Bank Supervision in a Changing Financial Environment

Good afternoon, ladies and gentlemen. I am delighted to have this second opportunity to address the Mid-Winter Meeting of the New York State Bankers Association and I want to use this occasion to discuss recent and prospective initiatives by the Federal Reserve aimed at strengthening (1) the supervision of banking organizations and (2) the operation of the payments system. These subjects are closely related, not only because banks are the dominant institutions through which payments are made, but more fundamentally because the safety and integrity of the banking system and the safety and integrity of the payments system are inseparable, with both ultimately resting on that great intangible—public confidence.

By way of background, allow me to highlight some of the recent developments which seem to me to underscore the need for further efforts in these areas The last several years have seen our banking and financial markets buffeted by a complex interaction of cyclical and secular forces. Some of these forces reflect changes in the economic environment; some are prompted by technological considerations; others stem from an intensely competitive environment in the financial marketplace fostered in part by deregulation; and still others reflect changing structural characteristics of our domestic and international economy. In the end, however, all of these factors blend together in a manner that makes it very difficult to distinguish causes from effects and actions from reactions. Yet, whatever the cause-and-effect relationships may be, the manifestations of the interaction of these forces in the marketplace are plain to see. For example:

Remarks of E Gerald Corrigan, President, Federal Reserve Bank of New York, before the 58th Annual Mid-Winter Meeting of the New York State Bankers Association on Thursday, January 30, 1986

- Most measures of the quality of financial assets in bank portfolios and elsewhere are at disturbingly low levels given where we are in the business cycle. Some of this is the inevitable fallout of imbalances in economic performance and policies here and abroad, but some may also be due to aggressive and short-sighted behavior of individual financial institutions.

- Businesses and households continue to accumulate debt at very rapid rates despite what look like very high real rates of interest

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- Isolated but often sensational problems in individual financial institutions—almost always growing out of bad or abusive management practices—inevitably raise questions about the strength and stability of institutions more generally.

- The explosion in new financial market practices and instruments—many of which are not reflected on conventional accounting statements—strains the mental dexterity of even the best and the brightest among us.

- The apparent thinness of spreads and margins on individual financial transactions raises questions as to whether pricing adequately reflects risks.

- The internationalization of banking and financial markets has brought about a quantum leap in the degree of financial interdependence and in the structural complexity of the financial marketplace.

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- Finally, and reflecting all of the above, the volume, speed, and value of financial transactions are growing at a very rapid rate. For example, here in New York City, it is not uncommon for the value of large dollar computerized payments processed by the New York Federal Reserve Bank and by the New York Clearing House to exceed $1 trillion in a single day. To try to put that in perspective, $1 trillion is:
  - $35 million per second over an eight-hour day.
  - Forty times the reserve balances held at the 12 Reserve Banks by all banks.

When we pull together these various elements one message emerges rather powerfully: namely, that events have undercut the effectiveness of many elements of the supervisory and regulatory apparatus historically surrounding banking and finance. If it can't be done onshore, it's done offshore; if it can't be done on the balance sheet, it's done off the balance sheet; and if it can't be done with a traditional instrument, it's done with a new one. That is not to say that these developments are bad. To the contrary, taken together they are symptomatic of a vital and adaptive financial marketplace. Yet, as this process unfolds, we must recognize that the historic regulatory/supervisory apparatus associated with banking—whatever its limitations—was a source of restraint and discipline on individual institutions and on the system as a whole. If, therefore, I am correct in postulating that events are undermining that source of restraint, a key question that arises is what, if anything, should replace it?

In response to this, some—perhaps many—would say "let market discipline do the job". It's very hard to argue with that since all of us are powerfully attracted to the concept and the reality of the marketplace as the optimal vehicle for resource allocation. But, if in banking and finance we are to accept that concept in its fullness, we had better take market discipline out of the closet and take a good close look at it and its implications. For example, if we really want unfettered market discipline, then we must be prepared to accept the ultimate discipline of the market—outright failures regardless of their implications for other institutions and markets. Now, if that's what we want, several things seem to me, as a matter of logic, to go with it: we probably don't need the discount window; we don't need the Fed effectively guaranteeing large dollar payments; we don't need deposit insurance at the $100,000 level; as a matter of fact, we probably don't need much at all by way of rules or regulations, much less supervisory and examination programs.

