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Remarks by

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It is a pleasure to discuss with you the evolving challenges for bankers and supervisors posed by financial reform and continuing technological and financial innovation. Today the nation is enjoying the longest-running economic expansion in its history. The expansion has not only been unprecedented in its duration, but also in its strength. Clearly the rapid technological innovation of the past decade has played a strong role in the expansion's endurance by improving labor productivity and opportunities for businesses to efficiently expand their output of goods and services. Economic growth has also been supported by the strength and stability of our banking system, which recently recorded its eighth consecutive year of record earnings. The agility with which our banking system recovered from the severe difficulties of the late 1980s and early 1990s to fulfill a critical intermediary role is a testament to its resilience. However, as our economy continues to evolve rapidly, banking organizations will need to continue to adapt to the changing needs of businesses and consumers. In particular, with the passage of the Gramm-Leach-Bliley Act, our financial services industry will be better able to meet those demands in the decades to come through prudent innovation.

As an example of innovation and adaptation, I note that your own organization is widening its scope to invite membership from the entire financial services industry. Broadening your reach to include insurance, brokerage, and other financial services not only reflects market realities but should also assist in your endeavors to improve the economic development of underserved communities and promote the professional growth of your members.

While innovations and adaptations in our economy have helped create and prolong the prosperity we are now enjoying, they also bring to bear new challenges. Today I would like to provide a brief overview of what I think are the key challenges, risks, and opportunities faced by bankers and their supervisors.

To start, I would like to shift your attention from the vibrant economy and exceptional banking conditions to some of the risks that are always present. For example, the lax standards, excesses, and fraud present in the recent few recent bank failures show that even as most banks post record profits, the deposit insurance fund can still experience disproportionate losses from undisciplined institutions. The high cost of recent failures reinforces lessons of the past for banks and supervisors, including the need for continuous vigilance against causes of bank failure such as fraud, credit concentrations, and rapid entry into new and unfamiliar activities.

In addition to these risks, institutions face the challenge of fighting both complacency and competitive pressures with regard to their lending practices. There are some recent indications that the industry is aware of these challenges. The most recent Federal Reserve Senior Loan Officer Opinion Survey suggests that banking organizations are becoming more sensitized to risk and are continuing to firm their lending practices. In particular, the percentage of domestic banks tightening standards on commercial and industrial (C&I) loans was the largest since the November 1998 survey. In addition, risk premiums on C&I loans have also risen. While firming loan standards and terms is one technique for managing credit risk, sound risk-management systems also involve testing the performance of borrowers under more stressful conditions to reveal weaknesses. When strong conditions largely mask the susceptibility of marginal borrowers, stress

testing is invaluable for revealing the magnitude of portfolio risk posed by more challenging economic conditions.

Other factors that are important for strong asset quality include maintaining adequate pricing amidst fierce competition from other banks and nonbanks alike. Some organizations are responding to these pressures by moving lower on the credit quality spectrum in a reach for higher nominal yields. In a special question added to the latest lending survey, banks indicated that demand for C&I loans has somewhat strengthened as below-investment-grade borrowers have found unfavorable conditions in the high-yield bond market and have turned to banks as an alternative. The majority of banks reporting additional demand from these borrowers also indicated that they were fairly receptive to these customers. While lending to higher-risk borrowers presents opportunities, banks must ensure that their risk-management systems can properly discern the difference between nominal and risk-adjusted yields, identify credit concentrations, and allocate enough capital and reserves to offset the higher risk of these loans. Banks without these safeguards, as well as limits and adequate tracking and reporting to senior management and their boards, have in the past experienced significant problems and sometimes failure.

Credit quality issues are not the only areas of supervisory focus. The trend of narrowing interest margins at many banks has been coupled with lengthening asset maturities and declining core deposits. The erosion in bank core deposits is to some extent attributable to competitive pressure from the marked rise in equity values and mutual funds. In addition, as runoff of lower-cost deposits has been replaced with higher-cost funding from capital markets, pressures on interest margins and liquidity have

intensified. Moreover, the decline in stable core deposits and the steady rise in average asset maturities has resulted in higher levels of interest rate risk, a trend evident in our surveillance screens. Banking organizations with strong risk management systems will of course carefully evaluate how these asset/liability trends are affecting their performance and risk profile and take mitigating steps as appropriate.

