Mr. Ferguson looks at bank supervision from the consulting perspective

Remarks by Mr. Roger W. Ferguson, Jr., a member of the Board of Governors of the US Federal Reserve System, before the Conference of State Bank Supervisors in Washington, DC on 9/3/98.

It is my pleasure to join you today. The Federal Reserve has long enjoyed a cooperative relationship with the Conference of State Bank Supervisors, and I expect that relationship to continue.

As you are well aware, technological and financial innovation have become the norm in banking and bank supervision. These innovations have accelerated the pace of transactions and increased the complexity of transactions seen throughout the banking system. This is a pattern we can expect to continue in the years ahead. Indeed, it is this complexity and innovation that leads us, as supervisors, toward a more risk-focused supervisory approach with a greater emphasis on sound management processes. Only by ensuring that a bank's management and control processes are sound can we be confident that its risks will remain contained throughout business and market cycles.

It is not my intention today to espouse the merits of risk-focused examinations, since I trust we all recognize the value of that approach, especially in the case of larger, more-complex banking institutions. I would like to focus on a challenge that we face as we move more toward risk-focused examinations. This challenge or conundrum is captured in a comment I heard last year at a dinner hosted by the Bank Administration Institute. A leading banker at dinner complimented a regulator for having supervisors and examiners who provided "consultations" at the end of examinations. Since reviewing management and control processes is very much a "consultative" activity, I suspect such comments will become more commonplace.

Being perceived as being like consultants is useful, but it is not an unalloyed blessing. As I reflected on the compliment I heard, I wondered if the consulting metaphor was really one we should encourage. We should all do what we can to maintain a strong and vibrant banking system that is responsive to the needs of the public. That is part of our role as supervisors. We should also work hard to ensure that the supervision and examination processes are not unduly burdensome to the banks we examine. We should be supportive of financial modernization, a process that is overdue in the banking industry. We also want to provide guidance to banks on sound practices and to evaluate the extent to which they conduct their activities in prudent ways. But we should be cautious in fully adopting the label "consultants."

In my comments this morning, I would like to draw on my experience as a consultant to banks and other financial institutions to discuss some similarities and differences, as I see them, between the role of consultant and the role of supervisor.

I raise this topic today because the recent turmoil in Asia has some roots in poor banking performance and poor banking supervision. I believe that the market is ultimately the best regulator of financial services, but we will still need supervision and regulation to offset the limitations inherent in regulation from the market. The recent turmoil in Asia serves as a reminder of the risks that financial institutions take and the systemic impact that can emerge if supervisors are not mindful of the important role that they continue to play in containing that risk.

Why Do We Need Management Consultants and Supervisors

Let me begin with the basic question of why firms hire management consultants. Many large companies that hire management consultants have substantial talent, resources and expertise of their own. A key reason they seek outside guidance is that the employees of these companies often lack the objectivity, the cross-company and cross-industry experience, or the specific, technical expertise that the company needs. Companies also hire consultants simply because they want to avoid distracting key individuals from their on-going operational duties in order to conduct a project that an outsider can perform.

Why, on the other hand, do banks hire bank supervisors? The obvious answer is that they do not hire them at all. Supervision is found to be necessary -- not only here but also in virtually every country abroad -- to protect the public's interest in the lending and deposit-taking process. The fact that we continue to regulate banks reflects the economic concept of "externalities" and the need to protect the safety net that most societies extend to banks. It is not the impact of one bank's decisions on the wealth of its owners and the job security of its workers that worries us. Bank managers must be allowed to make managerial decisions with a minimum amount of regulatory and supervisory interference. Bank directors and managers have strong incentives to take care in their decisions due to a natural concern for personal job security, personal wealth, and continuing control in the active market for bank consolidation. Some will make wise decisions, and their institutions will thrive; others will make decisions that prove to be incorrect and their banks will suffer.

