Susan S Bies: Bank performance and corporate governance

Remarks by Ms Susan S Bies, Member of the Board of Governors of the US Federal Reserve System, at the 112th Annual Meeting of the Tennessee Bankers Association, Hot Springs, Virginia, 11 June 2002.

* * *

Good morning. Thank you for the invitation to speak to members of the Tennessee Bankers Association today. I have really enjoyed getting to talk to many old friends. Some of you have asked if I have had any surprises in my new role as a Governor of the Federal Reserve Board. I must say the biggest surprise is the amount of reading that I do. I haven't read so much on so many different topics since I was in graduate school! Not only do I get to discuss economics and monetary policy, but also bank regulation and operations issues. Even though I have experience at a Federal Reserve Bank and at First Tennessee Bank for a total of twenty-six years, I find that wearing the hat of a central banker makes me consider issues facing the financial industry in new ways. I hope that over the years I can continue to meet with groups like yours so that I stay up to date on issues important to bankers.

In my comments today, I will address: first, the financial performance of U.S. banks, in particular, of community banks; second, the improvements that banks large and small are making in measuring and managing risk; and, third, the responsibilities of directors and senior managers in corporate governance. In my view, these topics are integrally linked and, in light of current questions of confidence in America's corporations, quite timely.

Fourth and finally, I would also like to mention the proposal the Federal Reserve has issued for comment on changes to the discount window.

Financial condition of U.S. banks

Last year was exceptional in many respects, with the United States slipping into what appears to have been a mild recession, and with the terrorist attacks in September. In response, the Federal Reserve reduced interest rates at every meeting of the Federal Open Market Committee in 2001 and an additional three times between meetings, for a total of eleven rate cuts accumulating to 475 basis points. The Federal Reserve has now moved from a policy bias to address weakness, to one where the risks of inflation and weakness are balanced. Credit quality deterioration is concentrated in larger corporations, with several filing for bankruptcy. Serious concerns have arisen about the integrity of corporate management and financial reporting. Argentina's economic difficulties reminded us, yet again, that exposures to emerging economies could present substantial risk.

Given these events, the U.S. banking system has remained strong, possibly in large part because the recession in this country seems to have been relatively mild and short-lived. More directly, the strength seems also to reflect improvements in risk management at many banks and a greater awareness throughout the industry that institutions should promptly address problems as they emerge. This time both the banking industry and the regulatory agencies appear to have done just that--acted promptly--and without going too far and unnecessarily constraining credit.

Much of the weakness among banks recently has been concentrated in large regional and money center banks, rather than in smaller institutions. Bank earnings reached a record level in the first quarter of 2002, with one of the highest quarterly return-on-assets ratio ever reported of 1.33 percent. Net interest income was the driver of stronger revenue, despite lower commercial loan volume. Loan loss provisions were significantly above the first quarter of 2001, although below levels of the fourth quarter. Higher charge-offs were concentrated in commercial loans at large banks and in credit card specialty lenders.

What areas may present heightened risks to community banks today? First, for most of the past decade, community banks--particularly those in the asset range of $100 million to $1 billion--have actively expanded their commercial real estate lending. Since the early 1990s, larger community banks have expanded their commercial real estate portfolios from 13 percent of aggregate assets to 22 percent.

To date, these credits have generally performed well, and my comments are not intended to suggest a material concern. These credits, however, account for most of the group's increase in nonperforming

assets over the past year. Given the checkered history of commercial real estate lending and its increased relevance to many community banks, this portfolio must be monitored and managed carefully. We have often seen the cyclical nature of commercial real estate and its links to the general level of economic activity. The loss of anchor firms such as K-Mart, for example, may reduce the market value of certain shopping centers and the consumer traffic and the financial strength of nearby businesses as well.

The second area of potential risk relates to interest rates. For the industry overall, the Federal Reserve's rate cuts last year may have proved to be a mixed blessing. Lower interest rates undoubtedly eased payment pressures on many borrowers and prevented further deterioration in the quality of bank loan portfolios. Liability-sensitive banks saw their funding costs fall faster than loan and investment yields, and more than half of all banks had a wider net interest margin in the first quarter of 2002 than in 2001. However, lower interest rates will begin to narrow net interest margins for some institutions. Rates paid on deposits are close to their effective floors, and yields on loan portfolios are lower because of a record volume of refinancings and the falling prime rate.