As competitive pressures have intensified, large and small banks alike have sought solutions by broadening the variety of products they offer and delivering them through innovative delivery channels such as the Internet. Interestingly, though conventional wisdom would suggest that smaller community banks would be at a disadvantage in the competitive financial services arena, this has not been the case. By forging cooperative alliances with technology, insurance, brokerage and other firms, community banks have kept up with larger organizations in providing their customers with the diversity of financial tools and products they demand without the attendant fixed start-up costs. Moreover, while larger organizations may have some advantage over smaller banks through their brand identity and larger budgets for technology and marketing, community banks are more likely to have a comparative advantage in understanding the diverse needs of their customer base and in their ability to respond quickly with personalized service.

More fully recognizing and responding to customer needs is particularly important when viewed in the context of trends in wealth formation in our economy. The Federal Reserve's most recent Survey of Consumer Finances suggests that although the current economic expansion resulted in broad gains in median household wealth between 1995 and 1998, families with low-to-moderate incomes and minorities do not

appear to have fully benefited. For example, median net worth declined over this period for families with incomes below $25,000, and medians for non-whites and Hispanics were little changed. In addition, lower-income families were less likely to own homes, which constitute the bulk of the value of assets for those below the top quintile according to income. Despite these troubling indications, there were some encouraging signs. In particular, the share of families with incomes below $25,000 fell from 41 percent in 1995 to 37 percent in 1998, and more families within that lower-income group reported that they had a checking account. Moreover, homeownership rates among minorities have risen. For example, according to U.S. Census data, homeownership rates among blacks rose from 43 percent in 1995 to 48 percent in the first quarter of 2000, suggesting that some progress has been made in access to credit for minorities.

Although breaking down the barriers that have produced disparities in income and wealth is not simple, promoting equal access to credit for sound borrowers is one step in the right direction. As I have said previously, discrimination is against the interests of business--yet business people too often practice it. To the extent that market participants discriminate, they erect barriers to the free flow of capital and labor to their most profitable employment, and the distribution of output is distorted. In the end, costs are higher, less real output is produced, and national wealth accumulation is slowed. By removing the non-economic distortions that arise as a result of discrimination, we can generate higher returns to both human and physical capital. Banking and other lending organizations that develop expertise to tap, educate, and encourage underserved customers are likely to provide better and more informed access to credit and expand profit opportunities. In that regard, many banks are well equipped to tailor their services

to individual customer circumstances in a personalized setting and to educate customers about various products and services that could help them achieve their financial goals.

In today's more complex world, the diversity of financial product choices facing consumers is truly astonishing. Similarly, banks are now also facing much broader choices, especially when one considers the opportunities presented by the passage of the Gramm-Leach-Bliley Act. By modernizing our banking laws and making them more consistent with marketplace realities and the needs of consumers, the financial services industry will be able to grow and innovate with far fewer artificial constraints. How various financial service providers choose to take advantage of the act will be one of the more interesting dynamics as our financial system evolves in the years ahead.

Clearly, many franchises can succeed by continuing to focus on traditional banking. Organizations that decide to depart from past successful strategies by expanding into new activities should do so only after careful consideration. As of mid-May, 270 domestic banking organizations and 17 foreign banking organizations had filed to become financial holding companies. Of those, roughly three-quarters had less than one billion dollars in assets. I suspect that many of these organizations are not intending to immediately launch into full-scale brokerage, venture capital, or insurance activities, but rather are looking to keep their options open and retain flexibility should opportunities present themselves.

If true, that is encouraging, for it is one thing to gain FHC status and begin cautiously experimenting with these new powers, and quite another to take on the risks related to full-scale acquisitions or extremely rapid growth of new businesses. Whichever configuration financial firms choose, translating the traditional and new

financial powers into longer-term economic value for customers and shareholders will be the leading challenge in the coming decades.