However, we know that no single bank management team, regardless of how well intentioned, can accurately value the cost of its decisions, good or bad, on the banking system and economy as a whole. Therefore, supervision is a way of forcing banks, individually and collectively, to recognize the broader impact that their risk-taking and risk-mediation decisions might have on society at large. It also substitutes for some of the market discipline lost, and attempts to offset the "moral hazard" that arises, due to the existence of the safety net. It is the possibility that poor managerial decisions by one bank will then spill over to other banks and eventually to the public at large that provides the rationale for supervision and regulation. That possibility is also a key factor driving the Federal Reserve's need to remain a bank supervisor. Without such active, on-site experience supervising and evaluating bank activities, the central bank would, I believe, be less prepared to deal with financial crises that inevitably arise. In addition, the Federal Reserve is the operator of important parts of the nation's payment system, both wholesale and retail, and as such has a stake in the proper functioning of banks and the banking industry.

However, we should also recognize that supervision and regulation are not without costs to banks and, in turn, to society. Therefore, I believe that we should aspire to the minimum amount of regulation and supervision that is consistent with maintaining safety and soundness of the banking system and with maintaining financial stability. After all, the marketplace is ultimately the best regulator, and we should look to the market for guidance and feedback, wherever possible.

Similarities between Consultants and Supervisors

Given these fundamentally different incentives for banks to have consultants and supervisors, why would an obviously intelligent CEO of a major bank compliment us on providing "consultations"? The answer is that a good examiner brings some of the same strengths to an examination that a good consultant brings to a consulting assignment, namely objectivity, cross-firm experience and critical technical expertise. Like consultants, the independent assessments that examiners make are becoming more dependent on statistical sampling and on the accuracy of a bank’s internal information systems. Requiring banks to have, on an on-going basis, sound internal procedures should reduce risks to the financial system and lead to fewer surprises overall.

Reviewing procedures, though, entails a more subjective approach than reviewing credits. Although analyzing credits can be complex, the potential resolutions are few. The examiner reaches a conclusion about individual credits and the overall quality of the loan portfolio, and his findings are communicated to the bank. Some loans are charged-off, others are written down, and the results are clear. Addressing procedural problems, however, is rarely so decisive because we get into judgmental areas and into a range of potentially acceptable -- and unacceptable -- resolutions. In this, supervision and consulting are very similar.

One approach consultants use to resolve the challenge of dealing with more subjective judgments is to maintain open lines of communication between consultant and top management. The results of a consulting assignment are rarely a surprise when the final report is presented, and management has had an opportunity to respond to early findings and present their perspectives. Similarly, the results of a bank examination should not come as a surprise to bank leadership. Clear and frequent communication of supervisory guidance on sound practice is of critical importance. Particularly in new or innovative activities, bankers need to hear clearly which arrangements the supervisor will accept.

Another technique consultants use to analyze a subjective topic, such as bank processes, in which several practices might be acceptable, is to have open lines of communication within the consulting team. All team members have a chance to add their perspectives to the potential solution. Similarly, examiners from different agencies examining a single banking entity should be able to share perspectives and findings.

While both consultants and examiners may be forced to make judgments regarding management processes, it is essential that such judgments be made only after reviewing the relevant facts. For consultants, those facts may encompass a wide array of market or company data. For examiners, those facts may be gleaned from a credit analysis and the review of credit files. Despite all the innovation and structural changes we have witnessed throughout the financial system, extending credit and limiting the volume of bad loans remain the primary business of banks. Examiners will continue to need to evaluate whether a bank’s own internal assessment of its exposures is sound, which will by necessity involve a review of a sample of loans.

In another, less appealing, way consultants and bank examiners are quite similar. In both cases the process can be obtrusive, with outsiders asking for scarce time and attention from bank employees. Consultants and examiners alike must learn to adjust their professional approach to minimize the degree of disruption to the institution being served. In this regard, the move toward more off-site work and preparatory work is to be commended, and I am certain that it is appreciated by banks.

So in many ways, while the goals of the consultant and examiner are different, the techniques used may be quite similar. One can imagine an effective examination process resembling a good consulting process. Both rely, in part, on internal data. Both should be characterized by frequent and candid conversations between bank leadership and the leadership of the examination team. Both should help bank leadership to understand what is considered sound practice. Both consultants and supervisors must at some level analyze the tangible results of the management processes, be that loan quality or some other measure of corporate performance. Finally, to be successful both consulting and examination must be carried out with the minimum of on-site disruption after careful off-site planning.

