FEDERAL DEPOSIT INSURANCE CORPORATION

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THE FUTURE OF U.S. BANK SUPERVISION
An Address By

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THE FUTURE OF U.S. BANK SUPERVISION

I am honored to serve as the American ambassador to this distinguished gathering. Being on Scottish soil, I am reminded of Dr. Johnson's observation that "if one man in Scotland gets possession of two thousand pounds, what remains for the rest of the nation?" Fortunately, Dr. Johnson's assessment clearly was not "on the money," as is evidenced by the thriving banking and financial community centered around Charlotte Square. What better vantage point could a United States bank supervisor choose for contemplating the new wave of competition in his own country's financial services industry than the exciting deregulatory scene dramatically unfolding in the United Kingdom?

I am particularly encouraged to see a handful of U.S. banks positioning themselves as active competitors in the British market. Your dismantling of all restrictions against ownership of stock exchange firms just two months ago and the anticipated elimination of barriers between securities dealers and underwriters should reshape the British financial services sector. The fortuitous circumstance of having a few U.S. banks participating in the British experience is going to focus attention on how well American bank managers can handle the risks of new products and delivery systems. This is going to give U.S. supervisors a jump on the situation and make us better prepared for the widespread deregulation that is bound to take hold eventually in the States.

I feel confident that in due time the United States will take steps comparable to the far reaching deregulatory initiatives adopted in the United Kingdom. This will present greater challenges to the ability of supervisors to measure risk and maintain the safety and soundness of the financial system. In light of these challenges, I would like to explain some aspects of U.S. bank supervision, describe major changes we are making in the supervisory process, and note some of the major issues that still must be resolved.

HISTORICAL BACKGROUND

To put our supervisory challenge in proper perspective, a short lesson in modern American banking industry is in order. Let me start in the Roaring Twenties, when American bankers were a rather freewheeling lot. Banks offered a variety of financial products, underwrote securities, and participated in business ventures. They had a substantial amount of discretion to price their products as they saw fit.

Banks also had substantial authority to operate where they wished. State chartering agencies' geographic restrictions on the scope of in-state bank operations did not apply to federally-chartered banks until 1927. Moreover, banking entrepreneurs operated across state lines by establishing holding companies. Banks were, of course, subject to safety and soundness regulations and supervision. But, to a significant degree, they were free to carry on their affairs as they saw fit.

Then came the Crash of Twenty-Nine, followed in short order by waves of bankruptcies and the collapse of numerous banks. Congressional inquisitors sought out villains to blame for this sorry turn of events, and bankers served as ready scapegoats. Bankers, it was said, had "sinned" by entangling themselves in the hurly-burly of commerce, by "pumping up" worthless stock for a quick profit, and by abandoning sound lending practices.

Telling bankers to "sin no more" was not enough; Congress decreed that banks had to be removed from all sources of temptation. Accordingly, the Banking Act of 1933 enforced a separation of banking from commerce and largely prohibited bank underwriting activities. The products banks could offer--and the prices they could set--came under federal regulation. A relatively new law (passed in 1927) subjecting federally-chartered banks to state geographic restrictions was strictly enforced. A Federal Deposit Insurance Corporation--the FDIC--was created, charged with paying off all small depositors of failed banks. That institution, funded through annual assessments on member banks, was able to stem the tide of bank runs and restore stability to the banking system. This self-serving assessment was made not by me, but by those philosophical antagonists, Milton Friedman and John Kenneth Galbraith.

While federal deposit insurance clearly was a valuable step forward, some economic historians have questioned the need for the other Depression era restrictions. Those scholars have argued that the "sins" of which banks were accused were blown out of proportion, and were not responsible for the 1930's economic collapse. Whether accurate or not, those observations are merely academic. The fact is that the banking system became ensnared in a multilayered regulatory web. Whenever bankers attempted to disentangle themselves, Congress wove new regulatory strands. For example, when banks started to evade geographic restrictions on banking through holding company acquisitions, Congress quickly passed the Bank Holding Company Act of 1956. That law gave individual states veto powers over out-of-state holding company acquisitions. Because almost all states prohibited such acquisitions, interstate banking soon became a dead letter. When bank holding companies threatened to expand their range of product offerings, the law was amended, allowing the Federal Reserve Board to disallow activities deemed "not closely related" to banking.

