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Deregulation and bank supervision

Before I begin I would like to thank the Central Bank of Suriname for all its hospitality, and CEMLA and Dr. Blackman for inviting me to the Conference. It is proving to be an excellent opportunity to exchange views and share differing perspectives. The discussion has shown that many things in banking are universal despite widely differing structures.

What I have been asked to talk about today is deregulation and bank supervision. I will be focusing on the actions of various US legislative and regulatory authorities designed to increase the range of permissible activities of commercial banks and thrifts or to eliminate restrictions on them. I will be particularly talking about these deregulatory initiatives in the context of the troubled US thrift industry and in the context of how the Board of Governors of the Federal Reserve System is trying to shape the future direction of bank holding company activity. On the latter score, we will be spending a fair amount of time looking at the Board's decision permitting commercial bank holding companies to get into the securities underwriting and dealing industry.

In the discussion of these various areas, perhaps the key point I will be emphasizing is that the notion of deregulation and increased bank supervision are far from inconsistent concepts - quite the contrary. As banking organizations are given broader statutory and regulatory authority and begin to exercise their new powers, there is increased pressure on the bank supervisors to devise means to ensure that the new powers are being used prudently. We as bank supervisors will have to ensure that an appropriate prudential framework is in place at the institutions to limit the risks of the new activities. And we will have to increase our efforts to

examine banks more closely as they enter fields with which they have less familiarity and lines of business that involve more risk.

Let me provide a brief road map of how I will be structuring this morning's presentation. I will begin by discussing a handful of key concepts from the US institutional structure. I will not try to provide a comprehensive description but rather will highlight 4 or 5 concepts governing our historical structure that will also come up as we talk about some deregulatory initiatives. Secondly, I will describe some of the external shocks to the system that led to the need for changes in that structure. Then I will talk about some of the deregulatory changes. I will finish by talking about the supervisory response to those changes.

I. BACKGROUND ON US INSTITUTIONAL STRUCTURE

Let us turn to some of the key concepts governing the structure and supervision of the US banking system. I should say at the outset that the evolution of the US institutional structure is by no means a textbook example of how best to establish a financial infrastructure, and in fact it is difficult today to fully rationalize why some elements of the current or recent past structure were put in place or allowed to remain as long as they did. Yet overall the structure has served us well.

In any event, there are four or five key concepts worth keeping in mind when we get into deregulatory initiatives.

1. Separation of banking from commerce

After the experience of the depression of the 1930s the United States adopted very strongly the concept that banks should be separated from other lines of business. Banking was perceived as uniquely important to the viability of the economy. The concern was that a bank engaging in activities other than traditional deposit taking and lending activities could bring not only increased risk, but also the potential for conflicts of interest. In order to ensure that banks not be unduly exposed to risks of firms engaged in commercial activities -firms that could encounter financial problems of their own and could cause their bank affiliates to lend to them on more favorable terms- the US Congress enacted the Glass Steagall Act in 1933. For similar reasons, the Glass Steagall Act also separated commercial banking from investment banking, as it was felt that banks should be insulated as much as possible from the risks of the stock and other securities markets.

This was further codified by the enactment in 1956 of the Bank Holding Company (BHC) Act. Among other effects of the passage of this statute was that companies owning banks could only engage in
non-banking activities that were found by the Board of Governors of the Federal Reserve System to be closely related and properly incident to banking.

2. Dual banking system

The United States has always had something of a dichotomy between federal control and the rights of States to set policy within their own boundaries. This is certainly true in banking. The Federal Government (through the Office of the Comptroller of the Currency) and each of the 50 States are authorized to charter banks. The powers of the banks are at the first instance determined by their charterers, so they can vary quite widely depending on what the 51 independent decision makers feel is appropriate for their banks to engage in.

While we have this basic structure of 51 different charterers, there is also an important Federal overlay over the structure. The Federal authorities have an important interest in the actions of State chartered banks given the importance of the banking system, reflected in what is referred to as the Federal safety net. Among the many outgrowths of the Depression was the establishment of the US system of deposit insurance through the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). Also within that safety net is the Discount window lending powers of the Federal Reserve and similar emergency lending powers of the Federal Home Loan Bank system.

Given this Federal involvement in the picking up of the pieces when banking organizations get into trouble, there is a clear Federal interest in ensuring that to the extent possible the banks do not get into trouble in the first place. Thus any State chartered bank that has the benefits of Federal deposit insurance, and almost all now do, is also subject to regulation and supervision by a Federal banking agency.

