Susan S Bies: Bank performance and corporate governance

Speech by Ms Susan S Bies, Member of the Board of Governors of the US Federal Reserve System, before the Pennsylvania Association of Community Bankers, Memphis, Tennessee, 28 September 2002.

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Good morning. Thank you for the invitation to speak to members of the Pennsylvania Association of Community Bankers and to return to my home of twenty-four years, Memphis, Tennessee. 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 that the biggest surprise is the amount of required reading. 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--as chair of the Board's bank supervision committee--I am deeply involved in bank regulation and operations issues. Even though I brought with me twenty-seven years of banking experience, including an earlier stint with the Federal Reserve, I find that my current responsibilities make me consider issues in new ways. Consequently, I look forward to meeting with groups like yours so that I have a better understanding of emerging issues from diverse perspectives.

In my comments today, I will first address the recent financial performance of U.S. banks, and of community banks in particular. I will then turn to improvements that banks large and small are making in measuring and managing risk, the responsibilities of directors and senior managers in corporate governance, and finally, to the importance of sound accounting practices. In my view, these topics are inextricably linked and in light of continuing questions of confidence in America's corporations, they are quite timely.

Financial condition of U.S. banks

Last year was exceptional in many respects, with the United States slipping into a recession, the September terrorist attacks, the stock market declines, and all of the related events. 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. Since then, the Federal Reserve has shifted its bias from one in which we were concerned more with weakness, to one in which the risks of inflation and weakness were balanced, then back again--most recently--to a concern about economic growth.

The direct effects of the past year's stressful events were painful enough. In addition, abusive accounting and corporate-governance practices made conditions worse, as large corporate bankruptcies imposed substantial losses on investors, lenders, and employees. These domestic events increased the uncertainty about earnings reported by other firms and dampened financial markets that were already weak. Abroad, Argentina's economic and political difficulties reminded us, yet again, that exposures to emerging economies can also present substantial risk.

Throughout this period, the U.S. banking system remained strong, reporting continuing record earnings and profitability, despite a slip in asset quality. During the first half of this year, U.S. insured commercial banks earned more than $44.5 billion and an annualized return on assets of 1.37 percent. Both figures represent the industry's best six-month performance ever and reflect impressive growth on top of what were already impressive results.

Net interest income was the primary driver of increased revenue, despite a notable decline in commercial loan volume. Loan loss provisions remained relatively high by the standards of most of the past decade but dipped notably from the second half of 2001. Net charge-offs, which were concentrated among commercial loans of large banks and credit card specialty lenders, also dropped. While this improvement since year-end may signal that problem assets have peaked, some large institutions have not yet fully recognized the results of this year's supervisory assessment of shared national credits. Consequently, we may see further deterioration in asset quality during the periods ahead. Moreover, the general economy needs to strengthen further before we can be much more comfortable that we're out of the woods.

As noted, current weaknesses appear to be largely within the commercial loan portfolios of large regional and money center banks rather than those of smaller institutions. Even the problems of large banks could be viewed as mild, however, given the shocks felt by many in their customer base. In some respects, bank performance may reflect improvements in risk-management practices and also the greater diversification of revenues and exposures that has occurred in the past decade. Bank performance also reflects, I believe, a greater awareness by institutions throughout the banking system that they should promptly address problems as they emerge.

During this recession and recovery, both the banking industry and the regulatory agencies appear to have responded well, by acting in a timely manner and without unnecessarily constraining bank credit. That positive outcome was made easier, of course, because the banking system was strong as challenges began to build. Because the industry had the earnings and capital to absorb increased losses, there was time and opportunity to deal more calmly with emerging weakness.

If smaller banks, generally, are not seeing the commercial loan weakness that some larger institutions are facing, which areas may present them with heightened risks? A couple of possibilities come to mind. 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 these portfolios from 13 percent to 22 percent of aggregate assets.