I could go on, but the message is clear. Congress created the chains that bound the banking industry, and government regulators made sure they stayed in place. Regulators told banks where they could operate, what products they could offer, and what prices they could charge. The aim of such tight "command and control" supervision was, in effect, to "lull banks to sleep." Bankers were to lead quiet lives and not enmesh themselves in the rough-and-tumble world of the commercial marketplace. Risk-taking that could disturb the system was to be avoided at all costs. "Excessive" competition among banks was to be prevented.

For many years, the system operated smoothly. Three supervisory authorities--the Comptroller of the Currency, the Federal Reserve Board, and the FDIC--controlled their separate domains. The Comptroller told federally-

chartered banks what to do. The Federal Reserve Board regulated bank holding companies and state-chartered bank members of the Federal Reserve System--that is, banks that chose to avail themselves of certain Federal Reserve System facilities. The FDIC held sway over state non-member banks. This compartmentalized system--which arose by historical accident, not design--worked surprisingly well, despite a lack of coordination among the three federal agencies.

The prototypical banker was the "organization man" in the gray flannel suit, content to live quietly and do what he was told. Not all bankers fit that mold, of course. The more entrepreneurial sorts lived "lives of quiet desperation," eager to innovate but prevented from doing so by congressionally-crafted shackles.

Eventually, however, the system began to crumble at the edges. What man had created, market forces eroded. Nonbank financial service firms began offering bank-like products accessible to small depositors, such as money market mutual funds. Businesses not regulated under the banking laws began marketing bank-related services to their customers through "one-stop-shopping" financial supermarkets. New technologies, such as electronic fund transfers, helped this process along. So did clever lawyers, who exploited legal loop- holes to create "nonbank banks" and other exotic, less-than-fully regulated entities.

Let me say a word about the nonbank bank, a strange beast that arose in recent years. This beast was created by securities firms and other businesses that wanted to enter the banking business. They took advantage of the fact that federal law defines a nationally-chartered bank as an organization that both takes demand deposits and makes commercial loans. The "nonbank" does not make commercial loans but does take deposits--deposits that are insured by the FDIC. The FDIC insured the first nonbank in 1969, and worked hard to construct reasonable ground rules that would allow nonbanks to obtain insurance. The Federal Reserve Board, however, adopted a critical posture toward nonbank banks. In January 1986 the U.S. Supreme Court struck down the Federal Reserve Board's attempt to close the nonbank loophole by regulatory redefinition. Thus, the nonbank--which can avoid geographic restrictions that apply to "bank banks"--will continue to thrive unless and until new legislation renders it extinct.

The nonbank bank was only one of many devices businesses employed to poach on the bankers' domain. The banks were bound to react, and they did. To hold their customers, they began experimenting with new products, expanding their interstate activities, and testing the limits of the prohibitions against underwriting. Although they initially resisted this shocking outbreak of competition, Congress and federal regulators in recent years began to give way, at least at the margins. They realized that if banks were to remain viable competitors, they simply had to be given greater pricing and operational flexibility. New laws and regulatory modifications have begun dismantling command-and-control restrictions on bank activities.

This has fostered a financial marketplace more responsive to consumer needs. I must admit, however, that we have only advanced a few tentative steps down the deregulatory road. Interest rate ceilings and other restrictions on the prices banks can charge for their offerings have been abolished. A greater amount of interstate activity is permitted. We are allowing banks to offer a somewhat more varied menu of financial products, such as discount brokerage services. Nevertheless, we are still far from a regime of full-scale interstate banking. Restrictions on interstate holding company acquisitions--except when the acquired bank is failing--remain in place. Similarly, numerous state law limitations on interstate mobility--and on geographic diversification within states--remain on the books. Furthermore, banks are still largely barred from corporate underwriting and other "commercial" functions.

Legislative proposals to loosen some of these regulatory bonds are under consideration. For example, the Reagan administration supports a measure that would allow banks to underwrite commercial paper. But old Washington hands like myself do not expect an overnight transformation of the system, akin to what is happening here. In the American banking landscape, the canvas of change features minute, carefully crafted etchings, rather than sweeping broadbrush strokes.

