Ms. Phillips' testimony before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services of the U.S. House of Representatives Testimony of a member of the Board of Governors of the US Federal Reserve System, Ms. Susan M. Phillips in Washington, on 8/10/97.

Madam Chairwoman and members of the Subcommittee, I am pleased to be here today to discuss the Federal Reserve's efforts in recent years to strengthen its supervisory processes and also to share with you the Board's views about what challenges lie ahead, both for the banking system and the supervisory process. As you know, the U.S. economy and its banking system have enjoyed half a decade of improving strength in which U.S. banks have become better capitalized and more profitable than they have been in generations. Moreover, in the past 13 months not a single insured bank has failed, and the Bank Insurance Fund is now capitalized at a level requiring most banks to pay only nominal fees for their insurance. While we can take comfort and, to some degree, satisfaction in these events, experience has demonstrated that at times like these -- if we are not vigilant -- risks can occur that set the stage for future problems.

As I begin my remarks, I would like to point out that no system of supervision or regulation can provide total assurance that banking problems will not occur or that banks will not fail. Nor should it. Our goal as regulators is to identify weak banking practices early so that small or emerging problems can be addressed before they become large and costly -- either to the insurance fund or the financial system as a whole. We believe that progress made in recent years to focus our examinations on the areas of highest risk at banking organizations places us in a better position to identify problems early, control systemic risk, and maintain financial stability. That goal and the need to adapt the supervisory process to the potentially rapidly changing conditions in banking and financial markets underlies our decision to pursue a more risk-focused supervisory approach.

We are well underway in implementing this new supervisory framework, and initial indications about that process from both the Federal Reserve's supervisory staff and the banking industry, itself, have been favorable. The risk-focused approach reflects our supervisory response to the effects that technology and financial innovation have had on the pace of change in banking organizations, the nature of U.S. and world financial markets, and the techniques employed for managing and controlling risk. As banking practices and markets continue to evolve, our emphasis on risk-focused supervision will be even more necessary in the years to come.

The Federal Reserve's Oversight Role

As the primary federal supervisor of U.S. bank holding companies, state member banks, and most U.S. offices of foreign banks, the Federal Reserve has sought to apply effective supervision and contain excessive risks to the federal safety net, while also ensuring that banks adequately serve their communities and accommodate economic growth. As the nation's central bank, the Federal Reserve brings a different, important perspective to the supervisory process through its attention to the broad and long-term consequences of supervisory actions on the financial system and the economy. Significantly, the practical, hands-on involvement which the Federal Reserve gains through its supervisory function supports and complements our other central bank responsibilities, including fostering a safe and efficient payment system and ensuring the stability of the financial system.

Past studies of bank failures have cited a number of contributing factors including, but certainly not limited to, inadequate supervisory staffing and antiquated examination procedures. Over the years, as it has supervised and regulated banking organizations, the Federal Reserve has emphasized periodic, on-site examinations that entail substantive loan portfolio reviews and significant transaction testing to identify emerging problems. In that connection, the Federal Reserve has sought to maintain a sufficient number and quality of supervisory personnel to conduct

examinations with appropriate frequency and depth. That approach appears to have provided us with some consistent success.

As conditions within the industry have substantially improved, the Board has been mindful of the cost of conducting its supervisory activities and has worked to contain those costs in the face of increased responsibilities. Throughout this period we have recognized the need to maintain stability in our work force, and have sought to avoid excessive build-ups or periods of disruptive retrenchment. That approach has enabled us to maintain what we believe has been an adequate and consistent level of oversight of banking organizations under our supervision during both good times and bad.

Developments Driving Change

During the past decade, the U.S. banking system has experienced a great deal of turmoil, stress, and change. Ten years ago, many of the country's largest banks announced huge loan loss provisions, beginning the process of reducing the industry's overhang of doubtful developing country loans. At the same time, many of these institutions and smaller regional banks were struggling with oil and agriculture sector difficulties or accumulating commercial real estate problems. These and other difficulties took a heavy toll. By the end of the 1980s, more than 200 banks were failing annually, and there were more than 1,000 other problem banks.

This experience provided important lessons and forced supervisors and bankers, alike, to reconsider the way they approached their jobs. For their part, bankers recognized the need to build their capital and reserves, strengthen their internal controls, and improve practices for identifying, underwriting and managing risk. Supervisors were also reminded of the need to remain vigilant and of the high costs that bank failures can bring, not only to the insurance fund but to local communities as well. The FDIC Improvement Act of 1991 emphasized that point, requiring frequent examinations and prompt regulatory actions when serious problems emerge.