Most Reserve Banks are reporting generally weak commercial real estate markets, as failing companies vacate office and retail space and renters move into single family homes. Commercial real estate credits are still performing relatively well for this stage of the cycle, and my comments are not intended to suggest a material concern. Nevertheless, they account for most of the increase in nonperforming assets over the past year for large community banks. Given the checkered history of commercial real estate lending and its increased relevance to many banks, this portfolio must be monitored and managed carefully. We have seen before 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 interest rate cuts last year certainly appear to have helped bank earnings, but they present management with new challenges, too. Lower rates undoubtedly eased payment pressures on many borrowers and prevented further deterioration in the quality of bank loan portfolios. Nearly 60 percent of all banks also saw wider net interest margins in the first six months of 2002 than in the comparable period of 2001. At some point, however, lower interest rates may begin to compress net interest margins for some institutions as deposit rates reach their effective floors. Those holding low-yielding, long-term assets could get hurt.

Indeed, many banks have responded to the low rates by sharply reducing their investments in Treasuries and shifting funds into mortgage-backed securities in the search for higher yields. Given the historically low interest rates at which recent mortgages have been originated or refinanced, one might expect these loans to be prepaid much more slowly than they have typically been in the past. 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. My point is that banking organizations, and investors generally, should recognize that domestic interest rates are historically low and that the possibility for a rising rate environment should not be overlooked. Even stable rates could present increased risks, if savings and money market deposit accounts flow out of banks as quickly as they came in when equity markets declined. We should all ask ourselves how long depositors would be content to earn the currently low rates when those markets stabilize or 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 own yields.

Managing risks

The health of financial institutions today is also a result of improvement in the 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 to collect and process data at lower cost, but also improved techniques for measuring and managing risk.

As you are aware, bank regulators are working to develop a more modern international approach to bank capital--called Basel II. Although those standards, in the first instance, are being designed to address changing practices at large, internationally active banks, we can expect the lessons learned about risk management to have much broader effects. We do not anticipate, for example, that large numbers of banking organizations in the United States would formally adopt the data and analytically intensive and sophisticated processes to determine regulatory capital under development today. The costs and resources to develop such systems and frameworks are beyond the resources of all but a limited number of very large banks. We would expect, though, that the effort would eventually strengthen risk management and provide best practice examples industry wide.

In quantifying credit risk, larger banking organizations are taking the lead, measuring a borrower's probability of default, the bank's loss given default and its likely exposure to the borrower at the time of default, taking into consideration future draw downs.

The greater use of credit scoring in retail transactions provides a stronger framework to assess risk and ensure that loan pricing reflects the credit quality. Such tools should perform even better as the effects of the most recent economic slowdown are incorporated into bank statistics. Most consumer credit models were developed after the 1990-91 recession, and so their reliability in predicting default rates and losses during a severe economic slowdown is yet to be fully tested. We are already observing, for example, significant 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 should help validate the strength of the new statistical models.

The measurement and management of interest rate risk has also improved greatly in recent years, perhaps particularly at community banks. Asset/liability committees at banks throughout the country now routinely consider the results of models developed either internally or by vendors to identify the market sensitivity of loans, investments, and deposits. As a result, managers can better anticipate changes in net interest income and develop responses to their specific circumstances.

The industry is also developing new revenue streams and diversifying its earnings sources. Such efforts help increase the cross-sell ratio with key customers, which in turn should improve customer loyalty and further stabilize a bank's revenue base. Providing the personal touch has long served community banks well, but personalized service alone may become less sufficient in the years ahead. Conducting sound market research and pricing to reflect competition, customer value, and underlying risk are becoming more important for success.

