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Remarks by

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It is a pleasure to be here to discuss with you the new world that bankers and supervisors face in the wake of financial reform and continuing technological and financial innovation. Today we are in the midst of the U.S. economy's longest running expansion. Moreover, the American banking industry has just set its eighth consecutive year of record earnings, exhibiting substantial resilience and strength in rebounding from the troubles of the late 1980s and early 1990s. In the course of the banking rebound and escalating industry consolidation, concerns arose that both community banks and the dual banking system in this country would be noncompetitive. You and thousands of other community bankers have shown that such notions were erroneous.

Indeed, in true entrepreneurial spirit, community banks have used opportunities provided by the mergers of the past decade to their advantage in attracting customers that are either ill-served or ignored by larger, less responsive banks. Community banks have also responded well to technological challenges. Despite false warnings and recommendations by some that depositors should move their money to larger "sophisticated" banks, your communities continued to give you their trust. With hardly an exception, community banks made a smooth transition through the century date change, not to mention the leap year.

But with the Y2K threat a fading memory and business conditions strong, what are the next challenges? Today I would like to provide a brief overview of what I think are the key challenges, risks, and opportunities faced by community bankers and their supervisors.

To start, I would be remiss as a central banker and bank regulator if I did not first point out some of the risks that still are lurking. Despite the vibrant economy and exceptional banking conditions, we have seen how instances of lax standards, excesses, or fraud can cause disproportionate losses to the insurance funds. While their high cost may be considered exceptional, these recent failures perhaps offer broader lessons. In particular, banks and supervisors need to be continuously vigilant about traditional causes of bank failure such as fraud, credit concentrations, and rapid entry into new and unfamiliar activities. History has shown that entry into new business lines without the experience, tools, and controls to do the job right most often leads to losses and sometimes failure.

Besides these risks, a broader and more troubling trend is that many banking institutions view current strong economic conditions as no longer extraordinary and exceptional but rather as ordinary and expected. Lending granted on that basis could have grave consequences for the industry's ability to weather weaker economic conditions. We have seen growing evidence of credit granted solely on the expectation that current robust conditions will continue indefinitely, with little thought as to how borrowers might perform under more stressful conditions. As experienced lenders know all too well, most bad loans are made in the good times; lenders that are not attentive to this vulnerability are unlikely to survive in this business.

Maintaining strong asset quality, of course, is only one of the many challenges that community banks face. The marked rise in equity values and mutual funds has put competitive pressure on your core deposit base. As these lower-cost funds have been replaced with funding from the Federal Home Loan Banks and capital markets, pressures

on interest margins and liquidity have intensified. Such funding shifts raise the important risk-management questions of how well the institution will function under stressful conditions and whether enough has been done to maintain adequate liquidity. The decline in stable core deposits has also been coupled with a steady rise in average asset maturities. This pattern indicates a growing exposure to rising interest rates, and our surveillance screens suggest that this is indeed the case.

Other challenges include maintaining adequate pricing amid fierce competition from other banks and from nonbanks. Some organizations are responding to these pressures by moving lower on the credit-quality spectrum in a reach for higher nominal yields. Too many lenders learn too late the difference between nominal and risk-adjusted yields, experiencing calamitous losses and sometimes failure as a consequence. Some institutions are also beginning to recognize that to be done right, nontraditional lending programs may have hidden costs in the form of higher overhead and increased management attention.

As competitive pressures have intensified, community banks have used a variety of tools to maintain a competitive edge. In the past, of course, you have successfully forged cooperative alliances with technology, insurance, brokerage, and other firms that have allowed you to provide your customers with the diversity of financial tools and products they demand. A major advantage of that approach is the ability to avoid the inconvenience and fixed costs associated with independently acquiring or developing these products and delivery channels.

With those past strategies for product diversification largely implemented successfully, what are the new opportunities offered banks of all sizes with the Gramm-

Leach-Bliley Act? The act provides a long-overdue modernization of our banking laws and makes them more consistent with marketplace realities and the needs of consumers. Now the financial services industry must decide to what extent and in what fashion it will take advantage of the final crumbling of the walls between banking, insurance, and securities to build value for both shareholders and customers.