Beyond these largely domestic, institutional events, banks and businesses throughout the world were dealing in the 1980s and 1990s with new technologies that were leading to a multitude of new and increasingly complex financial products that changed the nature of banking and financial markets. These technologies have brought many benefits that facilitate more efficient markets and, in turn, greater international trade and economic growth.

They may also, however, have raised macro-stability concerns by concentrating the growing volume and complexity of certain activities within a small number of truly global institutions. It is essential that these largest firms adequately manage the related risks of these activities and that they remain adequately supervised. For it is these institutions that have the potential to disrupt worldwide payment systems and contribute most to systemic risk. In addition to the formal supervisory oversight exerted by regulators, concerns may be eased somewhat by the strong counterparty discipline being brought to bear world wide on banks and other financial institutions dealing in these new products. The scrutiny among counterparties in the global market place has contributed to improvements in capital positions and in overall risk management practices.

In many ways, U.S. banks have been in the vanguard in applying technological advances to their products, distribution systems, and management processes, with such applications and innovations as ATMs, home banking, securitizations and credit derivatives. Such efforts, combined with greater attention to pricing their services and measuring their risks, have had material effects on the increased strength and profitability that our banks have seen.

Within the United States, our banking system has also experienced a dramatic consolidation in the number of banking institutions, with the number of independent commercial

banking organizations declining from 12,400 in 1980 to 7,400 in June of this year.[1] That structural change has also contributed to industry earnings by providing banks with greater opportunities to reduce costs.

The challenge going forward for many of these institutions may be in managing the growth and the continuing process of industry consolidation. This challenge may be greatest as banking organizations expand, particularly through acquisitions, into more diverse or nontraditional banking activities. That growth into a wider array of activities is especially important if banks are to meet the wide-ranging needs of their business and household customers while competing effectively with other regulated and unregulated firms. However, the managerial implications of rapid growth and growth into new activities should not be overlooked, either by the institutions or their supervisors.

Supervisory Challenges Ahead

There is also no shortage of tasks facing the Federal Reserve as a bank supervisor, despite the virtually unprecedented strong condition of the U.S. banking system today. We, too, must deal with the evolving financial markets and advances in technology. At the same time, we must ensure that our own supervisory practices, tools, and standards take advantage of technological improvements and financial techniques so that our oversight is not only effective, but also as unobtrusive and appropriate as possible. These tasks are wide ranging, extending from our own re-engineering of the supervisory process to the way supervisors approach issues such as measuring capital adequacy and how we seek convergence on bank supervisory standards worldwide.

Risk-focused examinations

Constructing a sound supervisory process while minimizing regulatory burden has been a long-standing and on-going effort at the Federal Reserve and an objective we have sought to advance with our emphasis on risk-focused examinations. Particularly in the past decade, we have found that the increased range of products and the greater depth and liquidity of financial markets permit banking organizations to change their risk profiles more rapidly than ever before. That possibility requires that we strike an appropriate balance between evaluating the condition of an institution at a point in time and evaluating the soundness of the bank's processes for managing risk. Recognition of the need for that balance is at the heart of the risk-focused examination approach.

The risk-focused approach, by definition, entails a more formal risk assessment planning phase that identifies those areas and activities that warrant the most extensive review. This pre-planning process is supported by technology, for example, to download certain information about a bank's loan portfolio to our own computer systems and target areas of the portfolio for review.

Once on-site, examiners analyze the bank's loans and other assets to ascertain the organization's current condition, and also to evaluate its internal control process and its own ability to identify and resolve problems. As a result, the Federal Reserve is placing greater reliance than before on a bank's internal auditors and on the accuracy and adequacy of its information systems. The review of the information flow extends from top to bottom, and with the expectation that bank senior management and boards of directors are actively involved in monitoring the bank's activities and providing sufficient guidance regarding risk assumption.

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[1] "Independent commercial banking organizations" is defined as the sum of all bank holding companies and independent banks. Multi-bank holding companies are, therefore, considered as a single organization.

As in the past, performance of substantive checks on the reliability of a bank's controls remains today a cornerstone of the examination process, albeit in a more automated and advanced form. For example, automated loan sampling is performed for the purpose of generating statistically valid conclusions about the accuracy of a bank's internal loan review process. To the extent we can validate the integrity of a bank's internal controls more efficiently, we can place more confidence in them at an earlier stage and can also take greater comfort that management is getting an accurate indication of the bank's condition. Toward that end, Board staff is working to refine loan-sampling procedures that should further boost examiner productivity and accomplish other supervisory goals. Moreover, as examiners are able to complete loan reviews more quickly, they will have more time to review other high-priority aspects of the institution's operations.

