Fed's Role in a Changing Banking Industry

For Supervision, Regulation and Credit, facing change and managing risk are all in a day's work. Senior Vice President and Chief Lending Officer Michael E. Collins talks about the dynamic nature of the banking industry and how the Fed is adapting to changing times.

Q: How is the banking industry faring in today's economy?

Collins: In 2005, the industry delivered strong performance, smoothly adapting from a benign economic environment to one of rising interest rates and stronger growth. Throughout this transition, the nation's financial institutions have been able to successfully deal with changing circumstances while still generating healthy profits. Going forward, we believe the U.S. banking industry is well positioned to support a thriving and prosperous U.S. economy.

Our banking system is truly the nexus of our economy. It supports a dynamic and competitive financial services market while still encouraging innovation and responsiveness. The industry's central role in allocating resources, pooling capital, and funding economic growth has continued to grow and change as its complexity evolves. Technological advances, combined with new products and markets, have changed the financial services landscape, creating opportunities and challenges for both financial institutions and industry supervisors.

Michael E. Collins, Senior Vice President and Lending Officer

Q: So, adapting to change is an important aspect of the banking business. How does this affect SRC?

Collins: Our supervisory practices have become geared more toward evaluation of risk management and less toward point-in-time financial assessments.

Supervision itself is a preventative and collaborative practice, intended to be flexible and designed to identify and assess risk. Our approach to supervision focuses on a bank's systems, policies, and internal controls. This helps us ensure that appropriate procedures are in place to contain risk and, importantly, that bank management adheres to them. Our goal is to ensure public confidence and a sound banking and financial system.

Regulation, on the other hand, is largely responsive. Regulation typically grows from fraud and abuse, disruptive technologies, and rapidly evolving social trends. It establishes rules and directives, with due consideration to past events, and should be an ongoing process aligned with strategy.

In both supervision and regulation, we always strive to avoid unintended consequences and excessive burden. Supervisory processes and regulations and guidelines undergo periodic evaluation to ensure their continued effectiveness. We believe governance is a fluid process, which should encompass best practices and guidance.

Q: How do you balance your supervisory and regulatory duties while still encouraging banks to sort out their own best practices?

Collins: Given the increasing scale and diversity of financial institutions and the rapid pace of change, it is important for supervision and regulation to try to mirror the discipline the market itself would impose.

Markets are remarkably resilient and have an inherent capacity to sort out shocks and risks, ideally with minimal regulatory involvement. Effective market discipline gives banks strong incentives to conduct their business in a safe, sound, and efficient manner.

However, since we can never exactly duplicate the market's discipline, we must depend on supervisory guidance, rules, and procedures to ensure safety and soundness in our institutions. Also, financial institutions may not always objectively consider the broader implications of their decisions on other stakeholders in the marketplace. So, it is incumbent upon the Fed and other regulatory agencies to work with financial institutions and help them achieve optimal outcomes without stifling their innovation.

Q: Credit risk has historically been the leading cause of bank failures. What is the industry doing to protect assets and ensure against undue credit risk?

Collins: Imbalances and undue risk can build on a bank's balance sheet as a result of the growth in nontraditional mortgage products, the rise in commercial real estate concentrations, and the increased use of leverage. We expect institutions with higher risk profiles to have more robust risk management systems. As such, institutions increasingly manage risk on a portfolio basis, conducting stress testing and using secondary markets to mitigate risk. They also price for risk to ensure a balanced risk-reward equation. Such risk-based pricing is consistent with expanding access to credit.

Banks are willing to take on riskier loans because they can hedge away

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Our supervisory practices have adapted to a changing banking industry, becoming geared more toward evaluation of risk management.

some risk by issuing asset-backed securities. These markets are sophisticated and complex, allowing many individual investors to purchase a portion of the loans, which have been "bundled" for diversification purposes. The situation is win-win. The bank is rendered less vulnerable to the risk of the original loans, and the investors are willing to bear that risk for the chance to earn higher potential returns.

