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An address by

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TRENDS IN BANKING AND BANK REGULATION

By William M. Isaac

I welcome this opportunity to be here with you this evening to discuss trends in banking and bank regulation. I will set the stage by providing a brief overview of the climate in the financial services sector. Then I will suggest a few things that commercial banks should be doing to prepare for the future. I will conclude by reviewing some items on the agenda in the supervisory arena.

I. THE BANKING CLIMATE

Probably the most important point to make about the climate in the financial services sector is that it is changing. A number of factors are combining to make the banking business more competitive, more complex, and less secure.

First, there is a definite trend toward deregulation of depository institutions, which has implications for the competition among banks and between banks and nonbank intermediaries. The restraints on geographic expansion are being gradually liberalized, and I suspect this evolution will continue to run its course. The Depository Institutions Deregulation and Monetary Control Act of 1980, which was signed into law on March 31, portends an end to the restrictions on deposit interest rate competition in six years, and relaxes government-imposed requirements for mandatory specialization among deposit-taking institutions. NOW accounts will be permitted nationwide next year, and thrifts have acquired some commercial and personal lending powers. Thus, the competition is likely to become more intense both among commercial banks and between banks and previously-specialized institutions such as credit unions, mutual savings banks, and savings and loan associations.

Second, the economic climate has become harsher and less predictable, which has made the banking business more difficult to manage. Over the past 15 years or so we have encountered periodic bouts with inflation, which have produced volatile and extraordinarily high interest rates followed by recession and high unemployment. It is relatively easy for bank managers to make serious mistakes in this kind of uncertain economic environment.

Third, the banking industry has had imposed upon it in recent years a vast amount of consumer legislation such as Truth-in-Lending, the Community Reinvestment Act, the Real Estate Settlement Procedures Act, and the Fair Credit Reporting Act -- to give just a few examples. The burden of

compliance with these laws tends to fall disproportionately on our smaller banks, which often do not have ready access to trained experts on regulation, either on their staffs or in their communities, and must amortize the cost of compliance over a comparatively small number of transactions.

Fourth, sophisticated and expensive computer and communications technology is playing an increasingly important role in the delivery of financial services. As is the case with regulatory compliance, implementation of new technology is more difficult for smaller banks.

Finally, competition from nondepository businesses is becoming more intense. We have all witnessed the recent tremendous growth in money market mutual funds. Investment banking firms, retailers, credit card companies, and others also have their sights set on markets that bankers have traditionally served.

When these various factors are taken in combination, there can be little doubt that the environment in the financial services sector is less hospitable today than it was a decade or two ago. I have no basis for predicting that the climate will be more benign in the future.

These trends portend great challenges for banks in the decades to come. Banking is becoming a more complex endeavor, less forgiving of mistakes and inefficiencies. There are still, and always will be, abundant rewards for success, but the penalties for failure are becoming more certain and more serious. Management skill and good business judgment are, and will be, at a premium.

II. PREPARING YOUR BANK FOR THE FUTURE

Let me suggest five things bank managers should consider to better prepare their banks to compete in the world of tomorrow. If you have not yet made substantial progress along these lines, I strongly recommend you take immediate steps to do so. If your bank has taken, or promptly takes, these steps, I believe its future will be bright and secure in any kind of economic or competitive environment.

A. Define Your Business. First, I believe that one of the most significant responsibilities of the board of directors and top management of each bank is to define the business of the institution -- its mission, its purpose, its goals. In defining your bank's business it is important to look not only at your current customers and services, but also at how they will likely evolve in the years ahead. You must decide not only the kind of bank you are, but also the kind of bank you are going to be.

The process of defining your bank's business requires strategic and long-range planning. Key existing and potential markets must be identified, and strategies and products for penetrating those markets must be developed. Should you concentrate on a segment of the market or offer a full range of services? Should you expand your geographic market? If so, should it be accomplished by _de novo_ growth or by acquisition? Are your offices suitable and well located? Do you have too many branches or too few? Do you have the requisite technological resources? These are the kinds of questions that must be addressed.

B. _Evaluate and Develop Managerial Resources_. A second major responsibility is to evaluate and develop your bank's managerial resources. Good, strong management is the key to any bank's future. A well-managed bank, no matter what its size, will be able to succeed in any future environment. A poorly-managed bank, whether large or small, will be severely tested in the years ahead.

Does your bank have the team of managers and experts necessary to meet the long-range goals you have established? If not, what steps do you need to take to attract them? Does your bank have a plan for management succession and an effective program for management training? Has your bank established a realistic compensation program, and does the program contain well-designed incentives for senior management?