A significant benefit of the risk-focused approach is its emphasis on ensuring that the bank's internal oversight processes are sound and that communication between the bank and senior examiners is ongoing between examinations. That approach is generally supported by institutions we supervise and provides a more comprehensive oversight process that complements our annual or 18-month examinations. Such an approach strengthens our ability to respond promptly if conditions deteriorate.

Another benefit of the risk-focused approach has been a greater amount of planning, analysis, and information gathering at Reserve Banks prior to the on-site portion of the examination. Far from reducing our hands-on knowledge of the institution, this approach has ensured that when we are on-site, we are reviewing and analyzing the right areas, talking to the right people and making better use of our time and that of the bank's management and employees. In addition to improving productivity, it has also reduced our travel costs and improved employee morale.

Examination staff at the Reserve Banks indicate that this process may be reducing on-site examination time by 15-30 percent in many cases and overall examination time of Federal Reserve personnel by perhaps 10 percent. While those results are tentative, partial, and unscientific, they are certainly encouraging in terms of resource implications.

Complementing the risk-focused approach to supervision are enhancements to the tools we use to grade a bank's condition and management. Since 1995, we have asked Federal Reserve examiners to provide a specific supervisory rating for a bank's risk management process. More recently, the CAMEL rating system, too, has been revised by the banking agencies to place more emphasis on the adequacy of a bank's risk management practices and was expanded to include a specific "S" rating for an institution's sensitivity to market risk. As you may know, the Federal Reserve has also, for some time, used a rating scheme that focuses heavily on managerial procedures and controls in its oversight of U.S. branches and agencies of foreign banks.

How effective is the risk-focused process? Since economic and industry conditions have been generally favorable for the past several years, there has not been a sufficiently stressful economic downturn to test fully bank risk management systems or supervisory practices. The market volatility beginning in 1994 did, however, provide some tests for the risk management systems of the larger banks with active trading desks. Nevertheless, there are many indications that bank and supervisory practices are materially better than they were in the 1980s and early 1990s.

For example, the risk-focused approach is helping to identify certain deficiencies before they show up in a bank's financial condition. These are evidenced by instances where ratings for the quality of bank management are lower than those for capital, asset quality, or earnings. Because managerial weaknesses eventually show up in a bank's financial condition, it is important to identify and resolve those weaknesses early. In that regard, the risk-focused approach endeavors to prevent problems from developing to the point that they cause unnecessary losses that impair the institution's capital and require resolution under the Prompt Corrective Action mandate.

One example of how the risk-focused approach is helping to identify and address deficiencies is our supervisory experience with the U.S. branches of foreign banks. Subsequent to the enactment of the Foreign Bank Supervision Enhancement Act of 1991, which gave the Federal Reserve greater supervisory authority over foreign branches, our examinations uncovered a number of entities with internal control and audit weaknesses. This result was not completely unexpected, as these foreign banking organizations were not previously subject to the same level of oversight as our domestic organizations.

Recognizing the seriousness of these weaknesses and their potential for causing problems in the future, the Federal Reserve has taken a number of steps to ensure that practices are materially upgraded at foreign branches and that any weaknesses continue to be uncovered. In addition to identifying and addressing internal control and audit weaknesses through examinations and supervisory follow-up, these efforts include ensuring that the foreign bank provides the necessary managerial support to its U.S. branches, including adequate systems of controls and audit. To place even more emphasis on internal controls and audit systems, the foreign branch rating system was revised in 1994. Furthermore, in 1996 additional steps were taken to ensure that internal control weaknesses are corrected and will not cause financial harm by adopting requirements for audit procedures in situations where significant control weaknesses are detected.

These efforts to detect problems at their early stages and resolve them appear to be having positive effects. After peaking in 1993, there has been a steady decline in the number of U.S. branches and agencies with an overall examination rating of fair or lower and a rating of fair or lower in an examination component substantively affected by internal control and audit weaknesses. We believe that our continued efforts in this area will lead to further improvements in the internal control and audit practices of foreign banking organizations

Implementing the risk-focused approach has not been an easy task. It has required a significant revision of our broad and specialized training programs, including expansion of capital markets, information technology, and global trading activities, as well as courses devoted exclusively to internal controls. These education programs will, of course, need to be continually updated as industry activities and conditions evolve.