This reluctance to embrace rapid change renders some observers indignant. They attribute legislative inaction to the connivance of investment firms that scheme to keep commercial banks from poaching on their turf. Certainly, there is a hollow ring to the bleatings of those poor sheep who would keep commercial bankers out of the investment field--but who reserve the right to steal away traditional banks' customers, thank you very much. Claims that new bank powers threaten conflicts of interest, financial instability, and unspecified "subtle hazards" to business as usual also appear rather suspect. The risks of securities underwriting are manageable and of short duration--and lower than with many types of commercial lending. Securities law information disclosure requirements and bank law controls on insider transactions enable the market to monitor and discipline self-dealing. Our central bank, the Federal Reserve Board, is much better able to deal with monetary contraction and related financial instability than in the 1920's or '30s.

Dr. Pangloss might say, "Aha! The arguments against deregulation are utter drivel. Everything is for the best in this best of all possible worlds. Let us fully deregulate at once." I, however, am a conservative, Burkean to the core. I worry. I am instantly suspicious when told that a system that has facilitated America's rapid economic growth lo these last 50 years--with scarcely a hitch, mind you--runs no risks from massive free market surgery. If surgery is called for--and I believe it is--a trained physician had better monitor the patient's convalescence.

That Scottish apostle of free markets, Adam Smith, warned in The Wealth of Nations about the perils to commerce and industry arising from "the unskillfulness of the conductors of paper money." Surely, this concern is as valid in the late 20th century as it was in the 18th. Indeed, the mischief caused by banks' "unskillfulness"--and, I would add, "unscrupulousness"--is

magnified by the new opportunities deregulation creates. In short, deregulation poses an increased challenge for that policeman of the banking world, the bank supervisor.

CHALLENGE TO BANK SUPERVISION

The move from a regulated to a deregulated banking environment bears a striking resemblance to the move from a police state to a free society. In a police state, the citizenry is cowed, making it relatively easy to keep a lid on violent crime. Unfortunately, a police state also prevents individuals from speaking up in public, and puts a crimp on merrymaking. Similarly, bankers were cowed in the days of heavy regulation. Outright fraud and theft were certainly reined in, but so were procompetitive product line and geographic diversification--the banking counterparts of free speech and merrymaking.

Now observe what happens when police state controls are lifted. Individuals are able to express themselves freely in public, and welfare rises--much as consumers and businesses benefit from new products and services following bank deregulation. But at the same time, the policeman's job becomes harder. Violent criminals find it easier to circulate in public, and even "average citizens" may have fewer inhibitions. "Making merry" may lead to accidents behind the wheel, injuring innocent bystanders. Thus, in a free society, the policeman is transformed from a regulator into a supervisor. He must allow free speech and public merriment, but be ready to step in when liberty becomes unrestrained license. While this job may be relatively less demanding in more "civilized" societies where the public order is widely respected, it presents a significant challenge in all democratic nations. Bank supervisors increasingly will face the same problem. They must allow banks to compete in new areas, while keeping a sharp eye out for trouble--whether by hard core embezzlers and corporate looters, or by "solid citizens" who drink too freely of the wine of risky opportunities. These policing functions are particularly hard to carry out in the United States, which in 1985 boasted a grand total of 14,405 federally-insured commercial banks. Obviously, the possibilities for fraudulent and excessively risky behavior are manifold in a society peopled by so many banking institutions.

In order to further clarify the distinction between regulation and supervision, I would commend to you the example of the American airline industry. I happened to be in the Ford White House when the blueprint for airline deregulation was laid out. The plan was to eliminate economic regulations that fixed airline prices and routings, while leaving safety supervision in place. That plan has been implemented, and airlines are free to enter and exit geographic markets, charging the prices they choose. On the whole, passengers have certainly benefitted. Airline bankruptcies have also soared, as the market has weeded out ineffective competitors. And, while airline travel safety remains high, safety supervisors have their hands full. They have to watch out that aggressive competitors, living on reduced margins, do not excessively "cut corners" on maintenance and crew training in order to stay in business. Those worries were far less serious in the old days of the U.S. airline cartel, when everyone had his share of the pie and price competition didn't matter.

