Achieving Bank Safety and Soundness:
A Central Banker's Perspective

Remarks by
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I am delighted to be here today and to have the opportunity to address this conference on "Strengthening Latin American Banking in a Global Environment". All of the sponsors of this event, the Argentine Bankers Association, the Institute of International Finance, the Inter-American Development Bank, and the World Bank, have demonstrated a genuine interest in the strength and stability of the banking sector in Latin America, and have taken constructive steps to achieve those goals.

My remarks on this important topic will, necessarily, reflect my perspective as a central banker and, specifically, as President of the Federal Reserve Bank of New York, an organization that has had very close ties with the international banking community and with Latin America. However, I should also make clear that my remarks will be based on our experience in the United States in promoting safety and soundness within the U.S. banking sector.

Of course, each country has its own history, laws and customs, and that fact shades any attempt to apply the lessons of one country more broadly. I am keenly aware of that challenge, in large part as a result of my earlier experience as a commercial banker, which brought me in close contact with bankers and institutions in this region of the world.

Nevertheless, there are several identifiable themes that are widely applicable in countries attempting to achieve greater safety and soundness in their banking system. The goal of a strong banking system is one that we all share, particularly since -- as the main theme of the conference emphasizes -- we operate in a global environment in which interdependencies exist even among seemingly disparate and geographically separate regions of the world.

Another dimension in which collaboration is required involves both the public and the private sectors. It would be disingenuous to suggest that one country's central bank acting alone, or even in concert with other countries' central banks or government agencies, could generate a strong and sound banking sector. The achievement of that goal requires effective cooperation from the private sector as well. If private banking institutions do not have the proper systems and incentives in place to manage their operations safely and soundly, it will be very difficult, if not impossible, for supervisors and regulators to do the job themselves.

Each market participant, public and private, has a role and an interest in the creation of a strong and sound banking system. In the balance of my talk, I will address those roles by posing the following questions.

1. First, what can banking institutions do internally to strengthen their own financial soundness?
2. Second, what steps can be taken by central banks and other regulatory and supervisory authorities to improve the safety and soundness of the banking sector?
3. Third, what sorts of international initiatives by central banks and other supervisory authorities are useful in order to achieve strong banking systems?

Internal Measures by Private Institutions

It is well known to all of us here today that banks are subject to many types of risks and must find ways to manage them. My experience in commercial banking has left me with the conviction that there is much that a private banking institution can and should do on its own to promote its financial soundness.

One of the most important areas of risk control for banking institutions is the setting of appropriate credit standards. These days, one hears many horror stories associated with new and exotic financial instruments. Historically, however, most of the large losses suffered by U.S. banks have been closely linked to basic credit risk -- the inability of borrowers to repay their loans.

In the aftermath of the 1990-91 credit stringency in the United States, it was not surprising -- it was even desirable -- to see some easing in credit standards. Of late, however, it appears that increased competition among lenders for middle-market and large corporate business has produced a narrowing of profit margins and some additional relaxation of credit terms. But U.S. experience has shown that easing of credit standards can be -- and often is -- overdone, and it is incumbent on lenders to guard against a significant weakening of credit standards.

I have yet to find even a single example of a bank increasing credit risk significantly and not learning yet again that the end result is a debilitating increase in credit losses.

Another important challenge faced by banks and their supervisors is to continue the development of sound risk management practices to cope with the proliferation of new instruments and practices in the financial markets. In the current environment of rapid financial innovation, merely the pricing of instruments can be quite challenging, even for the most sophisticated market participants. However, it is not enough just to be able to price these instruments. Institutions involved in these markets must be able to analyze the consequences of changes in the value of the instruments, not only in isolation, but in the context of their entire financial portfolios. Furthermore, strong internal controls must be in place to ensure that all aspects of the positions involving those instruments come to the attention of management on a timely basis.

At the New York Fed, we have long encouraged financial innovation. Innovation improves market efficiency by expanding the menu of products that serve the needs of market participants, both in financial and non-financial sectors, dealers and end-users. But with innovation comes the responsibility for each institution to engage in prudent risk management practices. Each institution's evolving risk profile must remain consistent with the goals set by its management and directors.
I would like to share with you four basic principles that our experiences show should be part of a successful risk management system.

1. First, the risk management system should be subject to active oversight by the board of directors and senior management of the financial institution. Risk management is not a purely technical enterprise, but, rather, a practice undertaken to attain the strategic goals of the institution.

