William J McDonough: Future challenges for bankers and bank supervisors

Remarks by Mr William J McDonough, President of the Federal Reserve Bank of New York, before the 106th Annual Convention and Financial Services Forum of the New York State Bankers Association, held in New York on 6 April 2000.

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I am pleased to be with you today to discuss the new world that bankers and bank supervisors alike face in the wake of historic financial reform and continuing technological and financial innovation. Clearly, these are exciting, heady times. The American banking system has just posted its eighth consecutive year of record earnings, exhibiting substantial resilience and strength in rebounding from the troubles of the late 1980s and early 1990s. In doing so, banks have contributed substantially to, and benefited enormously from, the longest economic expansion in our nation's history. Simply put, most people in our country have never had it so good. And yet even as we celebrate our good fortune, we must bear in mind that this very prosperity exposes the seemingly unstoppable US economy to certain very real risks.

Today I would like to discuss the important issue of maintaining sound lending practices at this critical juncture in the extraordinary economic cycle we are enjoying. I'll also address the impact of technology on banking, the Gramm-Leach-Bliley Financial Modernization Act, and conclude with an update on the effort to revise the Basel Capital Accord.

Unprecedented economic prosperity

At the dawn of the twenty-first century, we find ourselves at an unprecedented moment in the nation's economic history. The US economy has just completed its 37th consecutive quarter of expansion, the unemployment rate is at its lowest level in three decades and labor force participation by our adult population is at its highest rate since the Second World War, when these statistics included the millions of Americans in uniform. Meanwhile, inflation has remained all but dormant, something thought not to be possible when the economy is growing so rapidly and unemployment is so low. Our prosperity is the envy of the world, and our economic model is acknowledged everywhere to be one that works. It's not perfect, nor is it applicable in every detail to countries with different histories, cultures and values. Still, it is clear that in the longer run the market is better at allocating scarce resources than any version of a command economy.

Importance of maintaining sound credit standards

The remarkable duration of the current economic expansion and the strength of the banking system are not coincidental events. Without an effectively functioning banking system for encouraging, collecting and deploying society's savings in a fair and impartial way into productive investments, there would be little hope for our economy, or any other, to mobilize the real resources necessary for economic growth and stability.

With this in mind, one of my major concerns going forward is the quality of bank lending. Banks are now at a critical phase in the credit cycle. After years of high quarterly profits, low delinquency rates and comfortable capital ratios, it is easy to forget the fundamentals of sound lending. And, as any good coach will tell you, it's the fundamentals, the basics, that make or break your performance.

The most important of the fundamentals is maintaining rigorous credit standards, especially in an environment of increased competition for new and existing customers. Experience teaches us that the worst loans are often made in the best of times. And because things are awfully good at the moment, I can't help but remind bankers and supervisors alike that the sun doesn't always shine so brightly.

Indeed, sometimes it even rains. To paraphrase Mark Twain, reports of the business cycle's demise are greatly exaggerated.

In circumstances this favorable, loan officers must make doubly certain that there is every reason to believe that the loans they make are collectible. This is especially important for younger bankers who, given the length of this expansion, have never experienced a serious recession and may mistakenly view current conditions as ordinary rather than as exceptional. Lending granted on that erroneous basis would have grave consequences for the industry's ability to weather weaker economic conditions which are, to be sure, inevitable.

From a supervisory perspective, I believe it is time for us to exercise an extra measure of caution. We must ensure that banks' lending decisions continue to reflect a disciplined approach, one that matches a clearly defined risk appetite - and a well understood risk capacity - with a real sense of the returns that are necessary to cover that risk. I see such a supervisory approach as increasingly essential to counterbalance the pressures of the fiercely competitive markets in which banks are operating.

Maintaining sound credit standards is one of several significant challenges banks currently face. Another is that the spectacular rise in equity values and mutual funds has put competitive pressure on the core deposit base. As these lower-cost funds have been replaced with funding from the capital markets, principally commercial paper, pressures on interest margins and liquidity have intensified. Such funding shifts raise the important risk-management questions of how well institutions will function under stressful conditions, and whether enough has been done to maintain adequate liquidity. The decline in stable core deposits has also been coupled with a steady rise in average loan maturities, indicating a growing exposure to liquidity and interest rate risk.

Another challenge is to maintain pricing that appropriately reflects risk amid fierce competition - from other banks and from non-banks. Some institutions are responding to these pressures by moving lower on the credit-quality spectrum in a reach for higher nominal yields. Too many lenders learn too late the difference between nominal and risk-adjusted yields. Other institutions are beginning to recognize that non-traditional lending programs, when done right, may have hidden costs in the form of higher overhead and increased management attention.