Clearly, many franchises will succeed by continuing to focus on traditional banking. The decision to change that formula by expanding into new activities should not be taken lightly. Some of the new technologies are beguiling, but we should not lose sight of the exceptional economic value of franchises based on old-fashioned, face-to-face interpersonal banking. The newer technologies may be awesome but human nature does not change--we still appreciate a face across the desk more than a computer screen.

Although some perceive that new powers available through the Gramm-Leach-Bliley Act fall exclusively in the domain of large bank holding companies, such opportunities are available to community-based organizations as well. Indeed, more than two-thirds of the applications to form financial holding companies have come from companies with total assets of less than $1 billion.

That said, it is one thing to gain financial holding company status and begin cautiously experimenting with these new powers and quite another to jump into the deep end of the pool with full-scale acquisitions or extremely rapid growth of new businesses. Personally, I am encouraged that there has not been a tidal wave of public announcements--from large banks or small--declaring rapid and large-scale affiliations among banking, brokerage, and securities firms. In the past, some criticism was leveled against the industry for announcing mega deals out of peer pressure rather than for the

convincing economics of the transaction. I would like to believe that the disappointing post-acquisition results of some firms have taught them to think more strategically today, and to carefully weigh the pros and cons of such affiliations--including whether and how the economics make sense. Deciding how to translate the traditional and new financial powers into longer-term economic value for your customers and shareholders will be the leading challenge as we enter the twenty-first century.

This new environment poses significant challenges to supervisors as well, as they work to appropriately calibrate their supervisory programs to the challenges of both innovations in traditional banking and new activities permitted by the act. By the early 1990s, it had become clear that the traditional approach to examinations with a one-size-fits-all approach was not as effective as it could be and, in some cases, was also needlessly burdensome. In advancing to a more risk-focused approach, we made the decision to distinguish between larger, more complex banking organizations on the one hand and the more traditional regional and community organizations on the other. The large complex companies are receiving a more continuous level of oversight given the rapidly shifting risk profiles that can result from their operations, while well-capitalized and well-managed regional and community organizations receive a greater degree of off-site monitoring and less-frequent on-site visitations, consistent with statutory mandates. Of course, both approaches are flexible, and the process is really a continuum, with the supervision of some of our medium-sized institutions blending the two programs.

The feedback we have received from our state member banks suggests that this approach is working well. Examiners are preparing more analysis in advance and off-site from the bank, ensuring that your conference rooms are filled with your staff or directors

--not our examiners. Further, through better preparation and organization, we have sought to make our reviews better tailored to the issues confronting your individual organizations, resulting, we hope, in a more effective and less burdensome process.

Striking the right balance, however, between analyzing an institution's risk profile and management control process, on the one hand, and performing tests to ensure that the risk-management process is actually working, on the other, has been difficult. Recent incidences of fraud have underscored that point. That difficulty does not mean that every institution we walk into should receive exhaustive transaction testing and reconciliation of the general ledger--that would obviously be needlessly burdensome and unproductive. Rather, supervisors must become even better attuned to early warning signals or red flags that suggest that management information may be unreliable and that more in-depth transaction testing and independent verification should be undertaken. Getting that balance right ultimately benefits the insurance fund, the banking system, and consumers.

Our bifurcated supervisory approach between larger or more complex organizations and regional and community banks extends beyond safety and soundness to compliance and the Community Reinvestment Act. As you are aware, a differentiated approach has been ongoing since 1995 for banks with less than $250 million in assets, when the CRA review process was significantly modified to look at less burdensome, commonsense indicators of an institution's community lending record. The feedback we have received about this change has been highly positive. The passage of the Gramm-Leach-Bliley Act takes the change one step further for small banks, extending the interval between CRA examinations to sixty months for institutions with outstanding ratings and forty-eight months for institutions with satisfactory ratings. We are working now to deal

with the logistical issues for implementing that mandate but have already begun to extend CRA examination cycles.