In this changing environment, supervisors will be challenged to adapt and refine their programs to accommodate both innovations in traditional banking and new activities permitted by the act. The supervisory strategy for addressing banking innovations of the past decade has been a risk-focused approach that moves well beyond earlier, one-size-fits-all examinations to achieve what we believe is a more effective and less burdensome process. The risk-focused approach has also been tailored 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. I should emphasize that these programs are not meant to be implemented in a rigid fashion; institutions that have characteristics that fall somewhere in the middle of the two programs would be flexibly accommodated through adjustments to our supervisory plan for the institution. That kind of flexibility will be essential with the emergence of smaller financial holding companies and the expanded range of permissible activities. Clearly, these two broad supervisory programs will need further customization or segmentation to respond to the evolving diversity of our supervisory caseload.

Another area where supervisors are attempting to more appropriately align risks with regulatory approaches is capital. You may be aware that the Basel Committee on

Banking Supervision and Regulation is working to refine and improve the risk-based capital measure to make it more sensitive to the underlying risks of various banking activities. As you might surmise, those efforts are likely to result in a revised framework that is geared toward the kinds of exposures and risk-management systems typical of internationally active institutions. For these organizations, the benefits from more precisely aligning risks with capital charges, we trust, will outweigh the substantial costs of added complexity. However, for community banks with traditional exposures, the costs of such a complicated framework will likely outweigh any benefits, and hence it will be impractical to implement.

This has led to the consideration of a dual or bifurcated approach to capital that parallels our approach to supervision. Such an approach would recognize the potential tension between the complexity and cost of the next version of the international capital standards and the more limited needs of smaller, more traditional banks. Implementing a second, more streamlined capital adequacy standard for qualifying domestic institutions would seem to have merit. Discussions on such an approach are only preliminary, but the arguments for continuing to more fully calibrate our supervisory and regulatory approaches to the nature and risk profiles of the institutions we supervise are compelling.

Capital standards and the supervisory process are two of the three key tools regulators use to get their job done. The third tool, disclosure, holds promise for yielding benefits to our financial system both domestically and globally. In past decades, the business of banking was fairly opaque but straightforward, with banking risks largely embedded in the credit judgments inherent in the loan portfolio. Today, with the explosion in financial innovation that has created various derivative, securitization,

insurance, and other structured products and the greater diversity in activities permitted by the Gramm-Leach-Bliley Act, not only are risks more opaque, but even when revealed, sometimes difficult to interpret.

Fortunately, the same technology and financial techniques that have created this added complexity can also be harnessed to produce more meaningful disclosures that allow markets to analyze risks and exert discipline on those that would take on imprudent levels of exposure. While not a panacea, improved disclosure can complement the supervisory process and regulatory capital, and obviate more intrusive investigations, holding out the promise of less supervisory intervention. Recently, the Federal Reserve, in collaboration with the Securities and Exchange Commission and the Office of the Comptroller of the Currency, established a private-sector working group to review industry best practices and develop options for improving the public disclosure of financial information by large, complex banking and securities organizations. Enhanced disclosures are also being pursued through regulatory reporting. A proposal to be released shortly will eliminate less meaningful items on the Call Report and request additional information on activities of growing significance for some institutions, including loan servicing, securitizations, venture capital, and insurance. More relevant regulatory disclosures should not only improve transparency but should also help our off-site monitoring and tailoring of our supervisory program.

In closing then, we live in a fascinating period in American history, in which rapid change will force business and government to continuously reevaluate previously held assumptions and adapt to change. There is no static, optimum model either for financial service providers or for financial regulators, as both are engaged in a

continuously evolving process. I am optimistic that recent financial reforms and continuing innovations will translate into more useful financial products and services to a broader spectrum of consumers and businesses and, in turn, fuller participation by all segments of our society in the kind of economic progress we have experienced to date.