Clearly, then, these are not trouble-free times. Banking is a business of identifying, measuring and managing risk, and significant risks remain, even as we enjoy remarkably favorable circumstances.

New opportunities

Of course, these also are times of enormous opportunity for banks. The rapid pace of technological advancement and recent legislative changes are opening new frontiers for banks and other financial institutions.

For example, the convenience of the Internet is changing how consumers shop for financial products and services and with which providers they establish relationships. In response, some institutions are seeking alliances or mergers to broaden the range of products and services they offer, such as the proposed acquisition of US Trust, a bank offering advisory services to high net worth individuals, by Charles Schwab & Co., one of the largest discount brokerage firms.

Once viewed mainly as a cost center, technology now is increasingly seen by banks as a means to enhance the value of customer relationships through cross-selling and improved customization. As a result, developing an Internet platform and other technological capacities is a major priority for many financial service providers. Indeed, a recent survey reported that US bank managers for the first time cited investments in Internet technology as their top budget priority, ahead of other traditionally key budget items such as investments in call centers and brick-and-mortar branch networks.

The focus on the Internet as a distribution channel is eroding boundaries between financial service providers and technology firms. Banks are increasingly providing technology services to customers, such as providing account reconciliation software. Likewise, technology firms are making inroads into services once thought the domain of banks and brokerage firms, such as financial planning or paying bills. Banks and brokerage firms are also partnering with Internet "portals" such as Yahoo! and America Online to offer services to Internet users.

It is still far too early to determine just how, or to what extent, the Internet will change the financial services sector. For instance, it is important to note that, with few exceptions, most banks view the Internet as an important supplementary distribution channel and not as a replacement for branches that give you a physical presence in the communities you serve. Moreover, the true value of cross-selling remains uncertain, and the ability to collect and use personal data will have to be balanced against the demand for more protection of consumer privacy. On the commercial side, the largest institutions are actively pursuing the emerging "business-to-business" e-commerce markets, but the experience there is still too fresh to offer much insight into how those markets will evolve.

As we struggle with our own assessment of the impact this remarkable technology is having on the industry, supervisors must take care that our efforts to ensure the safe and sound operation of the financial markets do not stifle innovation and vitality the Internet is injecting into our economy. To that end, we are developing examination methodologies and supervisory guidelines for banks with Internet operations, and, with our colleagues in other jurisdictions, are assessing cross-border issues raised by e-banking.

Of course, the other great source of new opportunity for banks and other financial institutions is the Gramm-Leach-Bliley Financial Modernization Act, which President Clinton signed into law last November. As you know, the Act repeals those provisions of the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956 that restrict the ability of bank holding companies to affiliate with securities firms and insurance companies. The Act authorizes bank holding companies that are well-managed and well-capitalized to become "financial holding companies" (FHCs) and to engage in a diversified range of financially related activities, including commercial banking, securities dealing and underwriting, and insurance agency and underwriting activities.

Passage of the Act is of truly historic significance, effecting reform that we at the Federal Reserve, and many of you, have supported for years. Together with the repeal of inter-state branching restrictions, the Act provides long-overdue modernization of our banking laws, making them more consistent with marketplace realities and the needs of today's financial services customer. Management will now enjoy greatly enhanced freedom and flexibility in determining how to best deliver products and services to the marketplace, and the market will judge the correctness of those choices.

Some have perceived the newly authorized powers to benefit only large bank holding companies. This is not correct. The strategic freedom the Act provides is available to all banking organizations, regardless of size. Indeed, more than two-thirds of initial institutions seeking to become financial holding companies have assets of less than $1 billion. Institutions will have to decide for themselves how, or even whether, they should take advantage of the newly authorized activities to build value for their customers and shareholders.

Many franchises will succeed by focusing on traditional, face-to-face banking, which continues to have real economic value. Newer technological capacities and techniques are awe-inspiring, to be sure, but effective and profitable banking is ultimately about trust, and human nature hasn't changed - we still appreciate a face across the desk. In addition, as some large organizations have become even larger through mergers, many community banks have been able to attract customers whose needs have not been met by larger institutions.