While we recognize that credit concentrations can be effectively managed, excessive levels may expose an institution to high credit loss volatility and, when unchecked, can be an unsafe and unsound strategy. Banks have implemented in-house limits and strengthened their oversight of concentrations by improving portfolio stratification. Nevertheless, regulators have released draft guidance related to commercial real estate concentrations given the historic adverse impact on the industry.

Q: What is the Fed's position on the use of more exotic instruments, such as interest-only loans?

Collins: The Fed understands the need for innovation in the financial services industry to ensure we have a vibrant banking system. Innovation is good, but, as with anything new, we must be careful about how these instruments are used. We must also ensure that the public is sufficiently financially literate to choose and use these instruments properly.

Of course, despite these solutions, the competitive drive to win customers should not supersede the discipline of prudent lending and adherence to good credit fundamentals.

It is incumbent upon bankers making these loans to ensure that borrowers have the capacity to repay them, thereby sustaining the expansion of homeownership these products make possible. This is an area of increasing sensitivity in regulatory circles, largely because of the newness of these types of products. Risk management procedures must consider the unique nature of these new loan types. Borrowers must be able to sustain their investment and repay these new loans. And underwriters must have systems in place to ensure that they will.

Q: What is the Fed doing to protect consumers?

Collins: As an agency charged with banking supervision and regulation, the Fed has a responsibility to ensure that banks follow safe and sound management practices and serve all segments of their community. People must have access to a sound banking system where their money can be invested productively with minimal risk.

The Federal Reserve writes regulations to implement many of the major consumer protection laws. These include the Truth in Lending Act, which ensures consumers receive adequate information about credit, and the Truth in Savings Act, which requires banks to disclose certain information about deposit accounts. The Federal Reserve also has responsibility for reviewing banks' compliance with its regulations. In addition, the Federal Reserve responds to inquiries and investigates complaints from the public regarding the institutions it supervises and refers other inquiries/ complaints to the appropriate regulatory agency.

Q: What is the purpose of the new Bank Secrecy Act manual?

Collins: The new interagency Bank Secrecy Act examination manual, released in June, was a collaborative effort of the federal banking agencies and the U.S. Department of the Treasury's Financial Crimes Enforcement Network. It introduces no new rules or guidance, but rather it is a compilation of existing regulatory requirements, supervisory expectations, and sound practices designed to ensure that the banking system is not used to finance illicit activities.

Sound Bank Secrecy Act/anti-money laundering risk management enables an organization to identify risks and better direct resources to safeguard its operations from money laundering or terrorist financing.

Q: Why do you think the industry has continued toward consolidation?

Collins: The trend toward nationwide banking and the desire to leverage investments in technology have contributed to banks' desire to consolidate. In addition, some consolidation activity has been the result of competitive changes that allowed financial institutions to cross lines of business and break into new markets. In turn, such activity has imposed significant change on the industry.

Consolidation can improve efficiency and scale while still allowing the benefits of local banking. Through branch networks, institutions build not only their reputation and brand but also the ability to expand distribution channels and delivery networks. However, despite ongoing consolidation among larger institutions, there continues to be a steady level of requests for new bank charters, which indicates that strong consumer and investor demand for community banks still exists.

The vast array of opportunities and risks likely means there will be no preeminent model for the successful banking organization of the future. Rather, several models will likely thrive and survive. The proper execution of the model and unparalleled attention to customers will determine its success.

Q: What is the status of Basel II?

Collins: Capital adequacy is an ongoing concern for bank supervisors. The U.S. is striving to implement the proposed international regulatory framework of Basel II by 2009. This framework will better align regulatory capital with risks and represent a vast change in how banks determine capital adequacy. Under its advanced approaches, banks will be required to adopt more formal, quantitative risk measures and risk management procedures. Essentially, Basel II strengthens the link between regulatory capital and risk management.

Now, more than ever before, capital adequacy, risk management, and effective supervision are of critical importance to maintaining a safe and sound financial system.