Now at this point, I'm sure all of you are saying "that's a straw man; that's not what we really mean by market discipline". And you would be right, it was a straw man, but a straw man with a purpose: namely, to make the point that I have no sense that any of us are prepared to dismantle the public safety net associated with our banking—and to a lesser extent—other financial institutions. On the other hand, I do have the clear sense that all of us recognize the need to adapt the safety net in ways that are more responsive to market realities of the day and more sensitive to the need to avoid penalizing the strong and prudent because of the mistakes and misfortunes of the weak and the reckless. Above all, I have the sense and the conviction that we need to adapt the safety net in ways that continue to protect the system as a whole from the misfortunes of the few.

However, it is easier to say these things than to do them, especially in the context of an intensely competitive and tightly integrated financial market within which sophisticated electronic payments systems provide the linkages by which billions of dollars can move domestically or internationally with the blink of an eye.

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To summarize to this point: if financial integration and complexity have increased dramatically; if events and technology have undercut much of the restraint and discipline associated with historic forms of financial regulation and supervision; if we are not prepared to accept unfettered market discipline as the sole or even the dominant source of restraint on the system as a whole; if the strong should not be penalized by the problems of the weak; and if we care about the stability of the system as a whole, then the case for strengthening the infrastructure supporting the operation of our financial institutions and markets is overwhelming

In the first instance, the primary responsibility for enhancing that infrastructure lies with the directors and officers of individual banking organizations. And, the events of the past several years have provided clear and unmistakable evidence that individual institutions recognize this responsibility and have risen to its challenge. Nowhere is that more evident than in the attitude of bankers toward strengthening capital and reserve positions. For example, between year-end 1982 and the third quarter of 1985, the primary capital of the 25 largest banking organizations in the United States grew by $26.5 billion, or 57 percent. Over the same time period the total capital of these institutions rose by $38.5 billion, or by more than 70 percent. And, these truly impressive increases in capital were recorded despite historically high levels of charge-offs. That enormously expanded capital base will be a source of great strength for the future but as large as it is, it does not reduce the need for conservatism in capital building efforts and in banking practices generally.

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However, just as bankers have responsibilities to adapt to the new environment, so too do the public authorities, including the Congress and the bank supervisory agencies. In that regard, some of you may recall that at this time a year ago I said that the case for broad-based and progressive federal banking legislation was urgent and I spelled out in some detail the specifics of a near-term legislative agenda which seemed to me both essential and pragmatic. In the interest of time, I'm not going to repeat that agenda today, but I do want to repeat—with an even greater sense of urgency—that if we don't get progressive federal legislation, and get it soon, events may result in a helter-skelter of circumstances that will make none of us very happy.

As I see it, that danger was driven home all too vividly in the Supreme Court ruling in the so-called "nonbank bank case" two weeks ago. In that opinion, the Court seemed to me to be saying that while it had sympathy for the substance of the Federal Reserve position, the proper remedy was legislative, not judicial—which, of course, has been the Fed's position all along. Hopefully, the Court's ruling will serve as a catalyst for federal legislation, not just to deal with the definitions of banks and thrifts but also to make progress regarding product and geographic expansion, the appropriate role of the states in banking structure and supervisory matters, and in simplifying some of the supervisory provisions of the Bank Holding Company Act.

However, even in a framework in which banks themselves are adjusting to the new environment and one in which appropriate federal legislation is forthcoming, it seems to me essential that we continue the process of adapting our system of prudential supervision to the realities of the new environment. The Federal Reserve and the other banking supervisors have been hard at work in that effort for some time and over the balance of my remarks today I would like to share with you some thoughts on several aspects of that process which seem to me particularly important. Before turning to some of the particulars, however, let me say a few words on the principles which I personally believe should guide this effort:

- *First*, the primary responsibility for the safety and soundness of individual institutions lies with the directors and management of each institution, not with the supervisors.
- *Second*, no system of official, prudential supervision can be, or should be, fail-safe If that's what we want, we might as well nationalize the banking system.
- *Third*, disclosure has a place—an important place—but it's not a panacea, and taken too far it can be destabilizing.
- *Fourth*, no set of rules, reporting requirements, guidelines, or disclosure requirements can substitute for the on-site examination and inspection process.
- *Fifth*, supervisory initiatives must be sufficiently flexible so as not to penalize the strong because of the mistakes and misfortunes of the weak.
- *Sixth*, to the extent possible, supervision should take account of function rather than form.
- *Seventh,* supervisory efforts must take greater account of the increased credit and operational interdependencies among banks and between banks and other major financial institutions, domestically and internationally.