Recent abuses of corporate accounting practices and other matters provide good lessons in risk management as bankers try to increase earnings by cross-selling more products. We have seen, for example, how conflicts of interest and the lack of a strong quality-assurance function destroyed the reputation and viability of a major accounting firm. Similarly, banks that compensate line officers on the basis of sales and cross-selling must guard against the adverse incentives that those compensation structures can provide. There, too, a strong quality-assurance function is essential. Given the dominant role of credit risk at banks, the chief credit officer should ensure that pressures to increase fee income do not lead to unacceptable levels of credit risk.

Corporate governance

Sound corporate governance is an essential element of a strong risk-management process. As bankers and bank directors, you have specific responsibilities to manage the risks at your financial institutions and effectively oversee the systems of internal controls. Not only are the activities of banks central to credit intermediation, but, in this country, banks fund their activities in part with federally insured deposits. Those deposits are the lowest-cost source of funds that banks have, specifically 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 institution's 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.

In the light of recent events, I might add that directors have the further responsibility to periodically consider whether their initial assessment of management's integrity remains correct.

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 that 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 a bank's internal controls. In the limited cases in which that function must be outsourced, best practice is to avoid using the same firm for the external audit as well.

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 must assure themselves that the combination of earnings, capital, and internal controls is sufficient to compensate for the risk exposures. Supporting functions such as accounting, internal audit, risk management, credit review, compliance, and legal, should 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 boards of directors. Both executive management and directors should be sufficiently engaged in the process to determine whether these reviews are in fact independent of the operating areas under review and whether the officers conducting the reviews can, indeed, speak freely.

The level of independence from executive management that a board can demonstrate has, of course, become a far more visible and more important factor in evaluating corporate governance. Recent audit failures have highlighted the value of sound practices, such as having audit committee members regularly meet privately with an institution's outside auditors to discuss matters without management present. The recent Conference Board and New York Stock Exchange recommendations, or prior reports by the Blue Ribbon Committee and the Treadway Commission in the 1980s describe best practices for audit committees and are worthy of your review.

This summer, the Sarbanes-Oxley Act took the matter of independence a step further, in the case of publicly traded firms, by incorporating specific requirements of independence into law. For example, all members of a company's audit committee must now be outside directors. Moreover, at least one of those committee members should be a so-called financial expert. If not, the firm must disclose why not. The legislation also assigns audit committees sole and direct responsibility for appointing, compensating, and overseeing the company's auditors.

Other provisions of the act set forth potentially broad ranging standards affecting the way public companies compensate their executives and directors and disclose their operating results. To strengthen the role of outside auditors, the act also limits the non-audit work such firms may perform for audit customers and creates an oversight board to regulate and oversee audit work.

Precisely how some of these legislative provisions will affect firms has yet to be decided by the Securities and Exchange Commission. Other provisions, though, are in effect now or will become effective soon and warrant immediate attention. Although the act applies only to institutions that register their shares with the Securities and Exchange Commission, its elements should be considered by virtually all commercial banks and by most other companies of any material size. They could well highlight weaknesses in your own procedures.

Indeed, beyond legal requirements, boards of directors and managers of all firms should periodically test where they stand on ethical business practices. They should ask, for example, "Are we getting by on technicalities, adhering to the letter but not the spirit of the law? Are we compensating ourselves and others on the basis of contribution, or are we taking advantage of our positions?"

Ultimately, of course, markets correct their excesses, and in this context "markets" include both the public and private sectors. Obviously, during the past year we've seen reactions not only from investors and creditors, but also from lawmakers and regulators, to observed failures within corporate boardrooms. All of the actions affect market practice.

My intent today is to remind you that as business and community leaders, you should recognize the value of exercising self-discipline within your own institutions. That includes maintaining sound ethical practices in protecting the reputations of your banks. As we have seen from recent events, the market's response can be harsh.

Quality of accounting practices

Uncertainty regarding the quality of corporate accounting standards strikes at the heart of our capitalist system and threatens the efficiency of our markets. Investors and lenders must be confident that they understand the risks they accept and that their counterparties are playing fair.

