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Remarks by

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FDICIA and the Future of Banking
Law and Regulation

It is a pleasure to participate again in this Conference, the theme of which is the Federal Deposit Insurance Corporation Improvement Act of 1991. As timely as this subject remains, my intent today is to move beyond FDICIA and discuss a more basic issue: What should be the goals of banking law and regulation, and how should we achieve those goals?

To understand optimal bank regulation, one should begin with an understanding and appreciation of the role of banks in a modern economy. Fundamentally, banks provide an intermediation function that results in depositors receiving rates that are lower than the yields on loans and securities, in return for increased safety, liquidity, and payments services. The intermediation process, in turn, is predicated on the ability of banks to develop specialized information on the creditworthiness of their borrowers, and to use this information in ways that take advantage of portfolio diversification. In other words, banks are in the business of managing risk. If done correctly, the bank will create economic value by attracting savings to finance investment. If done incorrectly, real resources will be misallocated, and the bank may fail. Moreover, even if risk measurement and management are done correctly the bank may still fail, simply because it was unlucky.

The historic franchise of commercial banking has always depended upon the credit insights of the banker, his ability to gauge the capacity and willingness of a borrower to repay a loan, his ability to sense which risks appear to hedge others. These old

fashioned concepts are still relevant in evaluating today's commercial banking, even as we move toward sophisticated risk-management involving betas, covariances, and the impressive, evolving techniques of risk reduction

Indeed, modern banking is not inherently different from traditional banking, except that there are now many more financial products involved than simple business and household loans. This continually expanding list includes instruments such as futures, swaps, caps, options, and other derivatives and guarantees -- instruments that do double duty as products that unbundle risks for customers, and act as tools for managing the bank's own risk position.

As the complexity of the financial marketplace has increased, so has the complexity of risk management. Many commercial banks, for example, now employ formal C&I credit scoring models to assist in assigning a risk rating to a prospective credit. Loan pricing models now incorporate methods for disaggregating a loan's risk into its separate components, and pricing these components against the marketplace. There are also intrinsic-value pricing methods, such as risk-adjusted return on capital models. But although modern banking may create sophisticated mathematical structures to measure and price risk, the raw data of these systems remain the credit judgments of the individual loan officers in classifying the risk of a potential loan.

Risk can be priced properly, and the nonsystematic portion of risk can be diversified away. But all risk cannot be eliminated. Even more important, the willingness to take risk is essential to the growth of the macroeconomy. All businesses face risk, and there is a systematic, positive relation between risk-taking and potential reward. Much of the growth in employment in our economy is associated with new firms (and often new technologies) coming into

existence at the very time that old firms (and old products or methods of producing products) have gone out of existence. The new firms exist only because they are willing to take on risk and, often, the old ones go out of existence because they did not take risks, or at least did not take the right risks. This replacement of stagnating firms by firms with high potential for growth is what Schumpeter referred to as the "perennial gale of creative destruction." Indeed, if all savers and their intermediaries attempted to invest only in risk-free assets, then the potential for business growth, and the growth of domestic product that flows from business success, would never be realized.

Modern, dynamic, competitive economies are characterized by rapid obsolescence of products and services displaced by ever more innovative ways of doing things. The extent to which new ventures are created and old ones lapse is truly startling. Indeed, the gross churning of employment is a clear reflection of that process. Currently, about 400,000 workers a week lose jobs as indicated by our labor force surveys and unemployment insurance data. But since total jobs are growing, albeit modestly, it means that gross additions to employment as a consequence of new firms, and expansion in existing firms, are in excess of 400,000 per week.

If risk-taking is a precondition of a growing economy, and if banks themselves exist because they are willing to take on and manage risk, what should be the objectives of bank regulation? The answer clearly should begin with the goal of circumscribing the incentive of banks to take excessive risks owing to the moral hazard in the safety net designed to protect the financial system and individual depositors. But the full answer must involve some benefit-cost trade-offs between, on the one hand, protecting the financial system and

taxpayers, and on the other hand, allowing banks to perform their essential risk-taking functions

Herein lies the basic problem with much of U S banking law and regulation. The legislative and regulatory process, in my judgment, has never adequately wrestled with the question of just how much risk is optimal. Recent banking law has perhaps too often constituted a series of reactions to perceived excesses, and thereby tipped the optimum balance. For example, the real estate appraisal requirements of FIRREA were designed mainly to eliminate excesses in commercial real estate and development lending but have ended up also excessively constraining banks' lending to small businesses. More generally, the toughened examination standards of the late 1980s and early 1990s were reactions to the lending excesses of the 1980s, but have also contributed to the credit crunch of the 1990s.

FDICIA also was a reaction, this time by the Congress, partly to excesses by the industry and partly to perceived inadequacies of the regulators. While these concerns surely needed to be addressed, the essential problem with FDICIA, in my view, was that its authors did not consider appropriately the question of optimal risk-taking by banks. Rather, the Act aimed at recapitalizing the Bank Insurance Fund, and making sure that future costs to the deposit insurance fund were minimized. But there is danger here. If minimizing risks to taxpayers is interpreted as minimizing bank failure, then we are very likely to deter banks to an excessive degree from accepting the kinds of risk that create the value of their franchises. The optimal degree of bank failure is not zero, and, in all likelihood, not even close to zero.

Perhaps the Congress and we regulators should step back and ponder the answers to some basic questions

What is the optimal degree of risk-taking by regulated financial institutions? In order to have a vibrant, expanding economy, to what degree of risk should depositors or taxpayers be exposed?

Second, with what kinds of risks, especially new risks, should we concern ourselves? Derivative markets provide important examples here. As banks invent and use ever more complex instruments, it becomes even more important for regulation to define clearly just where the regulatory risks lie. By doing this, regulators can take actions that address our legitimate concerns, but that do not stifle innovation.