3. Division of Federal banking supervision

The identity of the Federal Bank supervisor varies depending on the charter class and whether or not the bank elected to become a member of the Federal Reserve. Basically, all nationally chartered banks are supervised by the Comptroller of the Currency; all State chartered banks that have chosen to become members of the Federal Reserve are in fact supervised by the Federal Reserve; and all other State chartered, federally insured, commercial banks are supervised by the FDIC.

Moreover, the Federal Reserve was given by Congress the authority to supervise bank holding companies when the BHCA Act was passed in 1956.
4. Separate thrift industry

The final element in the institutional structure I will mention is the tradition of having a part of the financial services industry devoted to supporting home buying. The notion of Americans being able to buy their own home is a major part of our political and economic tradition. The thrift industry was established as a means to facilitate that process. Thrifts were given certain benefits including in particular favorable treatment in the raising of deposits, but were in turn effectively required to devote their resources to making home mortgage loans.

This is the basic structure that served the United States quite well from the 1930s through the 1970s but which has undergone significant change as a result of a series of developments in the past decade. Many of the developments were external to the banking system—competitors making serious inroads into aspects of bank operations or general economic turbulence upsetting parts of the banking system.

Competitive incursions. Among the major developments of competitors impinging on banking organizations was the development of the money market mutual funds in the late 1970s by large brokerage firms. The brokerage firms sought to bid away deposits from commercial banks and thrifts by paying higher interest rates on deposit-like instruments than what banking organizations could pay given the interest rate ceilings of Regulation Q. More generally the separation of banking from investment banking has eroded as the investment banks wooed many of the prime customers of commercial banks away by arranging their financing in the commercial paper and other debt markets.

General economic shocks. Among the general economic shocks were the rise and general volatility of interest rates beginning in the late 1970s and early 1980s and the volatility of energy prices and agricultural products with the resultant shocks to geographic regions heavily dependent on the energy and agricultural industries.

Philosophical support for deregulation. In the past eight years there has in addition been clearly a favoring of reducing, where appropriate, the amount of governmental restrictions on private business, including the banking industry.

Against this backdrop of institutional structure and external shocks, let us move on to the deregulatory developments in the United States and the supervisory responses to them.

II. Deregulatory Developments

1. Deregulation of interest rates

As money market funds began bidding away deposits from commercial banks and thrifts, the banking institutions began
requesting an increased ability to compete with these unregulated firms. Eventually, Congress and the regulators did remove all the deposit interest rate ceilings that had been in place for decades. Banks and thrifts had been in the enviable position of having a maximum interest rate established for essentially each class of deposits - a rate set so low for the most part that institutions in many markets typically set their rates at the maximum. Thus there was virtually no price competition among banks and thrifts and, until the money market funds, little or no effective external competition.

Thus banks and thrifts got a major part of their funding from low cost and highly stable sources - basically corporate and consumer deposits. They were then able to lend these funds out at an attractive margin with little risk of being whipsawed by a dramatic change in the cost of their liabilities. Thrifts in particular were thus able to ignore what we would consider today to be one of the guiding precepts of banking - that they should match the maturity structure of their assets and liabilities. The deposits they got might be nominally demand deposits or other very short-term deposits but in practice they were rolled over into very long-term maturities. These funds were then lent out to home buyers at up to 30-year terms at fixed interest rates with a reasonable spread over the effectively fixed costs of their liability structure. As long as the short-term deposits were in practice kept in the institution at a rate substantially below the rate on the long-term mortgages, thrifts could get away with this practice. The 1980s saw an end to escaping the results of this practice.

2. New activities for banks and thrifts

The 1980s has also seen a marked acceleration in the range of new activities permitted to thrifts and commercial banks. Three main sources:

a) Federal law changes. Once their built-in advantages over commercial banks and other competitors on the deposit side (owing to the differential they were able to pay) were eroded by the deregulation of interest rates, thrifts strongly requested to be able to do more on the asset side. Beginning in 1981 federal thrifts were allowed to offer adjustable rate mortgages that allowed them to have much more of the protection on the asset side to marked increases in the cost of their funds. Also very importantly they were allowed for the first time to get into commercial and consumer lending.

b) State law changes. State charterers of thrifts and commercial banks were also very active in giving their institutions more powers. State banking institutions have been allowed for example to invest directly in real estate, offer securities brokerage services, and to engage in a wide variety of insurance activities -
from the relatively riskless brokerage to potentially very risky underwriting of property and casualty insurance. The motivations of the various decision makers have been quite varied for granting such a wide range of new powers to their banks. While Federal regulators have a great deal of concern about how such actions of State authorities could affect the magnitude of the problems faced by the Federal safety net, I do not want to suggest by any means that all State authorities have acted improperly in granting new powers.