2. Second, the system should incorporate state-of-the-art risk measurement and reporting systems. The information produced by these systems should be of high quality and the reports should be transparent to key individuals and groups responsible for the overall well-being of the organization.

3. Third, the system should include comprehensive internal controls that emphasize the clear separation of trading and back-office operations such as recording, clearance and settlement.

4. Fourth, the system should incorporate well-defined limits on risk-taking by individuals and corporate units at different levels, as well as oversight of those limits.

If we go back and examine some recent, well-publicized problem cases, we see clearly that in each case there was a significant failure to incorporate one or more of these principles in the design or implementation of the firm's risk management system.

Even with a comprehensive risk management program in place, though, careful attention must be paid to a banking institution's level of capital. For some time now in the United States, we have operated under a system in which regulators specify guidelines that establish minimum levels of capital for banking institutions. For the most part, these rules have responded to specific historical needs of the banking industry. They are fairly general and have been accompanied by reminders from regulators that they should be interpreted only as minimum standards. In rapidly changing environment, it is imperative that each bank be able to determine the appropriate level of capital needed to support its own particular level of risk.

Our research on capital standards has led to the adoption by the Bank for International Settlements of banks' internal models for the purpose of establishing capital requirements for market risk. Additional research currently under way is investigating how to make banking institutions even more active participants in the development of optimal capital policy for regulatory and supervisory purposes. Ultimately, given the fluid nature of financial instruments and positions that we have seen recently and can expect to see in the future, simple regulatory rules or regulatory micromanagement of firms could never be the whole solution to the risk management problem.

But, let there be no doubt that there remains a very important role for the regulation and supervision of financial institutions. We live in an imperfect world in which firms may not have the proper incentives to choose the path that is best for the system as a whole.

One such imperfection arises from the informational asymmetries in banking markets. A company that goes to the financial markets to obtain funding has much better information about its own prospects than do the possible providers of funding -- be these individual investors, institutions or banks. Banks alleviate this problem by developing close bilateral relationships with the companies to which they lend; this gives banks access to better information about their customers than would be available otherwise. Nevertheless, the potential remains for weaker companies to be the most eager to seek funding, or for companies to do things that impair their ability to repay loans.

Similarly, banks present an asymmetric information problem to the supervisors and the market in that each bank has better information about its own operations than do its supervisors or the market as a whole. This informational asymmetry, together with the control banks have over their own positions, and the presence of deposit insurance and other governmental guarantees, raises the potential for moral hazard and serious systemic problems. We saw this very clearly in the United States in connection with the crisis of the thrift sector in the 1980s. Troubled institutions, confident of the government's safety net for depositors, took excessive risks that accelerated the pace of bank failures and strained the capacity of the deposit insurance system that guarantees the safety of the public's deposits.

In our complex financial markets, how can supervisors, investors, depositors, rating agencies and other outsiders gauge the success of an institution in meeting the challenges of risk management, adherence to a capital policy, and avoidance of moral hazard? To be sure, a simple balance sheet is no longer adequate for these purposes; it must be supplemented with various types of disclosure that help measure the risk appetite of the firm, the efficacy of its risk management systems and the adequacy of its capital levels.

The Federal Reserve Bank of New York has been actively involved in research in this important and still-evolving area. Through the BIS, we participated in the preparation of the 1994 Fisher Report on disclosure, which suggested various measures for reporting risk that, by and large, have been adopted voluntarily by major U.S. banking institutions. Another report issued by the New York Fed presented additional suggestions for voluntary disclosure of risk by financial institutions.

As you know or can well imagine, the transition to the world I have been describing is not always a smooth one for managers and boards of directors, let alone for the staffs of banking institutions. The transition creates another challenge for supervisors that I term "culture issues", which arise from a hesitancy or an inability to change the corporate culture rapidly enough to keep up with the fast-moving financial environment. Many of the well-publicized problems of the recent past may be traced back to such hesitancy. Experience to date makes it clear that the active involvement of directors and senior management in monitoring the activities of a banking organization is absolutely critical to their ability to articulate and promote an effective risk management policy. Directors and senior management must be knowledgeable about the bank's businesses and products in order to define the institution's tolerance for risk and to provide leadership in its implementation.

In addition, the board and management should stress the crucial role of communication, both within the firm and with supervisors. The overwhelming experience of the industry is that the sooner a problem is addressed openly and vigorously, the better the chances of limiting its financial and reputational impact.