One of your bank's most valuable assets should be its board of directors. A strong board has a good proportion of entrepreneurs -- people who have experience in managing successful businesses. An effective board is independent and challenges management's assumptions and conclusions. The best friend -- and the best protection -- that management can have is a strong and interested board that helps formulate policies and goals and participates in strategic decisions. Such a board helps management avoid serious mistakes and is more likely to share responsibility for the mistakes that will inevitably be made.

C. _Adopt and Require Adherence to Sound Operating Policies_. A third suggestion is that top management, in conjunction with the board of directors, adopt and require adherence to sound operating policies. While a bank's customer base may shift over time, and there may be variation in the array of services offered, the basic principles of banking do not change. Adoption of internal policies to guide the bank through fluctuations in the economic cycle is an important step that can be easily overlooked. Misplaced lending emphasis, inattention to liquidity, pursuit of growth at the expense of profit margins, and failure to provide adequate capital to support the bank's business are

examples of liberties occasionally taken by banks. During good times, there is a temptation to bend the basic principles of sound banking without an assessment of the potential effects of materially adverse changes in the business climate. The bank's policies and business plans should be formulated with a clear sense of the downside risks.

D. Improve Accounting, Control, Information, and Disclosure Systems. Fourth, as your bank grows in size and complexity, it will become increasingly important to improve its accounting system; its audit, credit review, and other control systems; its management information system; and its financial disclosure system. The accounting system should inform management what a service costs and how it must be priced to earn a profit. Good credit review and audit systems become essential as the bank grows and begins to lose intimacy with its customers and employees. The management information system should provide a means for top management and the board of directors to evaluate key personnel and business activities, to monitor credit exposures and asset and liability maturities, and to control interest-rate sensitivity. Development of an accurate and complete financial disclosure system is necessary if the bank expects to turn to money or capital markets to sustain its growth.

E. Control Costs. My final suggestion relates to expense control. In an intensely competitive environment, the ability to identify and control costs could be the difference between success and failure. Control of personnel and other operating expenses is becoming one of mangement's most important and difficult assignments. Success in this critical area requires good information, discipline, and determination.

III. THE SUPERVISORY AGENDA

Just as bankers are preparing their banks for the future, bank supervisors are also adapting to the changing climate. Let me highlight five areas which are receiving significant attention.

A. Coordination and Uniformity. First, there is a growing recognition that, as the barriers to competition among depository institutions are eroded, we must provide a "level playing field" for these institutions. As I mentioned at the outset, the three legal barriers to direct competition among depository institutions -- *viz*., geographic restraints, mandatory specialization, and interest rate controls -- are being eroded. As this occurs, significant differences in regulatory standards and procedures become less and less tolerable.

The federal regulators of financial institutions are working diligently to achieve greater uniformity in supervisory techniques and standards, training programs, and reporting requirements. The vehicles for these cooperative efforts are the Interagency Coordinating Committee, formed in the mid-1960s; the Federal Financial Institutions Examination Council, established in 1979 pursuant to the Financial Institutions Regulatory and Interest Rate Control Act of 1978; and the Depository Institutions Deregulation Committee, established this year pursuant to the Depository Institutions Deregulation and Monetary Control Act of 1980. Substantial results have been achieved in a number of areas, although I would have to admit that progress has been slow on some of the thornier, major issues such as capital adequacy standards and merger policies.

B. Training. A second area of emphasis involves the training of our personnel. As banking becomes a more complex business, proper supervision becomes more difficult. It is essential that the supervisory agencies attract and retain examiners of the highest quality. Our task is made more difficult by the limits placed on federal salaries, which have not kept pace with inflation.

Examiner training programs take on added importance in this kind of environment, and the agencies are committing substantial resources to training. The five federal supervisory agencies are working toward establishment of a joint training facility, which will enable us to pool our resources and improve the effectiveness of our schools. The focus of our examiner training is shifting from a heavy emphasis on reviewing the quality of assets to a more balanced approach that gives more consideration to profit margins, asset and liability maturity structure, interest rate sensitivity, internal controls, and operating policies and procedures.

C. Greater Commitment to Marketplace Regulation. Third, there is a commitment to a greater degree of marketplace regulation. By this I do not mean to imply that supervisory standards, designed to ensure the maintenance of a safe and sound banking system, are being eased. If anything, I would hope that our regulatory standards would be strengthened.

However, in times past, we have too often imposed our judgment in areas where the marketplace could have functioned more efficiently. I believe you will see less of that in the future. If, for example, honest and capable people with strong ties to a community believe there is a genuine need for a new bank in the community, and they are willing to commit a sufficient amount of capital to carry the institution through its formative years, the FDIC is not likely to sit in Washington and second-guess that decision on the

ground that the local community does not need or will not support the bank. The same approach is likely to be taken in other areas, such as branch applications by well-run, well-capitalized banks.