Many banks responded to the low rates by sharply reducing their investments in Treasuries and shifting funds into mortgage-backed securities, as they searched for higher yields. Given the historically low interest rates at which recent mortgages have been originated or refinanced one might expect that these loans would be much slower to prepay than previous ones. As a result, the effective maturity, or duration, of bank securities portfolios--and of many loan portfolios, as well--has been extended.

Clearly, I am not about to forecast interest rates, something I've already learned that central bankers never do. Nevertheless, the interest-rate environment could present banks with a greater challenge later this year. Even stable rates could present increased risks, if savings and money market deposit account deposits flow out of banks as quickly as they came in last year. We should all ask ourselves how long depositors would be content earning the currently low rates as equity markets improve or interest rates rise once again. At some point, even loyal customers--those on fixed incomes, in particular--may blink and take steps to improve their returns.

Turning to the longer-term outlook, what are the prospects for community banks? They have historically had higher profitability, as measured by the return on average assets, than large regional and money center banks and, on an individual-institution basis, have enjoyed relatively strong asset and deposit growth.

A study recently published in the *Federal Reserve Bulletin* examined growth rates during the past fifteen years for large and small banks. Adjusting the data for mergers and acquisitions, the authors found that small and medium-sized banks--defined as those below the 100 largest--grew faster than the larger banks in virtually every year between 1985 and 2000. Moreover, the smallest banks, those below the 1,000 largest in terms of assets, grew the fastest of all in both deposits and total assets.

The banks did this the old-fashioned way, by earning more on assets than larger institutions. Although small banks have paid higher average deposit rates than the large banks have paid, their net interest margins were still much higher, and by a growing differential in recent years. Measured by return on assets, small banks have done as well as or better than large banks in all but a handful of years over the past decade and a half.

Managing risks

The health of financial institutions today also reflects the improvement in risk management process that has been ongoing at banks for years. Increasingly, the entire risk management process has become more quantitative, reflecting not only the enhanced ability and lower costs of collecting and processing data but also improved techniques for measuring and managing risk. Larger banking organizations quantify a borrower's probability of default, the bank's loss given default and its likely exposure at the time of default--practices upon which we are trying to construct new international capital standards.

The greater use of credit scoring has, it seems, improved risk management as well. Such tools should perform even better after the effects of the most recent economic slowdown are incorporated. Consumer credit models were developed after the 1990-91 recession, and so their reliability in predicting credit quality in the current slowdown is yet to be determined. Further, we are already observing increases in delinquencies in subprime lending. Since many of these borrowers did not have

significant access to credit in previous recessions, their ultimate default rate will also help to validate the strength of the new statistical models.

Community banks have greatly improved their management of interest rate risk in recent years. Information developed from models that are used to identify sensitivity to market changes in the mix of loans and deposits are now part of asset/liability committee meetings at community banks. As a result, managers can better anticipate changes in net interest income and respond appropriately to their unique competitive conditions.

Community bankers are also developing new revenue streams that will help to manage risk by diversifying sources of earnings. In addition, the fee income streams help to increase the cross-sell ratio with key customers. This in turn should improve customer loyalty, another factor that should help manage risk by stabilizing revenue. Providing the personal touch has served community banks well, but conducting sound market research and pricing to reflect competition, customer value, and risk are becoming more important for success.

The Arthur Andersen matters and other corporate events currently being addressed provide good risk management lessons for bankers as they try to increase earnings by cross selling more products. When line officers are compensated on sales and cross selling, a strong, independent quality assurance or risk review function becomes even more essential. For public accounting firms, strong quality assurance functions are needed to protect the core business integrity of attestation services when the firm is trying to win consulting contracts. In banks, where credit is still the dominant risk exposure, the chief credit officer should make sure unacceptable credit risks are not taken to win fee income business whose net revenue may not cover credit exposures.

Corporate governance

Another critical element of risk management is effective corporate governance. As bankers and bank directors, you have specific responsibilities to manage the risks at your financial institution and effectively oversee the system of internal controls. Not only are the activities of banks central to credit intermediation, in this country banks fund those activities in part with federally insured deposits. These deposits are the lowest cost source of funds for bankers because of the government's guarantee.