In fact many of the actions by State authorities simply reflect a different perception of what banking really has become today or of how quickly banks should be allowed to enter appropriate new lines of business. Much is made of the concept of one stop shopping - the advantage to the consumer of being able to come into his bank and carry out a series of different financial transactions. If their commercial bank had broad powers, consumers could come in and buy some stocks, increase their automobile or life insurance coverage, and make a deposit all at the same location.

Part of the motivation was also that banks should share in some of the prosperity they financed. Rather than be restricted to making loans on real estate, why not let the banks also share in the profits as real estate was developed and appreciated in value. By letting banks invest directly in real estate they could be partners with the developers and share in the profits from a successful venture. When real estate markets are booming, this seems like an extremely good idea; when the markets turn around, direct investments only add to the banks' exposure.

Part of the motivation for State authorities to expand the range of permissible banking activities was much more questionable from the perspective of the Federal safety net than the reasons I have mentioned so far. There has been, to some extent at least, a competition between States to attract out of State firms to their States in order to create more jobs and help develop the local community. While this could make sense from the narrow perspective of the particular State, trying to lure firms in by offering the opportunity to engage in ever more risky activities they would otherwise not be allowed to do, put the Federal regulators in the position of picking up the pieces for those firms that lacked the expertise or luck in carrying out the new powers successfully.

For example, the relevant statute of the State of South Dakota made clear that the intent of the change was to secure employment and revenue for the State by offering out of State organizations a unique opportunity to engage in activities not otherwise permissible. It allowed banks acquired by out of State DHCS to engage in underwriting any and all types of insurance, even if the
bank became one part bank and 9 parts insurance company. When presented with an application, the Board of Governors of the Federal Reserve System denied it as an evasion of the BHCA. By that action the worst potential excesses of the South Dakota law were constrained.

**c) Actions by the Federal Reserve.** The Federal Reserve has itself been the third major generator of new non-banking opportunities for banking organizations with its decisions under the BHCA. Its decisions in the non-banking area have been under two main provisions—one governing expansion within the United States and one governing expansion outside the Country. The criteria under the latter section are broader and more liberal reflecting the fact the statute does not entail exporting some of our concerns about the separation of banking and investment banking overseas; it is also more liberal because there would not be a requirement for the Federal Reserve to preserve a particular competitive structure outside the United States.

Accordingly, the Federal Reserve has permitted banking organizations to do a wide range of insurance activities overseas as well as certain securities activities. The main restrictions have been driven by safety and soundness concerns. For example, the Board has not permitted banking organizations to underwrite property and casualty insurance and established limits on the underwriting of equity. It has permitted full-scale insurance brokerage and life insurance underwriting on the theory that these would not entail greater risk than traditional commercial banking.

Domestically, the Federal Reserve has been somewhat more constrained in what it could do. It has however in the past several years taken some major steps in the securities field. Just last month it broadened an earlier approval to allow underwriting and dealing of all types of debt securities. The order also presented a series of favorable findings about the permissibility of underwriting and dealing in equity securities, although final action on equities was put off for a year.

The actions the Board took also involved the imposition of a series of limitations or firewalls designed to insulate the bank affiliate from possible problems arising from the securities affiliate. For example, the Board’s order essentially prohibited the bank from lending directly to the securities affiliate and imposed significant controls on the parent bank holding company providing financial support to the securities affiliate. A number of the other firewalls were designed to limit the possibility of conflicts of interest leading to decisions being made by the bank not in the bank’s best interests. For example, strong limitations were placed on the ability of the bank to lend to customers of the securities affiliate, to issue or buy securities to be underwritten by the affiliate.
I will come back in a minute to the supervisory response to the
initiation of these new powers, but let me turn first to the
problems of the thrift industry following the various deregulatory
and other developments that I mentioned.

III. PROBLEMS OF THE THRIFT INDUSTRY

As I mentioned above with the current division of supervisory
responsibility in the United States, the Federal Reserve has little
direct role in the supervision of the Nation’s savings and loan
associations. Thus my comments on the thrift problems are those of
an interested observer rather than those of a day to day combatant.