How institutions pursue new opportunities will be just as important as their decision whether to pursue. It is one thing to gain FHC status and begin to prudently experiment with new powers, and quite another to dive head-long into the deep end of the pool with full-scale acquisitions or rapid expansion into new businesses. Personally, I am encouraged that we have not seen a tidal wave of public announcements declaring large-scale affiliations among banking, brokerage and insurance firms. Passage of the Act may well lead to a few more mergers among larger firms specializing in different financial service sectors and aiming to take advantage of perceived synergies and cost advantages. But we shouldn't be surprised if the Act has only limited immediate structural impact. This view is based on several observations:

- On the commercial bank/securities side, the Act to a great extent reflects structural reality. Following the liberalization of the rules governing so-called Section 20 subsidiaries in 1996, several dozen securities firms were acquired by bank holding companies over the 1998-99 period. There are now 51 active securities affiliates, most of them in this district. I think that most bank holding companies that want to engage in securities dealing are doing so already.
- On the insurance side, many banks have been engaged in agent activities for some time, particularly following the Supreme Court's 1996 Barnett Bank decision. However, it remains unclear whether more than just a few banks have real interest in underwriting insurance. Moreover, many insurance firms are mutual companies, which would prevent mergers and acquisitions, at least until they became stock companies.
- Another factor that may slow merger activity is that the strategic trend among the vast majority of bank holding companies in the United States has been toward specialization - focusing on core businesses or a core customer base, which in turn determines the type of products and services offered.

In past years, some criticism has been leveled at the industry for announcing mega-deals in what was perceived to be a response to peer pressure, rather than compelling economic reasons. I'd like to think that the disappointing post-acquisition results of some of these unions have taught the industry to think more strategically, and to weigh more carefully all the pros and cons of pursuing such transactions. Deciding what combination of traditional and new activities will best create long-term economic value for your customers and shareholders will be a leading challenge as you contemplate the future of your organizations.

Challenges for supervisors

The continuing evolution of the financial services industry and a newly modernized legal framework also pose significant challenges to supervisors. What are the objectives of supervision in the twenty-first century? How can those objectives be best pursued? Let me say first of all that there is no easy, single answer to these questions. The modern financial marketplace is too dynamic, too complex. We at the Federal Reserve, along with our domestic and international colleagues, are working hard to devise a flexible, multi-faceted strategy that emphasizes prudence and problem prevention, compatibility with the market, and a close and cooperative working relationship between the private and public sector.

With these priorities in mind, I believe there are three essential elements of a modern supervision framework - effective bank-level management, market discipline and official supervision.

Effective bank level management includes sound corporate governance, rigorous internal controls and effective risk management. Together these elements represent the first and most important line of defense against potential problems. This is increasingly the case as the activities of banks and other financial institutions become more complex and more global.

The second line of defense against financial instability is market discipline, which has become an increasingly important ally of the official supervisor. Of course, effective market discipline is not possible without meaningful public disclosure and more selective additional disclosure to counterparties. While significant progress has been made in recent years, it unfortunately remains the case that disclosure practices have not kept pace with the rapid changes in banks' business activities and risk exposures, and how these exposures are measured and managed.

For this situation to be fully remedied, notions of what is proprietary information and what should be in the public domain need to change. Knowing a company's appetite for risk and its approach to, and methodologies for, managing risk is essential to understanding the risks of being a shareholder, a creditor or a counterparty. I strongly encourage all financial market participants - commercial and investment banks, domestic and foreign - to approach the issue of disclosure as users of financial statements rather than as issuers. Clearly, a full appreciation of risk cannot be achieved without sufficient information. What we need to know about each other to be comfortable and secure in making our credit decisions should drive the debate.

While effective bank level management and meaningful market discipline are crucial elements of an overall strategy for promoting and preserving financial stability, neither can substitute for the critical role played by official supervision. While banks perform functions that are indispensable to the success of any market economy, these same functions, by their very nature, introduce risks that are capable of undermining the prospects for such success. This reality was acknowledged by Adam Smith over two centuries ago in his seminal tract The Wealth of Nations. It is with this fundamental reality in mind that governments have long recognized that banking and other financial institutions must be subject to some form of regulation and official oversight.

The Gramm-Leach-Bliley supervisory framework

The Gramm-Leach-Bliley Act presents major challenges to US supervisors. Under the terms of the Act, the Federal Reserve will continue to serve as the umbrella supervisor of all bank holding companies, including the newly authorized FHCs. However, the Act envisions oversight of the bank by the appropriate banking agency and functional supervision of individual non-bank subsidiaries - that is, SEC oversight of broker/dealers and oversight of insurance companies by state insurance departments. While the Act permits the Federal Reserve, under specifically defined circumstances, to seek information directly from or even examine non-bank subsidiaries of FHCs, the Act also stipulates that the Fed must rely "to the fullest extent possible" on publicly available information, externally audited financial statements, and reports and other information submitted to the functional supervisors.