For six years I was a member of the Emerging Issues Task Force of the Financial Accounting Standards Board, which provides the accounting industry with guidance in areas where financial reporting practices are diverging. During that time, I developed a better appreciation for the challenges that standard-setters face when dealing with topics that are becoming increasingly complex.

Informed and objective professionals can legitimately disagree on the best accounting standard to apply to new types of transactions. That is part of the challenge of keeping accounting standards current. The rapid pace of business innovations makes it impractical to have rules in place to anticipate every business transaction. Rather, the more complex and dynamic the business world 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.

At the core of such accounting principles should be professional standards that every corporate accountant and every outside auditor must follow. In part, auditors should be required to ask themselves whether a particular accounting method adequately represents the economics of the transaction and whether it provides readers with sufficient information to evaluate the risks. If not, it is likely that the procedure is not the best accounting method to apply.

Rules alone, however, do not ensure good financial reporting. At Enron and other companies, weak corporate governance practices apparently permitted sham transactions and misleading financial reporting. Outside auditors erred in trying too hard to please an important client. They forgot that their professional role is to assure users of financial reports that the statements fairly represent the condition of the corporation and that they communicate, not conceal, the level of risk. Some observers have asserted that new accounting standards are needed. In some minor ways that may be true. But judging from 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 impose extensive new rules.

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. Rather than creating new rules, forming the new Public Company Oversight Board established by Sarbanes-Oxley may provide a better approach and help to refocus public accountants on core principles and away from more aggressive and misleading practices. Given human nature and the complexity of many accounting issues, we must expect that rules will sometimes be broken or misapplied. But a new, authoritative oversight board--combined with more-rigorous reviews by corporate boards--should be able to discourage and address severe abuses.

For its part, the Federal Reserve is also willing to challenge accounting interpretations that it sees as too aggressive. By no means do we intend to supplant accounting authorities in making rules, but we do intend to provide discipline, when necessary, in their interpretations--particularly in the context of regulatory reporting and in light of the weaknesses in quality-assurance processes in public accounting firms. For example, the Federal Reserve has required loan pools at one large bank to be re-consolidated into their financial statements when it was determined that risk and control were not removed from that organization through the creation of special purpose vehicles.

In another example, the banking regulators have jointly issued for comment new guidance related to credit cards. This guidance not only deals with unacceptable practices, but also clarifies that revenue recognition of fees billed to customers should reflect the expected ability to collect those fees. In addition to the recognition and measurement aspects of financial reporting, we need to continually evaluate the effectiveness of disclosures. Public disclosures by banks, as well as other firms, need not follow a standard framework that is exactly the same for all. Rather, we should insist that each entity disclose the information it believes its stakeholders need to evaluate its risk profile.

Each business line in a complex organization is unique, and--to be most effective--the specific disclosures of its risks should be different, too. Even in smaller organizations, disclosures should be tailored to reflect the activities of the organization. A summary of the information that is important for executive management and the board of directors in monitoring the health of the bank is an excellent place to start to tailor the information that would be useful to investors and customers. That is the approach being taken in developing the Basel II Capital Accord. Disclosure rules that are too rigid may be, or become, incompatible with risk-management processes that continually evolve. In this area and many others, the best results are likely to come from bankers and regulators working together.

Conclusion

In closing, I congratulate you and the industry, generally, for successfully dealing with the challenges of the past year. The industry remains fundamentally sound and has consistently demonstrated that it can deal with stress.

Nevertheless, no business can afford to remain static, and banks of all sizes should continually pursue better ways to manage risk. Following sound accounting, auditing, and disclosure practices consistently is also crucial to maintaining the confidence of capital and financial markets. We should learn from the experiences of this past year and ensure that our own accounting and control systems practices are sound. We should also take the opportunity to strengthen areas of corporate governance that may be weak.

As bankers and bank regulators, we are responsible for conducting our affairs with competence and integrity. As we do so, our banking system should grow stronger still.