Bank directors are not expected to understand every nuance of banking or to oversee each transaction. They can look to management for that. They do, however, have the responsibility to set the tone regarding their institutions' risk taking and to oversee the internal control processes so that they can reasonably expect that their directives will be followed. They also have the responsibility to hire individuals who they believe have integrity and can exercise a high level of judgment and competence.

Interagency policy holds boards of directors responsible for ensuring that their organizations have an effective audit process and internal controls that are adequate for the nature and scope of their businesses. The reporting lines of the internal audit function should be such that the information directors receive is impartial and not unduly influenced by management. Internal audit is a key element of management's responsibility to validate the strength of their internal controls. If internal audit is outsourced, best practice is to not use the same firm for the external audit engagement.

Internal controls are the responsibility of line management. Line managers must determine the level of risks they need to accept to run their businesses, and assure themselves that the combination of earnings, capital and internal controls is sufficient to compensate for the risk exposures. Staff areas such as accounting, internal audit, risk management, credit review, compliance, and legal, independently monitor the control processes to ensure that they are effective and that risks are measured appropriately. The results of these independent reviews should be routinely reported to executive management and the board of directors. Both executive management and the board should be engaged enough in the process to determine if these reviews are in fact independent of the operating areas they are designed to review, and that the senior officers in those roles can speak freely on issues that need to be addressed.

Audit committee members should have regular time in meetings to talk with the outside auditors without managers present. Best practices for audit committee processes have been laid out many times, including in the 1980s by the Treadway Commission and in 2000 by the Blue Ribbon Committee. Beyond that, boards of directors and managers should periodically test where they stand on ethical business practices. For example, they should ask, "Are we getting by on technicalities,

adhering to the letter but not the spirit of the law? Are we compensating others and ourselves based on our contributions to the organization, or are we taking advantage of our positions?"

My intent today is to remind everyone of the importance of maintaining sound ethical practices to help protect the reputation of your bank. As recent events have demonstrated, if we fail to do so the market will enforce the discipline. And that discipline can be harsh.

Quality of accounting practices

The current framework of financial reporting in the United States effectively represents the performance of most corporations most of the time. Indeed the high quality of accounting standards in this country is one critical reason why capital markets are so efficient. But the lessons of the past few months remind us that accounting rules can be bent. For six years I was a member of the Emerging Issues Task Force of the Financial Accounting Standards Board. This is the rulemaking body that deals with divergence in practice. The EITF's role is to provide timely financial reporting guidance where divergence in practice is developing.

In the time I served on the EITF I came to understand that professionals could and did disagree on the best accounting standard to apply to a new type of transaction. That is at the very heart of the struggle to keep accounting standards current. The rapid pace of business innovations makes it impractical to have a rule in place to anticipate every business transaction. Rather, the more complex and dynamic the world of business becomes, the more important it is that accounting be based on strong principles that are sufficiently robust to provide the framework for proper accounting of new types of transactions. Further, we need to insist on higher professional standards and not permit financial officers and auditors to benefit from "gaming" the rules-based accounting standards that are increasing in complexity, particularly in the United States.

The core of these basic accounting principles should be professional standards followed by every corporate accountant and every outside auditor that would insist that they can answer "yes" to these questions: "Does the accounting method selected faithfully represent the economics of the transaction? Does the disclosure provide the user of financial reports with sufficient information to discern the nature of the significant transactions and risks of the organization?"

But rules alone do not guarantee good financial reporting. For Enron and other recent examples, weak corporate governance practices apparently permitted sham transactions and misleading financial reporting to occur. Outside auditors erred in trying too much to please a paying client. They forgot that their professional role is to provide assurance to users of financial reports that the quality of financial reporting meets the expectations of the marketplace.

Some observers have asserted that new accounting standards are needed. I do not know the specifics of many of the irregularities that have recently come to light. But judging from the publicly available information, I believe that what we need most is to restore the integrity of corporate accountants and the quality of the audit process rather than extensive new accounting standards.

One reason that accounting in the United States has become so rule-based is that we tend to add new accounting standards when abuses occur even when the abuses resulted from accounting and audit failures. Discipline against auditors should occur when accounting standards have been manipulated. The present industry-driven process clearly has not worked and a new oversight process is needed to ensure audit quality. Given human nature, we must expect that rules will sometime be broken. But we can expect oversight boards to enforce penalties appropriate to the situation that will discourage others from breaking the rules in the future.