One of those logistical issues involves how best to continue to meet the mandates of the compliance portion of our examinations, covering for example truth-in-lending, in light of the extended CRA examination interval. Our compliance examination program is intended to ensure that the essential consumer protections provided by the laws we enforce are realized as efficiently, and in the least burdensome manner, as possible. The change in the interval between CRA examinations, for some, may engender new approaches to the nature and frequency of compliance examinations, and we have been talking with the other agencies about how they are dealing with this issue.

Another facet we are considering in our dual supervisory approach is that of capital. As you may be aware, a number of initiatives are under way under the auspices of the Basel Committee on Banking Supervision and Regulation to refine and improve the risk-based capital measure. The consultative paper issued last summer hints at several ways to make the framework more sensitive to the underlying risk of various banking activities. At present, research and discussions suggest a revised framework that is geared toward the volume, complexity, and risk-management systems of the largest internationally active banks. Although the costs to institutions of implementing such a complicated framework might be justified and, indeed, appropriate for the largest banks, fully extending such a paradigm to community banks may be both impractical and unnecessary.

I'm sure many of you already view the current risk-based capital framework as unwieldy and see further complexity as unwelcome. I should point out that in

implementing the Basel Capital Accord in 1989, federal regulators extended that framework to all banks, even though technically the accord is directed toward only internationally active banks. Although many other countries have since taken the same course, it is far less clear we will do that with the next version of the risk-based capital standards. Indeed, I would think we would not.

The potential incongruity between the breadth and complexity of the next version of the capital accord and the more limited needs of smaller, more traditional domestic banks has spurred discussions with regard to implementing a second, more basic or streamlined capital adequacy standard. I should caution that these discussions are still only very preliminary, but just as we have taken a bifurcated approach to the way we supervise institutions, we should also be open to considering a bifurcated approach to capital adequacy standards as well.

As we think about differentiated approaches to supervision and capital standards, we must be cautious in basing our programs on a single factor; asset size, for example, is obviously not necessarily correlated with complexity or risk. Experience has shown that small banks can engage in relatively complex activities that raise many of the thorny issues facing the country's largest banks. The investment of many smaller institutions in so-called structured note products in the mid-1990s comes to mind as does the more recent emergence of smaller firms involved in securitizations and substantial investments in residual interest-only strips. Regardless of size, institutions engaged in these kinds of activities must, of course, invest in a risk-management infrastructure, management talent, and risk-measurement technology commensurate with the complexity and risk of those kinds of activities.

Today, in the spirit of the risk-focused approach to supervision, community banks with complex issues are singled out on an exception basis and specialists devoted to our large complex banking organizations are sometimes called in to examine their more challenging or complex activities. Clearly, with the emergence of smaller financial holding companies and the expanded range of permissible activities, our two broad supervisory programs will likely need further customization or segmentation to respond to the evolving diversity of our supervisory caseload.

Regulatory reporting will play an important role in ensuring that we retain the ability to customize our supervisory approach to the activities and risks undertaken by individual institutions. I know the Call Report is not the most popular topic among community banks, but it does have the potential for reducing burden by answering questions before on-site examinations. It can also help the agencies ensure that those picked for an examination team include specialists in the activities that you may be involved in, reducing your burden in bringing examiners up to speed on the nature of those business lines.

I think you will be happy to hear that the first round of efforts to revise and modernize the Call Report involves the elimination of many items that are less useful in today's environment. However, additional items are being considered to reflect the kinds of activities that banks are increasingly undertaking today, such as securitizations and venture capital. As most banks are not engaging in these specialized activities, the addition of those items should pose little burden or cost to the majority of institutions. But that reporting will have a significant benefit to bankers and to supervisors by improving our off-site monitoring and the tailoring of the supervisory program.

In closing then, the performance and strength of the U.S. economy and banking system over the past decade have been exceptional. How well the banking system performs in the coming decade will depend in large part on how well it navigates the rapids of technological and regulatory change. Although the advent of broader financial powers provides unprecedented opportunities to banks of all sizes today, it also poses significant risks, especially for those unwilling to take the time to understand sound practices and build the infrastructure necessary to succeed. I am confident, as we enter a new century, that community banks will show they are up to the task and will remain a vital part of their local communities and our financial system.