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Statement of

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

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Mr. Chairman and members of the Committee, I am pleased to be here this morning to discuss the condition of the U.S. banking system. In my presentation today, I would like to raise just a few issues. I have attached an appendix in which the Federal Reserve Board staff provides far more detail relevant to the purpose of these hearings.

There are, I believe, two salient points to be made about the current state of the banking system. First, many of the traditional quantitative and qualitative indicators suggest that bank asset quality is deteriorating and that supervisors therefore need to be more sensitive to problems at individual banks, both currently and in the months ahead. Some of the credits that were made in earlier periods of optimism--especially syndicated loans--are now under pressure and scrutiny. The softening economy and/or special circumstances have especially affected borrowers in the retail, manufacturing, health care, and telecommunications industries. California utilities, as you know, have also been under particular pressure. All of these, and no doubt other problem areas that are not now foreseeable, require that both bank management and supervisors remain particularly alert to developments.

Second, we are fortunate that our banking system entered this period of weak economic performance in a strong position. After rebuilding capital and liquidity in the early 1990s, followed by several years of post-World War II record profits and very strong loan growth, our banks now have prudent capital and reserve positions. In addition, asset quality was quite good by historical standards before the deterioration began. Moreover, in the last decade, as I will discuss more fully in a moment, banks have improved their risk management and control systems, which we believe may have both strengthened the resultant asset quality and shortened banks' response time to changing economic events. This potential for an improved reaction to

cyclical weakness, and better risk management, is being tested by the events of recent quarters and may well be tested further in coming quarters.

We can generalize from these recent events to understand a bit better some relevant patterns in banking, patterns that appear to be changing for the better. The recent weakening in loan quality bears some characteristics typical of traditional relationships of loans to the business cycle--the pro-cyclicality of bank lending practices. The rapid increase in loans, though typical of a normal expansion of the economy, was unusual in that it was associated with more than a decade of uninterrupted economic growth.

As our economy expanded, business and household financing needs increased and projections of future outcomes turned increasingly optimistic. In such a context, the loan officers whose experience counsels that the vast majority of bad loans are made in the latter stages of a business expansion, have had the choice of (1) restraining lending, and presumably losing market share or (2) hoping for repayment of new loans before conditions turn adverse. Given the limited ability to foresee turning points, the competitive pressures led, as has usually been the case, to a deterioration of underlying loan quality as the peak in the economy approached.

Supervisors have had comparable problems. In a rising economy buffeted by competitive banking markets, it is difficult to evaluate the embedded risks in new loans or to be sure that adequate capital is being held. Even if correctly diagnosed, making that supervisory case to bank management can be difficult because, regrettably, incentives for loan officers and managers traditionally have rewarded loan growth, market share, and the profits that derive from booking interest income with, in retrospect, inadequate provisions for possible default. Moreover, credit-risk specialists at banks historically have had difficulty making their case about risk

because of their inability to measure and quantify it. At the same time, with debt service current and market risk premiums cyclically low, coupled with the same inability to quantify and measure risk, supervisory criticisms of standards traditionally have been difficult to justify.

When the economy begins to slow and the quality of some booked loans deteriorates, as in the current cycle, loan standards belatedly tighten. New loan applications that earlier would have been judged creditworthy, especially since the applications are now being based on a more cautious economic outlook, are nonetheless rejected, when in retrospect it will doubtless be those loans that would have been the most profitable to the bank.

Such policies are demonstrably not in the best interests of banks' shareholders or the economy. They lead to an unnecessary degree of cyclical volatility in earnings and, as such, to a reduced long-term capitalized value of the bank. More importantly, such policies contribute to increased economic instability.

The last few years have had some of the traditional characteristics I have just described: the substantial easing of terms as the economy improved, the rapid expansion of the loan book, the deterioration of loan quality as the economy slowed, and the cumulative tightening of loan standards.