Corporate boards and accounting officers need to shoulder their responsibilities too. The surprises that typically occur at banks are due to the nature of risk exposures and the quality of risk management practices. In addition to applying sound accounting treatments, managers must ensure that public disclosures clearly identify all significant risk exposures--whether on or off the balance sheet--and their effect on the firm's financial condition and performance.

I particularly want to emphasize that disclosure need not be in a standard accounting framework or exactly the same for all--otherwise we would be certain to create statistical artifacts and implications of safe harbors. Rather, we should insist that each entity disclose what it believes its stakeholders need to evaluate its risk profile. The uniqueness of risks and business lines in complex organizations means that disclosures--to be effective--should be different for each bank. That is the approach being taken in developing the Basel II Capital Accord. Disclosure rules that are built too rigidly while risk

management processes continue to evolve may make them less effective in describing the risk profile of a specific organization. But if bankers do not voluntarily improve disclosures, rules will be written.

Proposed changes to Federal Reserve discount window operations

As you probably know, the Board of Governors recently requested public comment on a proposal to revise the Federal Reserve's discount window programs. Before I get into details, I'd like to emphasize that implementation of the proposal would not entail a change in the stance of monetary policy. There is nothing in the proposal that would necessitate a change in the target for the federal funds rate or the level of interest rates more generally.

The Board is proposing the establishment of a new type of discount window credit, to be called primary credit, which would replace adjustment credit, currently the Federal Reserve's main lending program. Primary credit would be available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition. There would be no prohibition on lending the proceeds of a primary credit loan to other depository institutions. Unlike adjustment credit, which currently is extended at a below-market rate, primary credit would be extended at a rate that would be above the usual level of short-term market interest rates, including the federal funds rate.

By restricting eligibility to generally sound institutions and by eliminating the incentive for institutions to borrow to exploit the below-market discount rate, the primary credit program should considerably reduce the need for Federal Reserve discount officers to review the funding situations of borrowers. And since only sound institutions will be using primary credit, banks should be less concerned that their use of the window would signal incorrectly that they were experiencing significant funding difficulties. As a result, the Federal Reserve expects that institutions will be more willing to use the window. This increased willingness, and the ability of institutions to resell the proceeds of discount window loans, should improve the functioning of the window as a safety valve for the reserve market and for individual institutions.

The interest rate for primary credit would be set through a procedure identical to that currently used for the basic discount rate. That is, the boards of directors at Reserve Banks would set the rate, subject to review and determination by the Board of Governors. In the proposal, it is envisioned that the interest rate on primary credit would initially be set 100 basis points above the target federal funds rate. If adopted, this program would align our lending practices to those of other major central banks.

The Board also is requesting comment on the seasonal credit program. The seasonal credit program was established in 1973 to address the difficulties that relatively small banks with substantial intra-yearly swings in funding needs faced because of a lack of access to the national money markets. However, funding opportunities for smaller depository institutions have expanded significantly over the past few decades as a result of deposit deregulation and the general development of financial markets, calling into question the continued need for the seasonal program. The Board is seeking specific comment on whether small depository institutions still lack reasonable access to funding markets and on the continued need for the seasonal lending program. The Board would also like comment on the method for setting the seasonal credit discount rate, which is currently the average of the federal funds rate and a certificate of deposit rate, well below the proposed primary credit rate.

We would value your comments on all aspects of the proposal. The ninety-day comment period ends August 22. Information on where to address the comments, and more information on the proposed revision, can be found on the Board of Governors' website.

Conclusion

In closing, I commend you and the industry, generally, for successfully dealing with the challenges of 2001. The industry has demonstrated that it is fundamentally sound and well positioned.

Bankers should support the development of risk management processes for those types of risk that are most relevant for their particular institution.

Sound accounting, auditing, and disclosure, consistently applied, have long been at the heart of efficient markets. Though the quality of bank accounting and control systems is strong, bankers should heed lessons to be learned from Enron and other breakdowns in accounting and audit processes. Strengthen corporate governance where needed to prevent such abusive practices from occurring at your institutions.

As bankers and bank regulators, we are responsible for conducting our affairs with competence and integrity. Let’s take the opportunity times like this present and make our banking system even stronger.