Now let's take a closer look at American banks. How have they fared lately? The short answer is, not too well--or at least not as well as they have historically. Average bank earnings and profitability have fallen in the last few years--both absolutely and relative to the risks banks assume. The return on average assets for all banks has declined steadily, falling from .82% in 1980 to .64% in 1985. The percentage of banks with a good return on assets--over 1.0%--has also fallen precipitously, from 60.47% in 1980 to 43.14% in 1985. Bank failures have also mounted, from 42 in 1982, 48 in 1983, 79 in 1984, to 120 in 1985. This compares most unfavorably to the average of about 10 a year in the 1970's.

A small chart, set forth below, summarizes recent key performance indicators for all insured commercial banks:

	1980	1981	1982	1983	1984	1985
Return on Average Assets	.82%	.81%	.74%	.67%	.65%	.64%
Percent of banks with good return on assets (over 1.0%)	60.47%	56.56%	53.07%	48.14%	43.03%	43.14%
Percent of banks with negative return on assets (under 0%)	3.71%	5.14%	8.33%	10.99%	13.82%	16.16%
Net chargeoffs as a percentage of average total loans	.38%	.37%	.57%	.69%	.78%	.86%
Loss reserves as a percentage of average total loans	1.06%	1.10%	1.15%	1.26%	1.35%	1.51%

Don't get me wrong. Without deregulation, banks would have experienced a massive outflow of funds to nonbank financial institutions and suffered a tremendous erosion in their competitive health. Deregulation was the tonic that banks needed to avoid serious illness. Already, that tonic has produced significant benefits. It has helped weed out ineffective management. It has allowed economies of scope from complementary financial activities to be realized. It has enabled consumers and producers to enjoy new products and services and to take advantage of "one stop shopping" opportunities. In short, bank deregulation has been a marvelous success story.

Of course, competition sharpens as regulatory obstacles are removed. In order to compete effectively, many banks will take larger risks--and some of those institutions are bound to incur losses. The lifting of interest rate ceilings eliminates cheap deposits. Aggressive banks, in order to pump up liquidity, will pay premium rates for fully insured brokered deposits sold in $100,000

blocs. This "hot" money can appear then disappear literally overnight--and hasten a bank's demise. Speculative loans may be needed to pay the premium for brokered funds. If those loans sour, a weak bank will swiftly collapse.

Deposit insurance compounds the incentive to take excessive risks in a deregulated environment. It does this by interfering with the free market's ability to price the cost of a bank's funds as a function of the risk that the bank incurs. In order to counteract this, we have explored the possibility of co-insurance--similar to the system in the U.K.--whereby depositors would be paid only 75 or some other percentage of their insured deposits in the event of failure. We also considered the possibility of placing the uninsured deposits--amounts in excess of the $100,000 limit of insurance per account--at greater risk.

Neither possibility, however, appears politically feasible at this time. Our experience with the Continental Illinois Bank rescue, where we arranged an assistance package that had the effect of de facto 100 percent deposit insurance, should tell us that we do not have the tools to pay off a giant bank or to assess properly the potential systemic harm of such a pay off. As a consequence, and to prevent the flight of large deposits from small banks to the largest, we should be thinking along the lines of providing 100 percent deposit insurance without regard to any limit per account. In some cases, we have it de facto; the question is, should we have it de jure?

And should deposit insurance be limited to transactions accounts--accounts that can be withdrawn without notice? Consider holders of certificates of deposit over $100,000, letters of credit and other off balance sheet guarantees, and additional bank liabilities. Should they be put on clear legal notice that their funds will not be guaranteed by the FDIC? If this limitation is put in place, we would need some means of keeping opportunistic bankers from sweeping as much as they could under the deposit insurance umbrella.

Given the realities of de facto deposit insurance, we must recognize that the deposit insurance agencies and the government, where it is the de facto insurer of deposit accounts, are subject to a considerable moral hazard. While most bankers are competent and honest and manage their banks prudently and efficiently, there are some who are not. Some bankers are willing to take great risks in the hope of making a fortune, and a few are crooks. Deposit insurance largely removes the necessity for depositors to monitor how banks are operated.