With the greater discretion provided to examiners to focus on areas of highest risk, ensuring the consistency and quality of examinations has increased in importance. Fortunately, new training courses and improved examination platforms, tools, and programs that guide examiners through the appropriate selection of examination procedures will help. In addition, our ability to evaluate more thoroughly the quality of an examination has improved with the greater depth of analysis provided in supporting examination materials such as the written risk assessments and analysis of exam findings. Those materials are allowing us to perform comparative reviews of examinations across institutions of similar size, risk profile and complexity, to ensure quality and consistency.

So far we have been able to evaluate the effectiveness of our examination programs by identifying whether problems are identified early and resolved in a timely fashion, by evaluating whether examination reports and findings provide clear feedback to management and identify areas of highest risk, and by monitoring the extent to which our examinations are complying with statutory mandates for the frequency of examinations. Based on those criteria, I believe our examination program has been generally successful.

Application of technology to supervisory process

The Federal Reserve has also done much to increase its own use of technology in an effort to improve examiner productivity, enhance analyses, and reduce burden on banks. Much of this effort has been conducted on an inter-agency basis, particularly in cooperation with the FDIC and state banking departments with whom we share supervision of state-chartered banks. Specific results include the development of a personal computer, lap-top workstation that provides examiners with a decision tree framework to assist them through the necessary procedures. The workstation also helps them document their work and prepare exam reports more efficiently. In addition, a software program has also been developed for receiving and analyzing loan portfolio data transmitted electronically from financial institutions. This process not only saves time but also improves the examiner's understanding of the risks presented by individual portfolios.

The Federal Reserve is also developing an electronic examination tool for large domestic and foreign banking organizations that enhances our ability to share examination analysis and findings and other pertinent supervisory information among our Reserve Banks and with other supervisory authorities. This platform should substantively improve our ability to provide comprehensive oversight to those firms that are most prominent in the payment system and global financial markets.

In addition to examination tools, the Federal Reserve has for many years maintained a comprehensive source of banking structure, financial, and examination data in its National Information Center. By year-end, we will have completed significant enhancements to the tools that provide examiners and analysts at the federal and state banking agencies with access to those data.

The Year 2000

One of the clearest reminders that managing technology is a challenge of its own is the need for banks to resolve the "Year 2000" problem. U.S. banks appear to be taking this matter seriously and are generally well underway toward identifying their individual needs and developing action plans. The Federal Reserve and the other federal bank supervisors are reviewing the relevant efforts of every insured depository institution in order to determine whether adequate progress on this issue is being made. This process should be complete by the middle of next year so that any detected deficiencies may be addressed in time. Meeting the demands of this review and ensuring proper remedies both before and after the year 2000 will be a significant and costly task to both the industry and the banking agencies.

However, even within the context of banking, the scope of the Year 2000 problem extends far beyond U.S. banks to foreign banks, bank borrowers, depositors, vendors, and other counterparties. Through the Bank for International Settlements and other international forums, the Federal Reserve and other U.S. banking agencies have emphasized the need for all institutions to recognize this issue and to address it actively. Importantly, century date compliance is gaining more attention internationally, and the Basle Supervisors Committee is taking steps to address this matter.

Banks and others need to address year 2000 system alterations, not only because of the potential effects on overall markets, but also as a threat to individual firm viability. At a minimum, banks should be concerned about their ability to provide uninterrupted service to their customers into the next millennium. If nothing else, it is simply good business.

Efforts to Accommodate Industry Growth and Innovation

Another goal of the Federal Reserve's supervisory approach is to remove unnecessary barriers that might hinder the industry's ability to grow, innovate, and remain competitive. Recently, the Board refined its application process to ensure that well-run, well capitalized banking organizations may apply to acquire banks and nonbanks in a more streamlined fashion and

commence certain types of new activities without prior approval. The Board also significantly revised various rules for section 20 companies and scaled back or removed many redundant firewalls. While these refinements require some changes to the supervisory process, we firmly believe that removing barriers to these lower risk activities is essential to maintaining the industry's health and competitiveness and its ability to serve its customers and the community.

Supervising nationwide and international institutions

The consolidation and transformation of the U.S. banking system resulting from evolving market, statutory, and regulatory changes are also requiring the Federal Reserve to adapt to new conditions. As previously noted, we are working closely with the FDIC and state banking agencies to deal with the challenges presented by interstate banking and branching to ensure that the dual banking system remains viable in future years.