A final point I would like to make with regard to the role of private institutions concerns the issue of payments risk. Ever since the problems associated with the collapse of Bankhaus Herstatt in 1974, participants in the foreign exchange market have been haunted by the specter of settlement risk. I believe that many have assumed that the solution to this problem would eventually come from the central banks and the regulators.

However, research performed under the auspices of the Federal Reserve Bank of New York's Foreign Exchange Committee and expanded by the BIS Committee on Payments and Settlement Systems, which I chair, has shown that the private sector can play a major role in the solution. We have come to recognize that settlement risk depends not only on the payments system infrastructure, but also on the way market participants use this infrastructure and manage their internal processes. The detailed findings of the Committee's report will be made public in just a few days, but I think it is fair to say that there are plenty of opportunities for private sector initiatives in reducing settlement risk. The central banks, of course, are ready to work closely with the private sector in achieving this goal.

Bank Regulation and Supervisory Measures

The forces of technological change, financial globalization and market innovation -- acting together and reinforcing one another -- have transformed the financial markets in a remarkably short period of time. These forces not only have dissolved the boundaries between domestic and international financial markets, but they also have blurred the formal distinctions between commercial and investment banks, securities firms, and insurance companies. As a consequence, market competition has intensified and the range of instruments that combine transaction, investment and risk transfer characteristics has broadened.

As regulators and supervisors, we must acknowledge these market realities and participate in the development of flexible regulatory structures
that can adjust to a rapidly changing financial environment. In the United States, for instance, we have been working to eliminate certain barriers that were created mainly in the 1930s to respond to the realities of the Great Depression, but which are still in place and, lamentably, at odds with current financial conditions.

One of these restrictions, which very recently was virtually eliminated, is a prohibition against interstate banking and branching. It has been clear for some time that the forces of market change had made it impossible to sustain outdated geographical restrictions that have been a fixture of the U.S. banking system for over a half a century. The problems resulting from the restrictions on interstate banking led first to piecemeal changes in federal regulations, then to much larger changes in state laws, and, eventually, to the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which effectively ends interstate banking restrictions by 1997. The long overdue implementation of this law should increase efficiency in the delivery and distribution of financial services, while preserving the dual banking system of federal and state regulation that has served the United States so well for so long.

Structural changes in the financial system also have made it increasingly difficult to maintain restrictions on the activities of U.S. commercial banks in securities underwriting and dealing. As is the case with interstate banking, these restrictions were established in a different era, when distinctions between the core functions of commercial banking and underwriting of securities were much easier to define and identify. With the blurring of the boundary between commercial banking and investment banking in modern financial markets, these outdated statutory restrictions result in higher costs and lower quality of services for everyone involved. The removal of these restrictions not only would improve the choices available to consumers of financial services, but also would permit banks to compete more effectively in the evolving global financial marketplace.

The importance of rational and flexible regulatory structures cannot be underestimated. Nevertheless, even the best regulations could be ineffectual in the absence of strong, informed supervision. Management and directors of banking organizations must assume responsibility for the design and implementation of adequate internal controls. Even if they do, however, a rigorous supervisory presence is needed to ensure that these organizations keep their end of the bargain.

In our global environment, bank supervision must approach institutions on a comprehensive, consolidated basis. This view may not yet be the norm worldwide, but I am convinced that it is the best way to preserve the integrity of financial markets around the world and therefore is in the interest of all banks. Independent units operating within banking institutions must be made accountable to the appropriate supervisory authority.

By way of summary, it is worthwhile to list the key lessons we have learned from our supervisory experience in the United States. They are:

- First, a sound and efficient financial system requires a rational regulatory structure supplemented by strong comprehensive, consolidated supervision.
- Second, the regulatory and supervisory environment must provide the right incentives for firms to manage risk properly. Capital adequacy policy and disclosure are helpful tools for these purposes.
- Third, supervisors must be ready to intervene promptly to deal with problem cases. This need for supervision is even more crucial when financial markets are liberalized or other changes in the regulatory structure take place.

**International Cooperation Among Supervisory Authorities**

Although the history of regulation in the United States is generally positive, it is clear that the global financial system works most safely and efficiently when national regulatory and supervisory authorities engage in a cross-border dialogue and coordinate their activities. International collaboration, in turn, works best when the regulatory structure of each country has been designed with full recognition of the extensive international relationships in the financial markets today. Much has been accomplished in this regard within the banking sector over the last two decades, and I would like to focus on some of the primary achievements.