Sharing Knowledge among Examiners

Another similarity between consultants and examiners is that there is much practical experience gained by the professionals that must be shared with their co-workers or team members or even more broadly among the community of professionals. For the community of supervisors, these insights are the results of many years of first-hand experience with banks. Consultants have developed the fancy phrase of "knowledge management" for the process of building individual insights, sharing them with others, and finally applying the collective knowledge through an individual professional working with a client. The challenge, of course, is how to complete this cycle of "build-share-apply" when the community spans several thousand people, across multiple locations and, possibly, multiple agencies. This gathering is an example of one possible solution to this challenge. Technology, through group software and the creation of more common, interagency tools, might prove to be another solution. I shall return to the need for broadly shared common technology platforms.

Distinctions between Consultants and Supervisors

Now let me turn to the numerous differences between consultants and supervisors. In adding value to the banking industry, supervisors have a major advantage over consultants in that we have the standing and authority to influence actions industry-wide. That ability to influence state or national policies is an important aspect of our work and one that helps to motivate and retain our key people.

This fact ties directly to the sound practice papers we provide. As supervisors, we need to share what we learn to help the industry manage and control its risk. To develop industry guidance, we do well in looking to leaders within the industry, and to institutions that know their business best. The knowledge we gain from our associations with so many banks also accommodates the development of new regulatory paradigms. The recently adopted rule for market risk that is based on the internal models of banks is a good example. Without the in-depth access to virtually all of the world's leading trading banks and to their experiences and observations, supervisors collectively could not have developed their own understanding and the willingness to pursue this approach.

This new approach highlights a series of significant differences between consultants and supervisors.

First, consultants often find themselves acting as "change leaders", attempting to get their clients to take greater business risk based on consulting judgment. Supervisors recognize that banks are in the business of taking risk, but our goal is not to encourage or to discourage risk-taking by individual banks. Our goal is to have banks recognize and manage well the risk they are taking, price the risk appropriately and avoid undue concentrations of risk. In that way we hope to reduce systemic risk.

A second difference between consultants and supervisors is in the need for consistency across banks. Consultants generally place little value on consistency across clients. The best consultants tailor solutions to each individual client. Therefore, two clients served by the same consulting firm on the same topic may receive different sets of recommendations. Supervisors, by comparison, properly put a premium on consistency across banks and over time. We do not want to create an unstable market by giving inconsistent examination advice.

A third difference that emerges is an appetite for novel professional approaches. Senior consultants reward younger professionals who develop new approaches. Within the fraternity of supervisors we want to maintain modern approaches to examination and supervision, but should only adopt them widely once we are sure they lead to the desired outcome.

Finally, you may recall that earlier I referred to the communication and feedback required in order for an examination to have the impact of a good consultative process. The challenge in providing this feedback is in knowing just how far to go. As supervisors, we need to communicate our views, but we must avoid making operating decisions for banks. Supervisors, unlike consultants, must let banks make independent judgments. The responsibility for sound banking is with the banks, and it is they who must, ultimately, develop and take full responsibility for their decisions. Supervisors must be free to criticize conditions that, if not corrected, may lead to heightened risk in the future. Unlike consultants, supervisors have in their arsenal the power to effect change not only through examination of findings but also through moral suasion, a strong bully pulpit and ultimately, supervisory guidance, regulations and enforcement actions.

One critical area where currently we are exercising the power of moral suasion is in connection with the possible decline in credit underwriting standards that may be becoming widespread. For more than two years now, we have heard persistent reports of declines in lending terms, conditions, and standards. It is not just isolated reports from some examiners. Leading bankers, such as John Medlin of Wachovia, and survey data, also support these reports.

The question then becomes "what should we do?" We can certainly expect that in the next economic downturn credit problems will rise and weaker lending standards, if they exist, will only make matters worse. While the lending decision is ultimately that of the banks, this is an important area in which we can offer advice and general counsel. We should not create an artificial credit crunch, and I do not think that we are at risk of doing that, but we can and should urge caution that is based simply on our long experience in watching business cycles. We can continue to make sure that bankers, themselves, understand their own procedures and the risks that they face. We all seem to be taking a more aggressive approach on this issue, and I expect that we will remain vigilant to sound the alarm when necessary.