D. Regulatory Simplification. A fourth area worthy of note is our commitment to regulatory simplification. About two years ago, the FDIC set up a task force to review each of our regulations to determine whether it was still needed and, if so, whether it could be simplified. When Irv Sprague became chairman a little over a year ago he asked that we step up these efforts, which we did. During the past year we eliminated six regulations, substantially reduced a seventh, and simplified several others. Admittedly, the results have been modest and have, in fact, been overwhelmed by new regulations required to be issued pursuant to newly-adopted legislation. However, we have cleaned house to the extent we can in the absence of specific Congressional action.

Moreover, we have put in place machinery designed to ensure continuing evaluation of the regulatory process in the future. We have adopted a policy statement which requires that the FDIC's board of directors be informed of each proposed regulation in its early, developmental stage and requires that a cost/benefit analysis be done whenever feasible. The continuing need for each regulation must be reviewed every five years.

We are keenly aware of the disproportionate impact that regulations have on smaller banks. Our policy statement requires that we specifically assess the impact of each regulation on small banks. If we find that the impact is likely to be significant, we must exempt the small banks, or develop a less onerous version of the regulation for them, whenever it is legally permissible and appropriate to do so. Moreover, recently we announced that we are conducting a series of seminars around the nation designed to assist banks in meeting their responsibilities under the various consumer and civil rights laws.

In short, we at the FDIC are committed to lessening the burden of our regulations to the maximum extent possible consistent with our statutory responsibilities and the maintenance of a sound banking system.

E. Streamline Dual Regulatory Process. The fifth and final area I want to touch on is the dual regulation of state banks. Without question, our present system involves redundancies and inefficiencies. The FDIC intends to eliminate them.

Government, whether at the state or federal level, can no longer afford the luxury of being inefficient or wasteful. Moreover, equalization of the reserve burden on banks -- which will be phased in over an eight-year period under the Depository Institutions Deregulation and Monetary Control Act of 1980 -- requires that we take immediate steps to streamline the regulatory process under which state banks operate, if we wish to preserve the dual banking system which has served us so well for over a century.

An important step in this direction is the divided examination program now being implemented by the FDIC and a number of states. Under this program, instead of the FDIC and the state authority each examining a bank every year or so, we alternate with the FDIC examining one year and the state the next. The results of the examinations are, of course, shared. This program was initiated in 1978 and will soon be operational in eight states. We hope to add about four more states by the end of this year. The total savings to the states and the FDIC will amount to millions of dollars annually. The burden on the banks should be lessened, and the program contains safeguards to ensure that quality will not be sacrificed.

We intend to do much more. We held a meeting at the FDIC in late May with the banking authorities from the eight states currently committed to the divided examination program -- Georgia, Michigan, Illinois, Missouri, Nebraska, New Jersey, New York, and North Dakota. Our mission was to explore other avenues for greater cooperation and coordination. A major topic of conversation was the applications process. We discussed and reached agreement in principle on the use of common application forms, simultaneous processing of applications, joint hearings, and increased use of delegated authority by the FDIC. As these procedures become operational, they will produce a much less burdensome, speedier applications process for state banks. Other topics discussed included greater access by the states to the FDIC's data base and processing facilities, more coordination in enforcement actions, an exchange program for supervisory personnel, utilization by the states of regional typing centers to be established by the FDIC, and greater participation by state personnel in federal training programs.

Not all states are willing and able to participate in the divided examination program. However, where possible we intend to implement it. Moreover, we intend to promote other cooperative efforts in every state that is receptive to them.

I might also note another recently completed project. Our board of directors has approved guidelines to assist banks in filing applications with the FDIC. The guidelines, which are available at our regional offices, set forth in clear and concise fashion the standards we apply in processing applications. We believe they will be helpful and will expedite the applications process.

IV. CONCLUSION

In closing, I want to say a few words about the FDIC's general approach toward carrying out its supervisory responsibilities. We have had a fair number of high-level personnel changes over the past year or so -- the most recent being the naming of Quinton Thompson as director of our Division of Bank Supervision. At the time of Quinton's appointment, Irv Sprague instructed him to review carefully each of the Corporation's supervisory activities. The chairman said, "Anything we need to do, let's do it better. Anything we don't need to do, let's cut it out." That puts it about as succinctly as it can be put.

The maintenance of a safe and sound banking system is, and always will be, our number one priority. We intend to fulfill that mission in the most effective and most efficient manner possible. Those few banks that are not attempting in good faith to comply with the law or are not being operated in a sound manner will find a staff at the FDIC that is willing and able to take whatever steps are necessary to correct the problems and carry out our statutory responsibilities. However, if your bank is well-managed and well-capitalized, I think you will find a courteous, cooperative, and responsive staff trying its best to help you conform to the law and to expedite applications and other matters pertaining to your bank.

I thank you again for inviting me to be with you this evening.

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