I said that the banking business hasn't really changed; only its techniques have changed. I could make a similar observation about auditing. Auditors' tools have changed, but your mission to provide accurate, relevant, objective, and timely information is fundamentally unaltered. If I am right about the direction of banking supervision, the importance of that mission will only increase in the years ahead.

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## **Extra Ideas and Language**

Ultimately, the central bank has little or no direct concern about the viability of banks as they exist today. Even if banks as we know them today cease to exist, someone will make loans, someone will take deposits, and someone will provide insurance. So long as customers are delighted, financial regulators should be too.

Our concern is not that traditional banks might wither away. Many in this room share the goal of seeing banks evolve to new forms that have greater freedom to more fully serve the financial needs of their customers. Our concern is that the new financial system be one that optimally promotes economic growth and efficiency.

Historically, bank examination involved credit risk analysis: going through the loan files and trying to assign a risk rating to the overall loan and sometimes the security portfolio of a bank. That no longer is adequate for the highly complex financial firms. Evaluating risk is not a simple matter; it involves compound probabilities and cross correlations.

Supervision of financial services must evolve at a pace that matches the evolution of financial markets and technologies of financial services providers. The approach to banking supervision early in this century was premised on a paper-based payment system and a highly fragmented, segmented financial services industry. In the next century, banking supervision will have to accommodate a more integrated financial industry that uses an electronic-based payment system.