We at the Federal Reserve take this aspect of our revised role - sometimes referred to as "Fed-lite" - very seriously. Clearly, it was not the intention of Congress to replace outdated and overly restrictive aspects of Federal banking law with a needlessly onerous and redundant regulatory regime. Moreover, functionally regulated firms should be able to compete on an equitable basis, whether or not they happen to be affiliated with a bank. To minimize regulatory burden and avoid duplication, the two-tiered framework of umbrella supervision of financial holding companies and functional regulation of their subsidiaries requires enhanced cooperation and coordination among Federal and state supervisory authorities. Efforts are well underway among the relevant Federal and state financial services authorities to establish agreements and procedures to effectively implement Congress' mandate.

Before moving on, I want to address the topic of community reinvestment in the context of Gramm-Leach-Bliley. As you may be aware, over the course of debating and negotiating the details of the Act, some members of Congress wanted to strengthen CRA requirements, while others wanted them rolled back. In the end, of course, the two sides compromised. Some have argued that those desiring to weaken CRA prevailed because, among other things, the Act extends the interval between compliance examinations for highly rated institutions. I disagree with this perspective.

Under the new law, bank holding companies cannot become financial holding companies or engage in any financial activities newly authorized by the Act unless all of their depository institutions have CRA ratings of satisfactory or better. And should any depository institution subsidiary of an approved FHC subsequently fail to maintain a satisfactory CRA rating, the FHC would be prohibited from commencing any new financial activities. In this way, the Act extends the ramifications of poor CRA performance to potential nonbank activities. It also provides powerful incentives for expansion-minded companies to achieve and maintain at least satisfactory CRA ratings. In my view, this amounts to a reaffirmation of the key principles of the Community Reinvestment Act.

Revision of the 1988 Basel Accord

Let me move on to the Basel Committee's major initiative to revise the Capital Accord. The primary tool of capital regulation currently is the set of minimum ratios that were devised in 1988 by the Basel Committee on Banking Supervision, which I have the honor to chair. Without question, the Accord was a milestone achievement - for the first time, supervisors in G-10 countries were able to use a common yardstick for assessing banks' capital adequacy.

But the Accord has a number of serious shortcomings. It does not adequately differentiate among degrees of credit risk and, as a result, banks have had incentives to take on higher risk exposures within broad risk categories. Banks have also tended to engage in transactions that lower regulatory capital requirements without reducing economic risk. For example, through asset securitization a bank may physically transfer assets off its balance sheet, but still retain some or even all of the associated risk. In addition, it has proved difficult to incorporate into the Accord's simple risk-weighting scheme the innovations of the last decade in the way banks manage and mitigate risk. As credit risk management techniques advanced, and as the importance of managing operational risk has been increasingly recognized, the long run relevance and efficacy of the Basel Accord has been eroded.

In June of last year, the Basel Committee released a Consultative Paper laying out its vision for a new, more refined capital adequacy framework - one that more accurately distinguishes degrees of credit risk, and that is appropriate for banks of varying levels of sophistication. The Consultative Paper represents an evolution in the Committee's approach to capital adequacy because, in addition to establishing minimum capital requirements, it places increased emphasis on the supervisory review of capital adequacy and the role of market discipline.

We refer to these elements - minimum capital standards, supervisory review and market discipline - as the "three pillars". Together these pillars mutually reinforce safety and soundness by aligning capital relative to risk and by encouraging prudent risk management. This evolution in the Committee's thinking follows from much of its recent work on risk management and surveys on banks' disclosure practices. It is also consistent with the broader notion of supervision that has evolved since the original Accord.

An important objective of the Consultative Paper was to convey the Committee's thinking and to solicit the industry's input. As you may know, the formal consultative period on the proposed capital framework ended just a few days ago, on 31 March. We are very pleased by the response. Comments have been received from a broad range of industry participants including banks of varying sizes, some of which I see represented here today, banking associations, securities firms, central banks and supervisory agencies, as well as rating agencies.

It will take some time to thoughtfully and thoroughly review all of the comments received. Still, I thought it would be useful to discuss some of the major themes we've been able to identify. Based on the views expressed by industry participants and the work the Committee is currently engaged in, I can tell you that we are firmly committed to the use of banks' internal ratings as an approach for setting regulatory capital requirements.