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Against that background, the Federal Reserve has undertaken a number of major initiatives aimed at strengthening the bank supervisory process over the past year or so. While time does not permit me to go into all of the initiatives, there are several areas which seem to me to merit special attention.

First, the Fed has adopted a new approach regarding the scope and frequency of on-site examinations for large institutions and for problem institutions. Specifically, all problem and potential problem institutions of $500 million or more will be subject to one full scope and one limited scope examination per year. In addition, for institutions with more than $10 billion in assets, the alternate year examination program with New York State will be dropped in favor of annual joint examinations. Finally, for all institutions over $10 billion in assets, there will be one full scope examination per year *and* one special or targeted examination per year.

Thus, the Fed will begin using the special or targeted examination but not at the expense of eliminating or reducing the frequency of the comprehensive overall examination, which I firmly believe must remain as the cornerstone of our examination efforts. Insofar as the special or targeted examinations are concerned, we expect that the point of emphasis will vary from institution to institution. For example, depending on the institution, the emphasis might be on a detailed look at operational systems, or off balance sheet activities, or particular points of interest in the loan portfolio, or patterns of worldwide funding activities. And, because these targeted examinations can be highly specialized, we have in mind augmenting our teams of examiners with specialists drawn from other areas of the Federal Reserve Bank of New York to assist in these efforts. While the combination of the comprehensive and the specialized examination will entail some greater effort on our part and on the part of affected institutions, we are confident that the mutual benefits will far outweigh the costs and potential burdens of this approach.

A second area of particular emphasis has been in regard to prudential standards. Specifically, the events of the last several years have made it clear that bank holding companies, as corporations in their own right, cannot always depend on an uninterrupted flow of dividends and other income from their bank and nonbank subsidiaries, or on bank-like liability management practices to fund medium- and longer-term assets. Thus we are placing new emphasis on holding company cash flow and liquidity in the inspection process.

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In accordance with this emphasis we have developed, field tested, and implemented revised and expanded examination guidelines relating to holding company cash flow and liquidity. The revised cash flow guidelines focus on cash flow in relation to operating expenses, debt service requirements, and dividends to shareholders. The holding company liquidity guidelines focus on contractual and actual maturities of the parent's assets and liabilities, the liquidity available in advances to subsidiaries, and the need for management policies and contingency plans regarding the parent company's liquidity. Of course, the holding company cash flow guidelines are broadly germane to the guidelines issued late last year by the Federal Reserve and the Comptroller of the Currency regarding circumstances in which the curtailment or elimination of dividend payments by banks or bank holding companies might be appropriate. We are also taking a fresh look at examination and supervisory guidelines as they pertain to loan concentrations and standards for judging the adequacy of loan loss reserves.

The single most important initiative on the table, however, is the proposed risk based capital adequacy guidelines which were issued for public comment by the Board of Governors in mid-January. The proposed guidelines are a response to events in the marketplace—such as the growth of off balance sheet activities—which simply could not be ignored. More importantly, these proposed guidelines are fully compatible with the concept that supervisory norms should take account of characteristics of individual institutions rather than painting with such a broad brush so as to treat all institutions more or less alike.

Because of its importance, the Federal Reserve has provided for a 90-day public comment period on this proposal. Needless to say, I would hope that all affected institutions would give us the benefit of their views on this subject. In framing those comments, I believe it is important to keep in mind that the approach is not intended to capture all of the nuances of risk and risk management in banking operations. Rather, it is a general framework designed to help bankers and bank supervisors better gauge overall risks and capital adequacy on the basis of four broad categories of relative risk. Thus, while there will be a natural tendency to quibble as to whether a particular item belongs in one category or another, excessive fine-tuning must be resisted in part to avoid undue administrative complexities but also to guard against the dangers of expecting more from such an approach than it can deliver.