But this interval has had some interesting characteristics not observed in earlier expansions. First, in the mid-1990s, examiners began to focus on banks' risk-management systems and processes; at the same time, supervisors' observations about softening loan standards came both unusually early in the expansion and were taken more seriously than had often been the case. The turmoil in financial markets in 1998, associated with both the East Asian crisis and the Russian default, also focused bankers' attention on loan quality during the continued

expansion in this country. And there was a further induced tightening of standards last year in response to early indications of deteriorating loan quality, months before aggregate growth slowed.

All of this might have been the result of idiosyncratic events from which generalizations should not be made. Perhaps. But at the same time another, more profound development of critical importance had begun: the creation at the larger, more sophisticated banks of an operational loan process with a more or less formal procedure for recognizing, pricing, and managing risk. In these emerging systems, loans are classified by risk, internal profit centers are charged for equity allocations by risk category, and risk adjustments are explicitly made.

In short, the formal measurement and quantification of risk has begun to occur and to be integrated into the loan-making process. This is a sea change--or at least the beginning of one. Formal risk-management systems are designed to reduce the potential for the unintended acceptance of risk and hence should reduce the pro-cyclical behavior that has characterized banking history. But, again, the process has just begun.

The federal banking agencies are trying to generalize and institutionalize this process in the current efforts to reform the Basel Capital Accord. When operational, near the middle of this decade, the revised accord, Basel II, promises to promote not only better risk management over a wider group of banks but also less-intrusive supervision once the risk-management system is validated. It also promises less variability in loan policies over the cycle because of both bank and supervisory focus on formal techniques for managing risk.

In recent years, we have incorporated innovative ideas and accommodated significant change in banking and supervision. Institutions have more ways than ever to compete in

providing financial services. Financial innovation has improved the measurement and management of risk and holds substantial promise for much greater gains ahead.

Building on bank practice, we are in the process of improving both lending and supervisory policies that we trust will foster better risk management; but these policies could also reduce the pro-cyclical pattern of easing and tightening of bank lending and accordingly increase bank shareholder values and economic stability. It is not an easy road, but it seems that we are well along it.

Appendix

Condition of the Banking Industry

Prepared by:
Staff, Board of Governors of the Federal Reserve System

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The U.S. banking industry is well capitalized and highly profitable by historical standards and in reasonably good shape, although there are signs of erosion as problem loans have risen, especially in larger syndicated credits. Moreover, some further erosion is likely as borrowers who have taken on heavy debt burdens experience less robust increases in profits and income than might have been anticipated not too long ago. In many cases, problem loans are a hangover from loans made in the mid-1990s when lenders evidently failed to exercise sufficient discipline. After about 1998, banks took a number of steps to tighten lending standards and terms, which should help to limit further deterioration. Nevertheless, with a weakening economy, problems could well worsen for some banks and some market segments, requiring vigilance by banks and their regulators. As always, the underlying issue is how to adopt and price realistic assessments of likely credit risks under alternative scenarios, keeping credit flowing to worthy borrowers at reasonable prices.

Today, banking organizations and their supervisors are taking a number of steps that will be necessary to ensure that our financial system continues to flourish and support long-term economic growth well into the future. Key elements of such actions are referenced in the last two sections of this appendix.

Earnings

Although banking profitability has risen to historically high levels in terms of return on assets and return on equity over the past decade, in recent periods higher loan loss provision expenses and narrowing net interest margins have placed pressures on bank profitability. Despite those emerging weaknesses, downside risks likely have been

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limited by the increasing diversity of noninterest and interest sources of revenues. The continued push by banks to diversify their revenues by expanding business lines devoted to asset management, servicing, securitization, investment banking, and other fee-based activities should help stabilize earnings streams. In addition, in the wake of consolidation and interstate banking, many larger firms are less vulnerable to downturns in particular regions or specialized business lines.