Nor are restrictions on how a bank can be run--what assets it can hold, which services it can offer, where it can branch, and how it should structure its liabilities--an adequate response to the situation. Such restrictions would unacceptably cripple banks' ability to compete with nonbank financial service firms. Moreover, bankers who want to take risks have ample means of doing so in today's marketplace. They can hold long-term fixed interest rate securities that are funded with short-term liabilities and hope that interest rates fall. Or they can do the reverse and hope that interest rates rise. Or they can buy and sell interest rate futures and options contracts. They can

make risky loans for high fees and interest rates or equity participations. There is almost no end to the ways in which the determined risk-seeking banker can gamble with, in effect, the FDIC's funds. The thieves can make self-dealing and outright fraudulent loans, as they have throughout history. With FDIC-insured depositors not very concerned, smarter and more vigilant supervision is essential.

I think by now you appreciate why the supervisor's ability to control risk and maintain safety and soundness in the system has become much more difficult. As banks get into a wider range of activities and as bankers become less conservative, the supervisors must increase their knowledge and oversight. Thus deregulation must be balanced with intensified supervision. Elimination of broadbrush rules that apply to all banks must be offset with aggressive case-by-case action to deal with individual problem banks.

The trouble is that developing and implementing new supervisory initiatives to address the risks and vulnerabilities of a deregulated environment is not easy. Regulators continually face the task of steering a course between what is good for the individual institution and what is good for the system. At the same time we must sort out the risks inherent in the changing operations of both the institutions and the marketplace. The FDIC has tried to meet these new challenges by reviewing and streamlining our internal operating procedures and by adopting policies that shift the focus of our efforts toward ensuring that the banks themselves are prepared to manage these new risks.

SUPERVISORY INITIATIVES

At the operating level, an insurance organization must have an effective risk identification and control system to limit losses. In the case of the FDIC, these preventative steps take on increased importance, because of the potential disruption that can result from a bank failure. The need for rapid action has been intensified by the advent of computers, combined with the increase in 1980 of deposit insurance from $40,000 to $100,000 per account. Now a bank can obtain a very large amount of funds very quickly, either through its own efforts or through brokers, from depositors who have no economic reasons to be concerned with the safety of the bank or with how it intends to use the funds. Thus a risk-taking or crooked banker can subject the FDIC to great losses in a very short time.

Bank Examination

Historically, the bank examination process has been the heart of the FDIC's risk identification program. Not so very long ago onsite examinations were conducted at frequent intervals on all institutions under our direct supervision. Their purpose is to: 1) provide an analysis of a bank's financial condition; 2) appraise the quality of bank management, including the board of directors; 3) identify areas where corrective action may be necessary; and 4) determine overall compliance with applicable laws and regulations. We still are trying to achieve those objectives, but the procedures for doing so have changed drastically.

We have moved away from the static, point-in-time reviews to more dynamic, continuous supervision. We have lengthened our examination cycles for the well-run banks in order to concentrate our limited resources on those institutions that present the greatest exposure and risk of failure. It is better to revisit a problem bank a second or third time than to visit a satisfactory bank once. This has been possible because we have developed sophisticated offsite computer monitoring systems and have increasingly relied on a number of state banking departments for day-to-day supervision of many well-run banks.

Through automatic screening techniques, offsite monitoring helps target specific banks for onsite review and identifies areas within those banks that show symptoms of emerging problems. Furthermore, it allows us to keep track of changes in the way banks are run so that we can move into situations for which our past favorable experience may no longer be relevant.

Automation is also playing a larger role in our onsite examination program. Today's examiners are much better equipped than their predecessors to evaluate a bank's condition. By using portable computers they have instant access to a wealth of bank performance and peer group data stored on our central database. Some loan analysis is being done with computers. We are developing sophisticated computer models and forecasting techniques to further improve onsite analysis. Furthermore, examiners now have the capability to transmit their findings electronically on an automated report format back to their regional offices.

Because of resource limitations, we have placed more emphasis on planning the examinations and targeting our resources to those areas of the bank that exhibit the greatest risk potential. One area we expect to stress is the bank's internal control systems. While our examiners have always reviewed this area, the increasing importance of sound control systems for the prevention of fraud and insider abuse warrants greater examiner attention. We expect to use more statistical sampling procedures to detect deficiencies and then use stringent follow-ups to determine if the control deficiencies were corrected. We are even evaluating the possibility of having the bank's outside CPA's play a greater role in our examination process. Our goal for the future is to identify and effectively use all available supervisory tools, whether they be found in the public or private sector.