To address that goal, the FDIC, the Federal Reserve, and the state banking departments began on October 1 a common risk-focused process for the examination of state-chartered community banks. Another initiative has been the State/Federal Supervisory Protocol, which commits the various banking agencies to work toward a "seamless" and minimally burdensome oversight process. In short, it sets forth a process in which state banking supervisors will accept the supervisory reports of other agencies for banks operating in their states through branches, but headquartered elsewhere. The fact that the plan has been accepted by all involved parties is encouraging. We now need to ensure that it is implemented as intended, as banks make use of their broader branching powers.

Similar coordination efforts are necessary and underway in an international context. Through the Bank for International Settlements, for example, the Federal Reserve and the other U.S. banking agencies participate with supervisors from other G-10 countries to develop not only prudential capital and other regulatory standards, but also to promote sound practices over a broad range of banking issues.

In this regard, the Basle Committee on Banking Supervision, with the approval of the central bank Governors of the G-10 countries, recently issued three documents: one dealing with the management of interest rate risk by banks, one dealing with the Year 2000 problems, and another identifying 25 "core principles" of effective supervision that is directed at bank supervisors worldwide. The Basle Committee is also working to improve international risk disclosure practices of banks, and has created the new market risk capital standard that is based on banks' internal value-at-risk models. That standard goes into effect in January of next year.

Beyond the work of the Basle Committee and the banking agencies, we are also meeting with the SEC and international securities and insurance regulators to identify common issues, and to bring about greater convergence in our respective regulatory frameworks. That effort also has links to the Committee's efforts and should prove helpful in strengthening the oversight and regulation of financial institutions throughout the world that provide a broad range of financial products. Successful groundwork from this effort could also have implications for moving forward domestically in an era of financial reform.

Guidance as well as supervisory and regulatory standards such as these -- whether developed in a domestic or international context -- are soon incorporated into examination procedures and help examiners in their reviews of many of the more complex activities of global banking organizations. These global institutions are perhaps the most challenging to supervise. Since it is not feasible for supervisors to review all locations of a global banking organization, emphasis is placed on the integrity of risk management and internal control systems, coordination with international supervisors, strong capital standards, and improved disclosures.

Staffing the Supervisory Process

A final supervisory challenge relates to the Federal Reserve's need to continue attracting, training, and retaining expert staff. Retaining sufficient numbers of individuals with the expertise to evaluate fully the risks in a rapidly changing banking industry is a major priority for the Federal Reserve and figures prominently in the bank supervision function's strategic plan. Particularly challenging is attracting and retaining specialists in the areas of capital markets and information technology where we have experienced increased turnover. We will continue efforts to attract and retain both specialists and generalists who are qualified to address issues as the industry evolves.

As I have outlined in my testimony, the Federal Reserve's supervisory strategy is to maintain staff who can adequately evaluate the general soundness of banking activities by placing strong emphasis on the bank's management processes, systems, and controls. I believe such an approach will serve us well as the industry continues to evolve either by expanding the scope of its activities or through broader structural changes from financial modernization legislation. Nevertheless, developing the supervisory techniques, and attracting and training the personnel to do the job will pose a continuing challenge in the years ahead.

Conclusion

The history of banking and of bank supervision shows a long and rather close relationship between the health of the banking system and the economy, a connection reflecting the role of banks in the credit intermediation process. We can expect that relationship to continue and for bank earnings and asset quality to fluctuate as economic conditions change. As supervisors, we must prepare for such developments.

In many ways, however, the banking and financial system have changed dramatically in the past decade both in terms of structure and diversity of activities. Risk management practices have also advanced, helped by technological and financial innovations. I believe that both bank supervisors and the banking industry have learned important lessons from the experience of the past ten years specifically about the need to actively monitor, manage and control risks.

Nevertheless, conditions can always change, and the risk-focused approach will be continually challenged to anticipate and avoid new kinds of problems. We must recognize that a risk-focused approach to supervision is a developing process and however successful it may be, there will again be bank failures. Indeed, having no bank failures may suggest inadequate risk-taking by banks and less economic growth. Through our supervisory process, the Federal Reserve seeks to maintain the proper balance -- permitting banks maximum freedom, while still protecting the safety net and maintaining financial stability. Devoting adequate attention to banking practices and conditions and responding promptly as events unfold is the key. We intend to do that now and in the years ahead.