Rising to the Challenges: Helping Ohio's Financial Institutions Manage Risk

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

Ohio Bankers Day

Columbus, OH

April 9, 2003

I am pleased to have the opportunity to talk with you today about Ohio's banking industry and some of its aspects that have my heightened attention. I will conclude with some thoughts about how we can continue to work together to keep Ohio's banking industry strong.

These are challenging times for our great nation. We are in the middle of a war, and our economy's performance is more sluggish than we would like it to be. But I can tell you that I am deeply committed to doing all that I possibly can to help ensure the strength of our nation's economy and the continued well-being of the banking industry.

Before I turn to those areas of banking that have my heightened attention, I want to start with some good news. Overall, Ohio's commercial banks, thrift institutions, and savings banks are sound and performing well. In fact, Ohio's banking companies as a group realized record earnings last year. When you stop to consider the weakened economy, heightened competition, and sluggish business loan demand, this performance is exceptional. We can attribute this growth to a substantial influx of core deposits and a healthy increase in earning assets. A rebound in noninterest income growth, a containment of noninterest expenses, and an increase in security gains also bolstered earnings. Largely as a result of these earnings gains, capital levels for most banking companies also rose in the last year.

Looking beyond Ohio, one of the barometers we use to gauge the health of the banking system as a whole relates to the number of problem banking companies and banking failures. Right now, that barometer is rising.

Nationwide, the number of companies on the FDIC's Problem Bank List has increased steadily since 1999, going from a low of 79 companies to 136 by year-end 2002. While this trend warrants some concern, even the current level compares favorably with the more than 1,000 problem banking companies back in 1991, when the industry experienced a rash of problem institutions following a recession and a downturn in credit quality. Meanwhile, the 11 bank and thrift failures we saw nationwide in 2002 represented the largest number of failures since 1994. Again, to keep things in perspective, however, almost 10 times that many institutions failed in 1991.

All things considered, then, today's banking environment in Ohio is relatively good. But you as bankers and I as a supervisor must not let

our guard down or the picture could change in a hurry. So let's turn now to the list of areas that have my heightened attention: credit quality, internal controls, the accuracy and transparency of financial information, and corporate governance.

First on my list is credit quality. On a positive note, the levels of noncurrent loans and leases and credit losses for Ohio banks compare favorably with national averages. Noncurrent loans and leases represented 1.33% of total loans and leases for Ohio banks, which compares favorably with a national average of 1.37%. In addition, Ohio banks experienced a net charge-off ratio of 0.92% of total loans and leases, compared with a national average of 0.97%. Nevertheless, measures of credit quality remain relatively weak, both here in Ohio and nationwide. Given the soft economy, some credit deterioration is to be expected. However, we've seen particular problems in credit quality in commercial and industrial loan portfolios, especially among some of the larger banking companies in Ohio. On top of that, Ohio continues to have an elevated level of personal bankruptcy filings, and the state has seen record-high levels of consumer debt. As a result of all this, continued attention is needed to manage credit risk in all loan portfolios.

Another area that deserves our heightened attention is internal controls. Our examiners have found lapses in operational procedures and internal controls that have led, at best, to inadvertent errors resulting in some loss to the financial institution or, at worst, to opportunities for fraudulent activity both inside and outside the institution. These losses could easily have been avoided with the proper checks and balances in place, adequate segregation of duties, and strong internal controls — all fundamental elements of safe and sound banking practices.

Unfortunately, these operational deficiencies have not been limited to backroom operations. They have also manifested themselves in the front office and have led to the third area requiring heightened attention, namely, the lack of financial reporting accuracy and transparency. What I mean by that is that instances of questionable reporting practices or misinterpretation of accounting standards have not been confined to notable examples in the energy and telecommunications industries. Stock analysts, institutional investors, and individual shareholders alike are subjecting the information that companies report to much greater scrutiny, and the sensitivity to errors in reporting, whether intentional or otherwise, is at its highest level. This lack of accuracy and transparency in financial reporting can quickly turn into legal problems and put a company's reputation at risk.