Evaluating credit risk is still a major part of our examination program, and it will continue to be. But we will highlight portfolio diversification more than ever before. The problems we have seen in banks serving the American agricultural and energy sectors demonstrate in spades why diversification is so important.

When problems are encountered at an onsite examination, our function is not to manage the bank. Rather, it is to work with management and the bank's board of directors to correct weaknesses and limit exposure to risk. If this proves unsuccessful, we have authority to impose enforcement actions, the procedures for which recently have been streamlined. The severity of those actions depends on the severity of the problem. Actions can range from simple

agreements to correct minor deficiencies or problems to cease and desist orders. Those orders may require the removal of bank officers, civil money penalities, and, ultimately, the elimination of deposit insurance coverage.

Interagency Cooperation

But even with all these changes to our examination and supervisory programs, much more needs to be done. The multitiered financial services industry that evolved out of the 1930's was monitored by a similarly complex regulatory apparatus. Coordination was not a major concern of the regulators. How times have changed! If deregulation has proved anything, it has proved that cooperation between regulators is essential. It has also shown that such cooperation should extend to the private sector and to the public at large. No longer do regulators have the luxury of concerning themselves solely with institutions under their direct supervision. In today's environment, cooperation is the name of the game.

I have already mentioned that the FDIC depends on many state banking departments to shoulder more of the burden for onsite examinations of well-run institutions. The FDIC simply does not have the resources to cover the increasing number of banks requiring special supervisory attention without some assistance with the well-run institutions. But this cooperative effort is not a one-way street. In return we are providing the states with training, legal assistance, examination forms, and access to our computer database.

At the federal level, cooperation has been and will continue to be one of our top goals. We have initiated cooperative examination programs for multibank holding companies exhibiting a high risk profile and for the multinational institutions whose size alone makes them a high potential risk to the FDIC. We have also implemented policies for sharing confidential supervisory information between bank and thrift supervisors. These efforts recognize that prompt and effective communication among the supervisors is in the best interest of all concerned, if excessive risks and abuses within the financial services industry are to be contained.

Since I have become Chairman of the FDIC, cooperation between the agencies has even extended to the breakfast table. Federal Reserve Chairman Paul Volcker, Comptroller of the Currency Robert Clarke, and I try to maintain regularly scheduled breakfast meetings to discuss regulatory and supervisory issues. I believe these meetings have been quite beneficial. I certainly see a cooperative spirit developing among the agencies.

This brings me to my final point about cooperation. The spirit of cooperation among supervisors has not stopped at national borders. The interdependence of world markets has necessitated more harmonization and cooperation to tighten the supervision of multinational banks. We have come a long way in the past few years and I am hopeful that these efforts will continue.

Problems of Geographic and Product Line Diversification

Increased cooperation among banking supervisors has come just in the nick of time. Such cooperation will be needed to confront emerging challenges posed by geographic and product line diversification.

First, let us focus on geographic diversification. As geographic barriers continue to erode, the emerging interstate banking environment will pose new supervisory problems for the regulators. As it stands now, regional interstate banking compacts among neighboring states appear to be a reasonable first step toward nationwide banking. How this will eventually turn out we don't know, although some form of nationwide banking seems inevitable. What we do know, however, is that our present supervision program is inadequate for the task. An effective interstate examination and supervision program that coordinates the resources of all affected regulators is a necessity.

Product line diversification is blurring the traditional distinctions among lines of commerce. The forces of the marketplace are making the wall between banking and commerce more porous each day. While there are sharp restrictions as to what types of business organizations may own banks, there are no such restrictions on the types of businesses that individuals who own banks may engage in. The result is that we have real estate developers, car dealers, insurance agents, and others from all walks of life owning and operating banks. The only restriction is that they are prohibited from placing the bank and other business interests under one corporate umbrella.

Over the years the FDIC has permitted a number of nonbank firms to acquire limited service banks. The FDIC also insures numerous industrial banks that are owned by many types of financial enterprises. The key question being asked is, how do you supervise these business entities as well as bank holding companies that are also diversifying into nontraditional banking activities? Should the entire organization come under close scrutiny even when the bank is only a small part? Or should a supervisory bubble be placed over the bank to try to ensure that the resources of the bank are not tapped to support an affiliate company? Should nonbank activities be conducted within the bank, as part of a separately funded affiliate of the bank, or in a holding company structure? Will the operating efficiencies lost by adding corporate layers be sufficiently offset by the added insulation to the bank? While we in the U.S. are still debating these questions, I have noted with great interest the recent policy notice issued by the Bank of England on this very issue. I believe your research in this area will be quite helpful to us.