Nonetheless, in the past few quarters, emerging earnings weaknesses have been pronounced at some of the larger banking organizations, which have experienced sharp increases in loan loss provision expenses, narrowing interest margins, and significant declines in venture capital revenues. During the first quarter of this year, those negative developments at large firms were somewhat offset by record trading profits and better overhead cost efficiency. While the net effect was a decline in profits at many larger banking organizations, the underlying strength in the profitability of regional and community banks, coupled with nonrecurring securities gains, helped the industry as a whole achieve record first quarter earnings of nearly $20 billion.

Asset Quality

The rise in nonperforming assets at banking organizations has been pronounced over the past year, especially at larger banking organizations. Despite that rise, these problems generally remain moderate in historical terms relative to earnings, assets and capital. Assets classified as substandard, doubtful or loss have also risen rapidly in recent periods, though again from a modest base. Much of that increase is attributable to larger syndicated credits, though there are some indications of softening in the credit quality of middle-market borrowers. In response to this rise, banks have written down assets to

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estimated net realizable values and replenished reserves for expected problems through loan loss provision expenses.

A common theme for many of the problem credits has been significant leverage employed to expand businesses during times of ebullient economic and market conditions. Many of these credits were originated during a period of relaxed lending standards that did not adequately account for the susceptibility of the borrower to weakening sectoral or economic conditions. After the reminders in 1998 from the Asian disruptions and the Russian default, lending standards were tightened. But, with the advent of a softening economy, the embedded risks of weaker or more vulnerable borrowers are becoming well recognized. Particularly hard hit have been certain borrowers in the retail, manufacturing, health care and telecommunications industries. In addition, unexpected developments in asbestos litigation as well as the difficulties faced by the California utilities have also added considerably to the stock of classifications.

The rapid deterioration of credit quality in certain segments of bank loan portfolios reflects the significant share of the growth in bank lending in recent years to borrowers on the borderline between investment and noninvestment grade creditworthiness. With the presence of active money and capital markets in the United States, and their ease of access by the best quality borrowers, these credit grades reflect the quality of those with which our banks now normally deal. They represent the types of borrowers that tend to require the more customized analysis, underwriting and structuring offered by banks that may not be as readily available or as cost-effective through the bond market. The higher magnitude and volatility of default rates in these types of borrowers is well documented from decades of experience in the below-investment grade

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segment of the bond market. Consequently, as conditions have weakened and defaults have risen sharply in noninvestment grade bonds, a parallel increase has occurred in troubled and nonperforming loans of bank portfolios. Forecasts for a continued rise in defaults for lower rated bonds by Moody's suggest that bank corporate asset quality is also likely to deteriorate further before it improves.

Although part of the deterioration may be a natural consequence of taking normal business risk in a weaker economy, part also reflects a lack of discipline by some banks, particularly in the 1995-1997 interval. As banking organizations relaxed their standards and the rigor of their credit risk analysis in this period, banking supervisors responded by issuing cautionary guidance and stepped up the intensity of reviews of lending operations at many banking firms. In particular, supervisors pointed out the need for lenders to avoid the use of overly optimistic assumptions that presumed strong conditions would prevail indefinitely. In addition, supervisors also noted the lack of downside risk analysis or stress testing as a weakness in risk management practices at many banks.

Recent credit losses have highlighted the importance of following those sound lending and evaluation fundamentals and have clearly differentiated strong credit risk management systems from weak ones, prompting many organizations to take remedial action. For the past several years, the banking agencies have shifted their supervisory approach to focus on risk management processes at banking organizations as a more effective means for promoting sound banking practices. While bank risk management practices have improved, in part because of supervisory efforts, recent experience has shown that more work needs to be done. More recently, to help facilitate improvements underway at banks in response to current credit difficulties, the banking agencies issued

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guidance earlier this year clarifying their expectations regarding sound practices for managing leveraged finance exposures.