And now let me turn to the fourth area deserving of heightened attention, corporate governance. Although the term “corporate governance” is bandied about quite a bit, it means different things to different people. One of the best explanations I've found comes from the Basel Committee on Banking Supervision, which defines corporate governance as “the system by which businesses are directed and by which controls are implemented.” In other words, corporate governance encompasses all of the systems and processes that provide accountability and responsibility for risk management and internal controls in a banking organization. The cornerstone of effective corporate governance is an active and involved board of directors. It includes the independence of directors, the role of board committees (including the audit committee), clear corporate strategies, and a system that ensures adherence to policies and laws and regulations.

A robust, enterprise-wide, risk-management system that is appropriate for the size and complexity of the banking organization is

a critical aspect of effective corporate governance. All banking organizations, regardless of their size, need to focus on corporate governance. The failure of Oakwood Deposit Bank last year shows that even community banks can suffer when corporate governance breaks down. A strong corporate governance process is critical to maintaining the strong reputations you have worked so hard to build.

Now that I have laid out the four areas that have my heightened attention, I would like to focus on how we can work together in the future. First and foremost, I do not want you to go away from here today worrying that the Federal Reserve is going to be taking a harder line in the examination process. I want to emphasize that our standards for compliance with laws, regulations, and prudent banking practice remain the same. Our expectations of you also remain the same.

We recognize that risk is a significant component of the business you are in. Certainly, we don't expect banks to stop taking risks. What we want to do is work with you to strengthen your risk management processes to avoid or minimize repercussions to your organizations. It's our challenge to adapt our approach to examinations to help ensure that financial institutions manage their risks effectively.

The real focus of our examination process has been, and will continue to be, understanding the processes and systems you have in place to help you understand and manage your risks — and then making sure those processes are working the way you designed them. We will continue to do transaction testing to confirm the credibility and reliability of the procedures that are in place. Consistent with our own risk-focused approach to examinations, we will conduct this testing in those areas where we believe there is the greatest risk to the banking organization — generally speaking, the ones I have mentioned: credit quality, internal controls, financial reporting, and corporate governance. And where there is significant risk — or evidence that would indicate a need for a closer look-we will conduct more testing or comprehensive reviews to affirm the integrity and reliability of the processes in place.

We will also continue to evolve from single, point-in-time examinations toward a more continuous approach to supervision. We've found that this approach is mutually beneficial in that it increases the timeliness with which we can respond. In addition, it allows us to do more of the work “off site,” that is, in our offices, not yours. The shift to more “real-time” supervision has also done a lot to improve communications. You've probably noticed that when you talk to someone at the Fed, it is typically someone you know. Assigning one person to maintain contact with an institution allows relationships to develop and tends to increase openness and the two-way sharing of information.

That is how we will work with you in our supervisory role. Now I'd like to talk about how we can work with you through our outreach programs. As most of you know, through our Banker Education program, we offer seminars and workshops designed to provide bankers with timely information about current and upcoming issues affecting the banking industry. In addition to that, during the past year our examiners began traveling to banks to meet with presidents and boards of directors outside of the examination process. These meetings, which we refer to as our Tailored Director's Program, give us the opportunity to have a direct dialogue with bank leaders on issues that are particularly important to them.

I hope that you will agree that our ideas for adding value to our relationship don't happen in a vacuum. Many of our best ideas come from you. I plan to meet regularly with bankers all over the District. You will be receiving invitations to join me for meetings in

communities throughout the District. You also have our standing offer to hold your board meetings in our Bank.

Your comments and suggestions are important to me. They help us at the Federal Reserve Bank of Cleveland add value to the services we provide you. And the information you share with me about your bank and your business customers lets me add to the information I share with the members of the Federal Open Market Committee. So let's keep listening to each other — and learning from each other. Let's keep in touch. I am committed to building on the spirit of dialogue and trust we already have, in order to help ensure the ongoing strength of your institutions and continued public confidence in our nation's financial system. I look forward to serving Ohio's banking industry and I particularly look forward to working with you.