Bank Capital Policy

Outside the internal operations area, the FDIC has adopted, or is considering adopting, bank capital and risk-related deposit insurance policies designed to enhance our supervisory capabilities. I will turn first to bank capital. Few disagree with the importance of adequate capital during times of economic uncertainty and change. The challenge supervisors face is how to set capital requirements effectively and fairly.

The first problem facing a capital standard is how capital is to be measured. We clearly would like the standard to refer to economic capital rather than to an accounting number equaling the difference between book assets and book liabilities. Banks' and other enterprises' accounting statements are designed primarily for purposes of control, not as measures of economic market values. For example, many important assets are understated or not recorded at all on a bank's books.

Some examples are customer goodwill, employee training and loyalty, buildings and equipment purchased at times when price levels were lower, and systems development and computer software. Other assets often are overstated. These include loans to countries carried at face value even though the borrower's ability to repay is in doubt, and fixed-interest obligations carried at cost even though subsequent interest rate increases have reduced their present values. Long-term fixed-interest liabilities can be similarly overstated. Considerable research is required before we could implement market-value accounting or even substantially improve our current historical-cost accounting for capital.

A second problem is what standard should be applied. How much capital is enough? How much is too much? In 1985 the U.S. federal bank regulators finally agreed on a uniform capital ratio for commercial banks of 6 percent of balance sheet assets. This was no mean accomplishment, since the agencies had debated the issue for years. Initially we were quite pleased with the industry's reaction, as many banks took quick steps to bolster their capital. However, as we all know, there are a variety of methods to increase capital ratios--some more desirable than others. Banks can increase their accounting-measured capital in ways that do not reduce the risk to the deposit insurance agencies. For example, banks can and have sold their buildings and leased them back. If they are only realizing the capital gains they had but were unable to record, the result is that their balance sheets better reflect their economic condition. This better accounting comes at the price of transactions costs such as real estate agents' fees and transfer taxes and higher income taxes. However, a bank might structure the sale and lease back to misstate the true capital effect by agreeing to a high promised lease payment, taking the gain on the sale without deferring it over the life of the lease, and not capitalizing the present value of the lease payments.

Another rather simple method to boost bank capital is through selective selling of fixed-interest rate obligations. Those with unrecorded capital gains are sold while those with unrecorded capital losses are held.

Perhaps a more serious problem is the tendency of banks to increase their risk exposure with off-balance sheet activities. Rather than take in a deposit and make a loan, a bank might guarantee a loan from one customer to another for a fee. Had it gone the first route, the bank's capital ratio would be lower. By shifting to off-balance sheet activities, the bank reduces its recorded assets and liabilities, thereby increasing the ratio of its capital to assets. But the riskiness of its activities and its need for capital has not decreased.

The entire issue of off-balance sheet activity is an excellent example of the supervisory challenges of a deregulated environment. The volume and diversity of this activity has grown to such an extent that we are now seeking ways to factor the risk into our capital calculation. Here again I am grateful to the Bank of England for providing us with the results of their analysis on off-balance sheet risk.

In view of the growing complexities of assessing risk, we are looking at other ways to relate capital to the risk undertaken. Gaining widespread notoriety, if not widespread support, have been some recent proposals for risk-based capital. Each of the federal agencies has issued preliminary proposals for public comment. As these comments are received, we will undertake analysis aimed at developing a uniform program that is acceptable to our banks and to all the U.S. bank regulators.

One stated reason for the proposal was to move toward a convergence of international standards for measuring capital adequacy. An international standard for capital would be most welcome, since it is difficult to make valid comparisons when every country counts it differently. We should recognize, however, that comparisons among countries and even among banks in a single country are limited by divergences between accounting and economic measures of assets and liabilities.

While we are trying to develop more meaningful measures for bank capital, we also have had to make our present capital standards somewhat flexible. As I've already explained, severe problems afflicting farm and energy production have strained the banks that service those sectors. Responding to this problem, we regulators have agreed to adopt a capital forbearance policy that allows those affected banks to operate temporarily with lower capital ratios if they meet certain requirements. This is a controversial initiative that runs contrary to our original capital policy. But it is a necessary step that will handle the immediate problem in an effective and relatively simple way.