Even before recent weaknesses, banks had begun to reevaluate their strategic direction and, with the encouragement of supervisors, had become more deliberate about the need to implement formal procedures for recognizing, pricing, and managing risk. Without these reforms, the recent deteriorating trends would likely have been considerably worse. In these emerging systems, loans are classified by risk, internal profit centers are charged for equity allocations by risk category, and risk adjustments are explicitly made. In addition, more advanced systems provide the metrics that are necessary to support active portfolio management, including decisions on whether certain loans exhibiting emerging weaknesses should be sold and at what price. The active sale of troubled syndicated credits has been an emerging trend among larger organizations. In particular, the increasing appetite for these loans by nonbank investors has helped deepen and liquefy the market, providing an outlet for banks with adequate capital and reserves to sell loans at a discount to par value and to rebalance their portfolios.

Today risk management systems have also helped rationalize the pricing of risk through stricter terms and conditions for more vulnerable borrowers. Sophisticated risk management systems are also helping banks to reevaluate the profitability of bank lending by benchmarking loans against corporate hurdle rates. In many circumstances, banks are recognizing that without the ancillary cash management or other revenue opportunities attached to the lending relationship, it is difficult to find stand-alone lending opportunities that meet these hurdle rates. By using these sophisticated quantitative risk management tools to support their decision-making, banks are better

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able to distinguish profitable versus unprofitable relationships and determine whether a particular customer is compatible with the bank's appetite for risk.

At present, the tightening of terms and standards at banks and the bond market has not inhibited the flow of funding to sound borrowers, though borrowers appear to be increasingly tapping the bond market, and lenders and the bond market also are requiring higher spreads for marginal credits. While tightening can be over done, so far banks seem to be making balanced decisions on the tradeoff between risk and returns. This is a favorable outcome, because it assists in directing capital flows to their highest and best use in the economy.

Much focus has been placed on the dynamics within the corporate loan book, which is currently experiencing the majority of problems, but banks and supervisors should continue to be vigilant for other potential risks. In particular, though retail credit quality has been fairly stable in recent years, consumers, like corporations, have also increased leverage, making their ability to perform under stressful circumstances less reliable. In recent years, buoyant economic conditions raised expectations for continued growth in income and employment for consumers, which along with rising levels of wealth, has led to growth in household debt that has outstripped growth in disposable personal income over the past five years. That expansion of debt has pushed consumer debt service burdens to new highs.

With the recent slowdown in the economy, rising personal bankruptcies, an increasing unemployment rate, and a modest deterioration in loan quality, lenders have tempered their outlook, tightening their standards somewhat for credit cards and

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installment loans. At the same time, while consumer spending has leveled out as the economy has weakened, demand for credit has strengthened in recent periods.

Over the past decade, banking organizations have taken advantage of scoring models and other techniques for efficiently advancing credit to a broader spectrum of consumers and small businesses than ever before. In doing so, they have made credit available to segments of borrowers that are more highly leveraged and that have less experience in managing their finances through difficult periods. For the most part, banks appear to have tailored their pricing and underwriting practices to various segments of their consumer portfolios to account for the unique risks related to each. Some institutions have also tailored lending towards segments with troubled credit histories, the so-called subprime market. Such lending can be favorable both to borrowers and lenders. Subprime borrowers benefit by gaining access to credit and the opportunity to build a sound credit history that may eventually allow them to achieve prime status. For lenders, subprime lending affords the opportunity for higher returns provided the necessary infrastructure is in place to closely track and monitor the risk related to individual borrowers, which can be labor intensive and costly. Lenders must also recognize the additional capital and reserve needs to support such lending, particularly if they have concentrations in subprime loans.

Banks that have not understood the subprime market have had significant difficulties. To ensure that banks entering this business properly understand these risks, the agencies have encouraged banks to adopt strong risk management systems tailored to the challenges posed by these loan segments. Beyond poor risk management, there have also been instances in which certain lenders have charged fees and structured loans

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designed not to protect against risk, but rather to deceptively extract a borrower's net worth. Such predatory lending practices, though rare, are a cause for concern and examiners are watchful for programs that would violate the law in this regard.