Interagency Coordination Efforts

Throughout my comments I have noted a number of points that bear directly on initiatives of state and federal supervisors to work together toward a stronger supervisory process. As the US banking system becomes more entwined through interstate banking and branching, it becomes ever more critical that we all coordinate our efforts in maintaining a healthy, viable, and attractive dual banking system. It is also important for states to work to minimize unnecessary distinctions that slow the progress of interstate banking.

I mentioned, for example, the need to modernize US banking laws, share practical supervisory experiences, maintain consistency, reduce intrusion during the bank examination process and, in general, improve the overall efficiency of our staffs. These are not new challenges and, indeed, are goals that we collectively have been working toward successfully for some time through the State-Federal Working Group and other forums. As we all know, state banking authorities have done much to advance interstate banking and branching and to work together and with federal authorities toward a seamless oversight process. The state-federal protocol has helped greatly to bring about that seamless approach and is a crucial element in maintaining the viability of the state banking charter.

Individual states and the state charter, in turn, have provided the industry with important flexibility to experiment in developing new banking products and delivery systems. In this and in many other ways, the state charter and the dual banking system have served the country well. Fortunately, the dual banking system seems healthy. Consider, for example, that of the 207 new banking institutions chartered last year, 146 were state chartered.

Adapting available technology to examinations and to sharing insights among examiners is another area in which significant progress has been made through our joint efforts to produce more efficient examinations. As you may know, the FDIC's ALERT system now permits examiners to download bank data onto their own PCs in order to analyze exposures and prepare for upcoming examinations. It is being used widely by many states and by a number of Federal Reserve Banks; more are likely to learn about and use it in the months ahead. The Fed's own ELVIS program is another important advance that assists examiners through the risk-focused process for community banks that is being used by the Fed and FDIC and by most states.

Looking forward, examiners should soon be able to use the "GENESYS" system to access a broad range of automated information contained in supervisory databases and download it into their examination reports. Together, these and other initiatives -- including greater use of analyst and examiner electronic desktops, new web pages, and expanded data access techniques between state and federal supervisors -- have helped significantly to improve the efficiency of our examiners and to create a less intrusive supervisory process. We should all be pleased with these results and should expect the process to become even better in the months and years to come.

Conclusion

In closing, I see many challenges ahead for us all, as we adapt the supervisory process to keep pace with events in financial markets. In some respects consultants and bank supervisors have much to share and can learn from one another:

1. Consultants and supervisors must have open, trust-based channels of communication with bank management and among their peers. Both must add value by analyzing both processes and the outcomes of those processes. They are both well advised to limit their intrusiveness while not foregoing a thorough and professional inquiry.

2. Both consultants and supervisors face the challenge of building, sharing and applying professional knowledge and skills in a rapidly changing business environment. The failure to manage our knowledge within teams, within agencies and even across agencies will certainly result in wasted effort and may even result in a caliber of supervision that does not keep pace with changing financial technology and increased sophistication by banks. The Federal-state coordination efforts that I mentioned are an example of this needed cooperation.

However, while it might be quite appealing to speak of supervisors as acting more like consultants, in many critical ways the consulting metaphor does not work very well for supervisors. There are at least three factors that make consulting an inappropriate model for supervisors to follow:

1. Consultants are hired by management and work to add value to the shareholders that management represents. Supervisors, in contrast, ultimately work for the public at large. Rather than adding shareholder value, supervisors seek to reduce or eliminate excessive risks to the financial system and the federal safety net.

2. Supervisors have much more impact in the banking industry than even the most savvy or articulate consultant. We must be willing to exercise that moral and legal authority to forestall as best we can practices that we know might become harmful even before the full results of such practices become evident. In this we may not always be popular.

3. Finally, consultants can be wrong with only relatively limited consequences. The caliber of their advice is rarely subject to after-the-fact scrutiny. When a consulting firm makes a mistake, it may lose a client and that company may lose some money. When a banking agency fails to act, the consequences can be widespread for the economy and the public at large.

To keep the public's trust, we need to be ever mindful of whose interests we serve. We do want to minimize the burden of supervision. We do want to foster modernization. We must stay current with the latest financial techniques. We can assist institutions by identifying weaknesses and, at times, we can offer views toward resolution. Ultimately, however, we are forced to supervise and regulate banks in the interest of the public.