We do not disagree with the position that previously attained high capital ratios were intended for use in just such a current situation. Indeed, capital is supposed to absorb reductions in the value of a bank's assets. Any unyielding, rigid required capital ratio would defeat the basic purpose of capital as a buffer. At the same time, we would not permit a bank that is in trouble to remove capital in the form of dividends or higher payments to owner-managers. We also intend to work toward changes in laws and regulations that would require more capital in better times and that would allow a bank to insulate itself better from the risk of local economic depressions through more effective diversification.

Risk-Related Deposit Insurance

A second major new supervisory policy that we will implement upon approval by Congress is a risk-based deposit insurance program, authorizing us to charge additional fees to those banks requiring more than normal supervision. As the law now stands, the FDIC charges a flat fee based solely on total deposits, excluding deposits held overseas. No consideration is given to an institution's overall risk or the amount of resources required to supervise the bank. We believe that banks posing higher than normal risks should pay higher premiums. Hopefully, higher premiums will serve to restrain risk-taking and have an impact on management's choice of the appropriate level of risk. We think this approach is equitable and is consistent with the private sector's concept of insurance. The details of such a program remain to be worked out, but we find little opposition to the concept of varying premiums by risk.

Public Disclosure

I would be remiss if I did not mention a most important element of supervision--namely public disclosure. We continue to encourage banks to disclose fully all relevant information regarding their financial condition, insider transactions, and their future prospects. Adequate information is necessary for the orderly functioning of markets and for customers and investors exposed to risk. We have publicly encouraged large depositors as well as the investment community to obtain and analyze quarterly statements of condition and income as well as Uniform Bank Performance Reports. The latter reports summarize a bank's performance relative to comparable banks. Disclosure complements our supervisory efforts by allowing the market to participate in the discipline of banks. All banks are concerned about how the investment community and the public perceives them, especially since a downgrading of a bank's debt can have a major impact on its ability to raise funds in the marketplace. But much more needs to be done to ensure that all depository institutions, not just a few, are subject to consistent disclosure policies. At the same time, we must find a way to accommodate these proper user needs without imposing red tape on our many small institutions.

In conjunction with other federal bank regulators, the FDIC is considering requiring that each bank annually submit a short, simple statement setting forth its financial statements, required securities law disclosures, and its business plans. We believe these disclosures could enhance the stock of valuable public information concerning banks.

Staffing Needs

Finally, I must say a word about the most important supervisory initiative of all--the development and retention of a competent staff. Our ability to supervise banks effectively is dependent on our having a cadre of experienced and capable examiners. The FDIC has devoted millions of dollars over the years to improve the skills of our people. As banks continue to diversify into new areas we will have to develop specialized skills necessary to evaluate new risks. At the same time, we also have to maintain a competent core of generalists to pull all the pieces together. While the lure of public service attracts some bright, hardworking, and dedicated individuals, the complexity of tomorrow's environment will demand that regulators retain the best and brightest. We also have to use the tools of analysis and data processing to hope the examiners be more productive. This, I have found, is no small challenge.

Summary

In sum, all of the initiatives I've discussed are designed to enhance the effectiveness of supervision and to strengthen the banking system. Banks are considered special, because of their role in the payments system. That is why they are insured. Some would even say they are over-insured. A deregulated environment gives management opportunities to fail. But because of deposit insurance, bank management often is not held as accountable for failure as the management of a nonbank competitor. That is why strong supervision is so important to us in this environment. As supervisors we must find ways to increase that accountability to bank's depositors and their public.

CONCLUSION

Times have really changed. Traditionally, prudential supervisors have tended first to be wary of innovation and then have tried to "regulate it to the eyeballs." However, in recent years supervisors have changed their tune. They have become the advocates of innovation. They realize that deregulation can enhance the safety and soundness of the system by granting financial intermediaries the flexibility they need to operate efficiently and to compete on equal terms. But enhanced supervision must go hand-in-hand with regulatory reform. Approached sensibly, broad-based deregulation in tandem with careful supervision will foster a stronger, more responsive, more competitive banking system. And that is in the best interests of the public.