The financial press is of course full with daily stories on the
dimension of the thrift problems and the difficult steps that are
being taken to try to address those problems. Just this past week
many of you may know President Bush unveiled a new program to
try to address the myriad problems of the savings and loan industry.
The program includes the creation of a new entity to issue bonds to
finance the assistance effort, the increase in deposit insurance
premiums for both S & Ls and banks, a restructuring of the Federal
Home Loan Bank System, and new programs of supervisory controls
and enforcement efforts. The Secretary of the Treasury, Nicholas
Brady, emphasized that never again would the United States allow
a federal deposit insurance fund to become insolvent; federally
insured depository institutions to remain open and operate without
sufficient private capital at risk; risky activities permitted by the
States to put a federal insurance fund in jeopardy; or fraud committed
against financial institutions to be treated as other than grave white
collar crime. Thus the action reflected a very serious indictment of
how the savings and loan industry was allowed to get into the crisis
situation that it has.

What caused the problems and what are the messages from this
experience for commercial banks and their regulators?

There have been two distinct stages of the US thrift problem - the
first in the early 1980s and the second in the past three years or so.
The first stage was almost totally interest rate driven. As I
mentioned, thrifts were caught in the middle of a chain of
circumstances that upset what had been a nice secure relatively low
risk industry. Thrifts had been able to take in money at 4% or 5%
and lend it out at 7% or 8%; its loans were generally very well
secured by what was the staple of their business - one to four family
homes. Federal and private insurance further protected the thrifts
from suffering major asset quality problems.

This nice quiet existence did not require the development of
sophisticated asset and liability management practices or hedging
techniques, because the industry was seemingly so well insulated
from the possibility of external shocks. This proved of course not to be the case when the forces of competition and interest rate volatility descended on the industry in the early 1980s. First, they suffered deposit outflows and then when they got the power to compete in terms of interest rates on the deposit side, they had the obviously unpleasant choice of either allowing the outflows to continue or to stop them at the cost of paying more for their deposits than they were getting on their assets.

With long-term fixed-rate assets comprising about 80% of the portfolio of the average thrift, there was little they could do but try to ride out the storm of greatly increased interest rates. Within the District covered by the Federal Reserve Bank of New York (FRBNY), a number of savings banks that had proudly operated for 100 years or more could not overcome these problems and were closed or acquired by other firms.

In some ways the current problem is even worse. Unlike the situation in the early 1980s, when the thrifts that were closing had really very clean asset portfolios, the problems today are much more intractable asset quality problems. They are, however, also considerably more localized within the United States. Energy and agricultural loan problems in the Southwest are driving many of the current problems with the East including the area covered by the FRBNY, for the most part not seriously affected. These asset quality shocks came of course on top of the problems in the early 1980s and in many instances the savings and loan associations had not fully recovered from the interest rate buffeting they had taken earlier.

In some ways the response to the earlier problems has aggravated the current problem. Thrifts, as I mentioned, were given new powers in part to broaden their sources of income and make them less dependent on just interest rate spreads for residential mortgages. Some thrifts went in a big way into commercial mortgage lending, construction lending, and in some instances even into straight commercial lending. Many also got explicitly involved into direct real estate investment and development projects. A number of observers in the early to mid-1980s felt these new powers were beneficial in turning the thrift industry at least somewhat around. Most observers are far from as sanguine today.

Many of the thrifts that got heavily into the commercial real estate market seemingly did so without the management's ability to truly understand the risks of the projects they were undertaking as they did not have in place experienced commercial loan officers who could make a definitive assessment of the risks involved. Moreover, the fact that thrifts were allowed to remain open despite deficit net worth on the basis of normal accounting practices undoubtedly contributed to an atmosphere where risk-taking was much more encouraged than has been traditional in banking. If you were poised on the edge of failure it may make a lot more sense to
take a big chance, knowing that your stockholders' equity was pretty much wiped out anyway. If your big gamble lost, the incremental loss would likely be felt by the insurance fund - the value of the assets it took over when it finally closed your institution was less because of the risk you took.

On the other hand, if your gamble paid off, you stood a chance of getting back your investment or even better. Since we are staying in a hotel with a casino for this Conference, I can't help but use the metaphor of betting with the house's money.

IV. SUPERVISION OF COMMERCIAL BANKING ORGANIZATIONS

What does the process of deregulation mean for the supervision of commercial banking organizations?

1. Increased examination activity.

One of the first reactions of the Federal Reserve to emerging problems was to increase the number of bank examiners and to focus their attention on major potential problem areas. In 1985 we began a program of requiring annual full examinations of all banking organizations under our supervision that are either major ones or that were judged to be in poor condition at their last examination, with supplemental targeted examinations to occur particularly for the major organizations during the rest of the year between full scale exams. The targeted exam might for a particular institution focus on the real estate portfolio or perhaps on the securities trading operation - wherever we perceived there could be some vulnerability.