Another area of particular concern to the Federal Reserve has been efforts to strengthen our examination and supervisory personnel. In part, that has entailed stepped-up efforts to recruit individuals with more diversified skills and to provide more intensive and sophisticated training programs for our examination personnel. In addition, we are increasingly looking to people drawn from areas of the Bank such as open market operations, foreign exchange trading, computer systems, legal, and research to help in framing supervisory policies and, in some cases, even to participate in field examination work. We have also been exploring ways in which supervisory personnel can quickly and flexibly be used to assist in dealing with particular problems when they arise. For example, last year in the context of the problems with state chartered thrift institutions in Ohio and Maryland, large numbers of Federal Reserve examiners from all over the country were utilized on-site to help contain and ultimately stabilize those situations. The importance of all of these efforts cannot be overstated because in the end, supervisory policies are only as good as the people who administer those policies. Achieving that needed blend of technical skills, professionalism, and good old common sense in our examination personnel was never easy but has never been more important.

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These initiatives—and others I have not mentioned—are, in my view, broadly consistent with the principles I cited earlier that should guide our efforts. But, as important as they are, they do not begin to capture all that needs to be done. For example, I have not even mentioned the case for greater international coordination of supervisory efforts and standards—a need that arises on both prudential and competitive grounds. Looked at in that light, the initiatives I have mentioned should be viewed as stepping stones in the continuing and very difficult process of seeking to keep the supervisory process attuned to a rapidly changing market environment.

In closing, allow me to make a few brief comments about the operation of the payments system and particularly large dollar electronic payments systems. The speed and efficiency of those systems are one of the marvels of our times. But, speed and efficiency can bring vulnerability and, in the case of large dollar electronic payments systems, those vulnerabilities can take many forms ranging from computer problems to credit problems. Recognizing this, the banking industry, in close cooperation with the Federal Reserve, has been actively exploring ways in which greater elements of discipline and control can be built into the operation of these systems As a result, caps or limits on intra-day extensions of credit on Fedwire and on the major private wire transfer systems have been or are being established by users of these systems. As best we can judge, this process of establishing caps on the basis of self-appraisal is going well and we are already seeing signs that it is having the desired effect of focusing even greater top management and directors' attention on the subject We are also aware that a few problems and glitches have surfaced and, where possible and appropriate, we are working with individual institutions to help remedy these problems. All in all, however, the process seems to be proceeding in a generally satisfactory manner.

In saying this, let me emphasize that these efforts are but a first step in strengthening this vital element of the payments mechanism. I say they are a first step because daylight overdrafts are the symptom, not the cause. Looked at in that light, current efforts—while necessary—can probably do little more than stabilize the situation. Since the object of the exercise should be to enhance the reliability of the system and ultimately reduce risk and exposure, we are going to have to get at the underlying problems, not just their symptoms.

That more penetrating effort will have to entail considerations relating to (1) possible approaches to achieving a higher level of operational reliability in the system; (2) more comprehensive procedures to be followed in emergency situations; and (3) a greater willingness to reconsider market practices in an effort to reduce daylight exposure and payment risk. Of course, in exploring these avenues for enhancement, we must take care so as not to undermine the liquidity and efficiency of our markets. Achieving that balance will not be easy, but we must try.

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The agenda for the future is long and imposing, but my colleagues and I at the New York Fed enthusiastically welcome the opportunity to play our part in helping to meet these challenges. Indeed, as the arm of the Central Bank located in the largest and most important financial center in the world, we believe we have a special role to play in that regard. That special role reflects not just a physical presence in the market, but rather a broad-based operational presence. We examine banks, we buy and sell securities, we operate in the foreign exchange markets, we are direct parties to billions of dollars in electronic payments daily, we clear checks, in short, we too are a bank. Thus, what we bring to the arena of public policy is not just an intellectual point of view, but a point of view that is tempered and conditioned by our day-to-day presence in the marketplace. We think that's important and we hope you share that view.

Thank you.