In the United States, we have taken several important regulatory steps in the last few years to implement the concept of national treatment of banking institutions, which is a cornerstone of international cooperation. National treatment accords foreign banking organizations the same access to our markets for financial services that domestic organizations enjoy. This is not only an issue of fairness, but an issue of maintaining competitive and efficient markets in which participants can be confident of obtaining high-quality services at the lowest possible cost.

In the United States, national treatment in banking had been approached for some time through bilateral treaties; more recently, it has been written into banking law. For example, national treatment was embodied in the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which brought the regulatory and supervisory structures applied to foreign institutions in line with those for domestic U.S. banks. These measures were enacted in conjunction with a more thorough review of U.S. regulation that was accomplished through the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

With these measures in place, U.S. authorities have been on firm ground to approach international agreements on supervisory issues. For example, in 1992, the Basle Committee on Banking Supervision issued a statement on minimum supervisory standards, which strongly endorsed comprehensive consolidated supervision of banks worldwide. The approach to the supervision of internationally active banks, contained in the two legislative measures from 1991 (FBSEA and FDICIA) and in the subsequent related regulation, facilitated our full compliance with the tenets of the BIS minimum standards.

Perhaps a more visible achievement of international supervisory cooperation was the Basle Accord on bank capital. In 1988, the Basle Committee issued an international agreement on capital standards that helped to level the playing field for internationally active banks. The agreement was reached by central banks in G-10 countries, but since 1988, the basic provisions of the Accord have been adopted by many central banks and regulatory authorities in non-G-10 countries as well, including Argentina. The Accord stressed the primary importance of capital for the financial strength of banking institutions, but was careful to point out that capital is only one of a number of factors to be considered when assessing the strength of banks.

I would also like to mention two recent developments related to the Capital Accord. First, starting in 1993, the Basle Committee issued amendments to the Accord that encourage market participants to take advantage of the risk-reducing effects of legally valid bilateral netting agreements. These contracts allow firms to focus on the overall net value of instruments covered by the agreements when determining their legal obligations. In most cases, the net obligations are significantly smaller than the gross and the potential for credit risk is correspondingly reduced.

The second recent development was the approval in December 1995 of amendments that introduce capital requirements to cover the market risk of banks. An important innovation in these requirements is the possibility for banks to use the internal models that they themselves have developed to measure market risk.

The G-10 central banks and the BIS also have been quite active in international initiatives to promote safety and soundness in the area of payments systems. A number of reports issued over the last seven years have deepened our understanding and contributed to improvement in international payments systems. Prominent among these reports are the 1990 report on interbank netting schemes (Lamfalussy Report), the 1993 report on cross-border multi-currency transactions (Noeuml Report), and the 1995 report on cross-border securities settlement. And, as I mentioned, the G-10 Committee on Payments and Settlement Systems will soon issue its report on settlement risk in the foreign exchange markets. These reports demonstrate powerfully the benefits to all countries that derive from successful international cooperation.
I think we can look with some satisfaction at these efforts on behalf of safety and soundness in banking and payments systems. But satisfaction must not mean complacency. In the quickly-moving environment that we face today, complacency would be a sure formula for future failure. We constantly face new problems and the only way to manage them is to move decisively and to think ahead.

**Conclusion**

For Latin America, the task of developing a stronger banking sector is clearly multi-dimensional. A strong system of regulation and supervision at the national level is certainly a requirement, but it is also just a beginning. The economies of Latin America are closely linked with those of North America, Europe and Asia, on which they rely as trading partners and sources of external finance. Financial and economic developments in those other regions are sure to be felt directly or indirectly by major sectors of Latin American economies.

As in many countries, including mine, there is an issue of coordination between the public and private sectors. The private sector must generate output, incomes, and jobs while promoting the efficient allocation of scarce financial resources. The public sector, in turn, must create an infrastructure that promotes the well-being of businesses and workers, and, through emphasis on safety and soundness in the financial sector, assures that economic and financial progress is not merely a short-term phenomenon.

In the United States we have struggled for most of the 20th century to maintain a safe and efficient banking sector, and our work is never done. I hope that the examples I have offered today about some specific issues we face may prove to be helpful as you strive to improve safety and soundness within your own banking systems. All of us, regardless of geography or sector of the economy, have an important stake in this endeavor.

Thank you.