Internal ratings

Many of you in the industry have noted that a capital regime based on banks' internal ratings, which reflect a wide range of information about borrowers, can prove to be quite sensitive to the level of risk in a bank's portfolio. From a supervisory standpoint, an internal ratings-based approach can also provide banks with the proper incentives to improve their risk management practices, which is consistent with our overall objectives for revising the Accord.

With this in mind, the Committee is actively exploring how to link banks' internal ratings to a regulatory capital scheme. We are seeking to develop flexible approaches since all banks wishing to use internal ratings may not yet be able to generate the complete set of information necessary to tie ratings to capital requirements. Thus, for at least some banks, we are investigating the possibility that some of the information would have to be supplied by the supervisor, even while the core elements were supplied by a bank's internal ratings scheme.

As an important first step in developing these approaches, the Basel Committee has been gathering information about banks' internal ratings systems, and assessing both "best" practice and overall sound practice in this area. In January of this year, the Committee released a paper on the range of current practices in banks' internal ratings systems. As the Committee builds on this work to develop operational proposals, we will be focusing on the need for banks to have robust standards and procedures governing the assignment of internal ratings, as well as the need for the Committee to establish appropriate supervisory guidelines. In this vein, we will be working to ensure that disclosure practices regarding internal ratings systems play an important role in the ongoing supervisory validation of these approaches.

External ratings

Of course, I also expect that a revised standardized approach will be a critical element of the new capital adequacy framework. As you may know, last June's consultative paper described a revised standardized approach building on the current Accord by tying risk weights to external credit assessments, such as credit ratings. In other words, OECD membership would no longer be relied on for setting regulatory capital for sovereign or bank claims. For example, loans to similarly-rated banks located in OECD and non-OECD countries would receive the same risk weight.

Industry participants have expressed support for the use of external ratings as an alternative to the current OECD/non-OECD distinction. Comments have also been received in favor of incorporating greater credit risk differentiation into the standardized approach, particularly for credit exposures to corporate entities. Some respondents have suggested that this might be achieved by introducing additional risk buckets into the framework. In considering suitable options, the Committee will have to balance technical complexity with a realistic understanding of practical considerations.

The Committee also is addressing what some observers have noted is the potential for introducing greater cyclicality via a more risk-sensitive capital framework. That is, the capital requirements for loans to troubled borrowers will tend to increase at just the point when such trouble is becoming apparent. This is an important point, and one that must be given serious consideration. It is my view that the global financial system needs to move toward addressing potential credit problems preemptively - before these problems have time to grow from minor disturbances to major disruptions. A more risk-sensitive capital framework should help ensure that banks hold appropriate capital behind high-risk credits in the first place, and thus reduce the cyclical tendency for retrenchment that often follows problems with such loans.

Credit risk mitigation techniques

Greater recognition of the benefits of risk mitigation techniques - such as collateral, guarantees and credit derivatives - also is at the forefront of the Committee's work in revising the Accord.

The Committee learned a great deal from recent consultations with over 50 banks and industry associations within the G10 on their methods for mitigating credit risk. We are now evaluating how best to incorporate the risk reducing benefits of such techniques, while at the same time addressing potential residual risks that may arise from their use. For example, changes in the market value of collateral received may result in a failure to fully cover the value of the underlying credit exposure. Residual risks could also arise when the maturity of the credit protection provided is shorter than that of the underlying exposure.

As I mentioned, we are now evaluating the comments received on the Consultative Paper and aim to publish, by early next year, a comprehensive set of proposals that will be responsive to the industry's input. I am confident that the broad goals we set out in June of last year - a "three-pillared" up-dated approach to capital adequacy - will remain. We will achieve our objectives through risk-sensitive capital requirements, effective supervisory oversight as a complement to minimum capital standards, and recognition of the role that market discipline can play in encouraging prudent risk-taking by banks.

Conclusion

I believe all of us are beginning the twenty-first century with an ambitious agenda. In pursuing the objectives of sustained prosperity and a modern, flexible yet stable financial system, we must all acknowledge that both the public and private sectors have a critical role to play. While the perspectives of market participants and official supervisors may differ from time to time, our objective is the same - to maintain a strong and vibrant financial system. Indeed, it is evident to me, as a former commercial banker and now as a supervisor, that only if we work together, each meeting our responsibilities and reinforcing the other, will we be able to successfully manage and supervise a rapidly evolving, ever-more complex financial services industry.