Another area of supervisory focus, of course, is commercial real estate. The exceptional demand for office and other commercial real estate in recent years has led to a rebound in the volumes of loans secured by these properties. This time, however, as demand has grown, larger banking organizations have managed to keep their holdings modest relative to their asset bases either through securitizations, sales or by avoiding originations altogether. In contrast, many smaller commercial banks have raised their commercial real estate concentrations relative to assets and capital. While underwriting practices appear to be much healthier today than they were in the 1980s and standards have tightened somewhat recently, supervisors are paying particular attention to community banks with concentrations that make them materially vulnerable to a downturn in this market.

While for the past several years there have been few real estate markets with material imbalances in supply and demand, emerging signs of weakness make the need for vigilance more pressing. In the first quarter of this year, there has been a pronounced increase in nationwide vacancies that has resulted in a negative net absorption of office space in the United States. That poor performance, the worst in twenty years, has been attributed by some market observers to the abrupt return of office space to the market by technology firms and to delays by prospective tenants hoping that softening conditions will lower rents further. In this environment, noncurrent commercial real estate loans have edged up somewhat in the first quarter. Whether the first quarter represents a

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temporary phenomenon or the beginning of a longer term trend remains to be seen, but the need for institutions to continue a realistic assessment of conditions and stress test their portfolios is paramount.

In addition to real estate, agricultural lending is also facing challenges. Commodity price weakness, coupled with changes in the federal price support programs, has placed pressures on the ability of farmers to service their debt. This in turn has led to a rise in noncurrent farm loans. Banks are continuing to identify ways to work with their borrowers to navigate through this difficult period.

Funding

For banks to remain in sound condition, they must not only pay attention to the quality of their assets, but also to the nature and quality of their funding. In recent years, large and small banks alike have come to rely increasingly on large wholesale deposits and nontraditional sources of funds. They have done so in part as the demand for loans and their own growth objectives have outstripped the growth in insured core deposits. It is true that retail core deposit growth has been quite meager over the past decade with higher returns in mutual funds and the stock market luring customers away from banking deposits. On the other hand, banks have also made the calculated decision to pay relatively low interest rates on some types of retail accounts and rely on higher-priced jumbo deposits or wholesale borrowing to fund incremental asset growth.

Despite competition for household funds, community banks have been relatively successful at maintaining their core deposit bases. For example, a decade ago banks with less than $50 million in assets funded around 80 percent of their assets with core deposits. Over the course of the past decade, that figure eroded by 7 percentage points, but remains

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a fairly strong 73 percent of assets. That compares to core deposit holdings of only 39 percent for banks with more than $10 billion in assets.

While community banks have experienced moderate erosion in the share of core deposits funding assets, when that trend is coupled with rapid loan growth, pressures on bank liquidity have intensified. To replace core deposits, community banks have been fairly successful at attracting jumbo deposits and have made use of Federal Home Loan Bank advances. Community banks have also funded the gap between loan and deposit growth by liquidating securities holdings and accordingly raising the quantity of loans relative to assets. The combined deposit and loan trends have pushed liquidity benchmark ratios such as loans-to-deposits to historic peaks. On the other hand, there are some signs of relief for bank liquidity. For one, the demand for loans by businesses and consumers appears to be moderating, and there are some early indications that consumers are returning to bank retail deposits in the wake of disappointing stock and mutual fund results.

Still, many of these liquidity pressures are likely to remain in one form or another, and banks are likely to continue to explore non-deposit alternatives for managing their balance sheets. While the use of non-deposit liabilities to fund growth is not new to banks, the growing volume, variety and complexity of these funds creates new issues. To meet this challenge, banks must strive to fully understand the implication of relying on these types of funds both from a liquidity and earnings perspective. The Federal Reserve recently issued guidance on the use of complex wholesale borrowings and the banking agencies recently issued guidance on rate sensitive deposits to highlight the importance of adequate management techniques for ensuring stable and consistent funding.