2. Increase the quality of the exam.

One thing we have struggled with is how to keep our examiners as sophisticated as the institutions they supervise. With the new volatility of interest rates and the globalization of the financial markets the need to develop sophisticated techniques to limit interest rate and foreign exchange exposures has of course developed in the financial services industry. With a new breed of rocket scientists being recruited from MBA programs to develop instruments and techniques in the swaps, options, and futures markets, the potential for the cure being worse than the disease certainly exists. Programs designed ostensibly to hedge exposures could prove themselves to involve inordinate risk if not carefully set up. The attempt to diversify income by increasing trading operations and reducing traditional commercial lending activities could lead individual institutions all but betting the bank in their pursuit of sophisticated new trading strategies.
We have long been concerned that senior management of the bank may not even be fully aware of the risks the designers of the new instruments are exposing them to. The sophistication and timing of the internal reporting and review mechanisms are fundamentally different than what all but the most sophisticated institutions can readily put in place. We have people working on approaches to assess foreign exchange, interest rate and swap exposures.

We have tried to keep up with the industry by changing our own hiring practices and training techniques. At the FRBNY we are now recruiting from some of the top MBA programs ourselves to get people whose education would allow them to understand more readily the instruments used by sophisticated banking organizations and gauge more effectively what the risks those techniques and instruments involve. It is at best only a partial answer though, as our resources are necessarily limited.


Historically we focused on relatively simple leverage ratios as our basic measures of capital adequacy. However, with the growth of off balance sheet activity we saw a need to develop a more sophisticated approach that took into account off balance sheet as well as on balance sheet risk. This was part of the motivation for the risk based capital approach.

4. Ensuring that appropriate restrictions apply to organizations under its jurisdiction exercising powers granted by other authorities.

There has long been some tension between the State regulators and the Board of Governors as to whether it is appropriate for the Board to interpret that the BHC Act can limit the activities of bank subsidiaries of bank holding companies. The Board has just recently made a proposal designed to limit where appropriate some of the activities conducted through State chartered bank subsidiaries of bank holding companies. Needless to say this has provoked considerable negative reaction from State banking authorities as well as from banks that are anxious to use the powers afforded by the more liberal charter powers of certain States.

5. Where the Board is the decision maker on the new activities, ensure that the BHCs using the powers have the requisite managerial and control infrastructure and financial resources.

As suggested above, one of the Board’s biggest concerns is that the BHC itself have the infrastructure in place to control the risks of
the new activities it might be allowed to undertake. This is particularly evident in the recent order concerning securities underwriting.

The Board approved general corporate debt underwriting but required prior to the time the BHC was actually allowed to start the activities that our examiners find that each organization had the operating and managerial infrastructure necessary to ensure compliance with the many requirements of the Board's order including general internal control procedures, internal risk management controls, and accounting, computer, and auditing systems. We will be sending a team of examiners into each of the subsidiaries to go through a lengthy checklist of things that have to be in place before we will sign off on the ability of the organizations to control the new activities.

Similarly, while the Board made a number of favorable determinations on the ability of BHCs to engage in equity underwriting it held off final authorization for a year in order to allow the organizations to build up their staffs and further fine tune their control systems. The Board recognized that the debt underwriting activities were closer to the traditional lending activities of commercial banks and could more prudently be initiated quickly. The equity underwriting would require more major staff and control procedure changes. Accordingly, the Board developed a more cautious approach to letting organizations enter that line of business.

6. To address these financial concerns, the Board has put in place conditions to ensure that the bank holding company can continue to support the bank and the bank will be insulated from risks of the securities affiliate.

I mentioned before some of the firewalls and other safeguards build in to reduce risks to the bank and conflicts of interest that could affect the bank. Another major element of the order was that the organization could not compromise the financial resources available to the bank by putting funds into the securities affiliate. The Board required that before the new activities were commenced it should approve a capital plan that would for at least most organizations entail the raising of new capital to replace the capital to be downstreamed to the securities affiliate.

The Board in essence is looking for the holding company to cover its investments in their securities affiliates 100% and keep all current resources available to support its bank or banks, as the capital to be invested in the securities affiliate will be deducted dollar for dollar from consolidated capital. Unless the holding company raises new capital externally, its capital ratios would go down.
When I left New York last Friday, these various steps were just taking place, so no organizations have yet to undertake the new powers. Moreover, Congress is considering what action it should take in the securities field. There are certainly people in Congress who believe that the Board went too far and did administratively what some members of Congress believe should have been left to Congress to decide. There are other members who no doubt believe more must be done in the securities industry that what the Board felt able to do given the limitations of current law and its own concern that the process move ahead with all deliberate speed. How it all plays out will be fascinating over the coming months.