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Capital and Supervisory Initiatives

The most stable funding source for bank balance sheets is shareholder equity. More significantly, shareholder equity's key feature is its ability to absorb losses. The need for banks to hold capital commensurate with the risk they undertake is highlighted by recent weaknesses in bank asset quality and the uncertain economic environment. Today, by virtue of market pressures following the difficulties of the late 1980s, minimum regulatory capital requirements and the ability of many banking organizations to measure and recognize their own needs for a cushion against more difficult times, the industry capital base appears adequate to meet emerging challenges. From a regulatory capital perspective, the vast majority of all banks meet the definition for well capitalized.

The original Basel Accord that was adopted in 1988 has served supervisors and the industry fairly well over the past decade as one of the primary tools for maintaining a sound banking system. More recently, the nature and complexity of risk undertaken by many larger organizations have made the blunt traditional measures of capital adequacy, whether equity-to-assets, leverage, or current risk-based capital ratios, less meaningful. In considering the likely continuation of innovations over the next decade, supervisors must develop ways to improve their tools while reinforcing incentives for sound risk management.

The new Basel risk-based proposal seeks to achieve the twin objectives of a more meaningful capital adequacy measure and promoting sound risk management practices. The proposal by the Basel Committee that was announced in January of this year calls for an international capital accord that is based on three pillars: a minimum capital requirement that is more sensitive to risk, a supervisory review process, and market

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discipline. It is important to note that the Basel Committee is in the process of reviewing the public's comments on the proposal and there are still a myriad of important issues and details to address and work out before it can be implemented.

The proposal offers a menu of alternative frameworks for establishing minimum capital requirements so that institutions can be matched with the approach that fits their particular degree of sophistication, risk profile and risk management capabilities. On one end of the spectrum, the proposed advanced approach, designed for the most sophisticated and complex entities, relies on a bank's internal risk rating and loss estimates in the establishment of the minimum requirements for credit exposures. At the other end of the spectrum, the proposed standardized approach modifies the current framework to be somewhat more risk sensitive but retains many of the simple features of the current accord.

The second pillar, the supervisory review process, requires supervisors to ensure that each bank has sound risk management processes in place. The emphasis in that review is both on the integrity of the process that produces the metrics used in calculating the supervisory minimum, as well as the adequacy of a bank's own analysis of its capital needs.

The second pillar fits very well with the Federal Reserve's efforts in recent years to encourage larger, more complex banks to improve their internal risk rating systems while placing more emphasis on their own internal analysis of capital adequacy. The new accord is much more than an effort to improve the meaningfulness of minimum regulatory capital ratios, although that clearly is an important aspect of the proposal. Embodied in the proposal are some important risk management principles and sound

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practices that supervisors would expect all of the very largest and most complex U.S. banks to be following or aspiring to, even those not electing to use one of the more advanced approaches. As proposed, the capital standards should provide banking organizations in the United States and abroad with strong incentives to accelerate their development and implementation of improved risk management systems in order to qualify for a more risk-sensitive regulatory capital treatment. Moreover, the review necessary to ensure that bank risk measures are sound maintains the focus of supervisors on the key elements of control and risk management that govern safe and sound banking.

The third pillar complements the first two by bolstering market discipline through enhanced disclosures by banks. By their very nature, many banking risks are opaque. However, innovations in recent years that have helped improve the management of risk have also led to the development of various summary statistics to meaningfully describe risks that were qualitatively described in the past. While challenges remain in making such measures comparable or differences across institutions well understood, such disclosures are a necessary complement to the other two pillars for the overall approach to retain the necessary level of rigor and integrity. Disclosure of information that helps stakeholders determine risk profiles is designed, of course, to increase, when necessary, the market pressure and costs on bank lenders that they would otherwise receive as a matter of course if they were not beneficiaries of the safety net. Market discipline can also provide useful signals to supervisors.

Significantly, the opportunity for enhanced market discipline through disclosure is substantial given that larger organizations fund about two thirds of their assets with uninsured funds. However, supplemental information will be irrelevant unless uninsured

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creditors believe that they are, in fact, at risk. Uninsured creditors have little reason to engage in risk analysis, let alone act on such analysis, if they believe that they will always be made whole under a de facto too-big-to-fail policy. Recognizing that dilemma, in 1991 the Congress placed in the Federal Deposit Insurance Corporation Improvement Act a requirement for a least-cost resolution of financial institutions. Although an exception clause exists, it does not require that all uninsured creditors be made whole. Conceptually, there are rare situations where events may require that the FDIC and other governmental resources be used temporarily to sustain a failing institution pending its managed liquidation. But indefinitely propping up insolvent intermediaries is the road to stagnation and substantial resource misallocation, as recent history attests.

Indeed, if the government protects all creditors, or is generally believed to protect all creditors, the other efforts to reduce the costs of the safety net will be of little benefit. The implications are similar if the public does not, or cannot, distinguish a bank from its affiliates. As financial consolidation continues, and as banking organizations take advantage of a wider range of activities, the perception that all creditors of large banks, let alone of their affiliates, are protected by the safety net is a recipe for a vast misallocation of resources and increasingly intrusive supervision.

Financial Holding Companies and Umbrella Supervision

Mindful of the potential for the federal safety net to extend beyond what Congress intended in its enactment of the Gramm-Leach-Bliley Act ("GLB Act"), the Federal Reserve has been careful to distinguish between insured depositories and uninsured holding company affiliates and parent organizations in the supervision of financial holding companies ("FHCs"). Consequently, the Federal Reserve's focus in FHC

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supervision has been to identify and evaluate, on a consolidated group-wide basis, the significant risks that exist in a diversified holding company with a view to evaluating how such risks might affect the safety and soundness of insured depository institution subsidiaries. Such supervision is not intended to impose bank-like supervision on FHCs, nor is it intended to duplicate or replace supervision by the primary bank, thrift, or functional regulators of FHC subsidiaries. Rather, it seeks, on the one hand, to balance the objective of protecting the depository institution subsidiaries of increasingly complex organizations with significant inter-related activities and risks, against, on the other, the objective of not imposing an unduly duplicative or onerous burden on the subsidiaries of the organization.

To accomplish that objective we have relied on our long-standing relationships with primary bank, thrift, securities and foreign supervisors while forging new relationships with the functional regulators that oversee activities that are newly permitted under the Act. These relationships respect the individual statutory authorities and responsibilities of the respective supervisors, but at the same time, allow for enhanced information flows and coordination so that individual responsibilities can be carried out effectively without creating duplication or excessive burden. The Federal Reserve places substantial reliance on internal management information maintained by FHCs and on reports filed with, or prepared by, bank, thrift, and functional regulators, as well as on publicly available information for both regulated and non-regulated subsidiaries.

Since enactment of the GLB Act, over 500 FHCs have been formed. The vast majority of those are small community holding companies that converted largely in an

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effort to take advantage of the insurance agency provisions of the GLB Act or to be well positioned should opportunities for exercising new powers present themselves. Most of the larger holding companies have also converted to FHCs, and appear to be taking advantage of the securities, merchant banking, and to a lesser extent, the insurance provisions of the Act. In addition to the conversion of existing bank holding companies, there have been a few nonbank financial service companies that have applied for and received FHC status in connection with their acquisition of banking organizations.

In general, banking organizations appear to be taking a cautious and incremental approach to exercising new powers under the GLB Act. In addition, the number of new, truly diversified financial holding companies across securities, insurance and banking has been few enough to let organizations and supervisors gradually gain experience and comfort in their operations.

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