Third, which entities should be subject to regulatory controls over their risk-taking activities?

Fourth, what tools should regulators use to measure and limit risk-taking? Here I would emphasize that "tools" should be broadly defined to include the use of not only modern analytical and empirical methods, but also a highly educated and sophisticated staff throughout the supervisory function. Indeed, the maintenance of a high quality staff is probably the single most important prerequisite for successfully implementing the principles of optimal regulation. As an example, I would note that we are considering the formation of highly trained and specialized teams of examiners to assess the asset-liability models and other procedures used by bankers to manage interest rate risk.

Fifth, to what extent should we seek global convergence of supervision and regulation? Certainly, individual country banking structures and cultures differ, and they are not all subject to the same forces. In one area closely related to banking, the payments system, international convergence could significantly reduce risk.

without impairing innovation. As indicated in the Promise Report, issued in October 1992 under the auspices of the Basle Committee, improvements in netting schemes, accounting and disclosure rules, and the removal of cross-border legal uncertainties, would significantly lower payments risk. This is of special importance as payments systems become ever larger in the years ahead.

I do not propose to answer the questions I have posed here today, only to emphasize that regulators and the Congress should give them more thought. My predilection is that while risk-taking should be restrained, we should not seek to minimize it. Regardless of the degree of permitted risk-taking, I believe that the specific tools used by regulators to measure and control bank risk-taking generally should not be legislated. There is a danger that legislated tools will be formulistic, and will result in an overemphasis on regulation, which is the writing of rules that apply to all institutions, rather than supervision, which strives to take into account the differences across institutions.

A characteristic of the modern banking system is that technological advances breed increasing numbers of ways to take on risk, as well as increasing numbers of ways to measure and control risk. Thus, we see ever more diversity across banks in their approaches toward risk management. No single quantitative standard or ratio could capture this diversity across institutions nor even capture the complexity of risk at any one institution. Moreover, rigidly applied formulas can not adequately take account of the need for banks to evolve, regulatory formulas may, in fact, stifle productive innovation.

Given these thoughts regarding optimal bank regulation, how should we assess FDICIA and its ongoing implementation? The portion

of the Act that, in my judgment, is most inconsistent with appropriate bank regulation is Section 132 -- what I and others have termed the micromanagement provisions of FDICIA. Section 132 directs each Federal banking agency to set standards regarding operations, management, asset quality, earnings, stock values (if feasible), and employee compensation. The necessary regulatory response to this portion of the legislation, and the anticipated industry response to the new regulations, have and will divert scarce human resources at regulatory agencies, add to the regulatory burden on the industry, and create uncertainties, all of which reduce the incentives of bankers to take on risk, perhaps even reasonable business risk.

The creation of uncertainties has been especially burdensome, because FDICIA was passed in December of 1991, but the provisions of Section 132 will not be finalized until this summer, and they will not take effect until later in 1993. During this almost two year period while regulatory agencies have been wrestling with meeting the letter and intent of the legislation, bankers no doubt have been reluctant to take new initiatives that may run afoul of rules yet to be announced. The agencies, meanwhile, have been trying to meet the intent of the Congress while minimizing the burden on banks and the deleterious effects on the supply of credit.

Late last month, the Federal Reserve approved for publication a Notice of Proposed Rulemaking regarding Section 132 Safety and Soundness Standards. I anticipate that bankers will offer timely and constructive criticism so that final adoption can proceed apace. It is the Board's hope that, as the regulations are being implemented, the agencies and the industry will be diligent in seeking to ensure that the intent of the law is achieved at minimum cost. Finally, in response to continuing serious concerns regarding excessive regulatory

burdens in banking, the Federal Financial Institutions Examination Council is expected to propose legislative changes later this spring. I trust the Congress will consider these proposals carefully.

FDICIA requires that risk-based capital include standards for interest rate risk, the risk of concentrations of credit, and the risk of nontraditional activities. The legislative language calls for improving risk-based capital in such a way as to make the capital ratios better indicators of bank safety and soundness. The regulatory agencies are attempting to achieve this congressional intent without subjecting banks to rigid formulas and heavy reporting requirements that are unlikely to prove fruitful in achieving improved capital measurements. Indeed, a reading of the draft Notice of Proposed Rulemaking concerning interest rate risk, approved for publication by the Federal Reserve Board in March, should convince observers that great care is being taken in the implementation of this provision. For example, many institutions with demonstrably low interest rate risk would be exempt from the reporting requirements of the proposed rule, and many others could use their internal asset-liability management models to demonstrate that they are taking on acceptable levels of rate risk. The ability to use their own rate risk models should encourage market participants to continue to develop and refine interest rate risk measurement and management systems, as knowledge and technology in this area evolve.

Similarly, the draft proposals on concentrations of credit and the risk of nontraditional activities recognize that such risks depend critically on the details of the asset composition of the individual bank, and on management expertise and information systems. Again, no numerical standard, however complex, is likely to capture these important details as they affect overall banking risk. In

addition, the state of scientific knowledge in these areas is, quite frankly, rather crude. Quantitative standards here could give a false sense of precision and, very possibly, could inhibit the development of more sophisticated and effective approaches to risk management. For these reasons, the proposed regulations minimize the use of formulas and rely heavily on the supervisory process.

Let me emphasize that the prudent supervision of banking organizations must be forward looking, and consistent with the goals and objectives of optimal regulation. Any other approach will be at best counterproductive, and at worst may deter the innovation and risk-taking that are essential for a growing economy. Forward-looking policymakers should also be concerned about the potential for future decline in the value of the banking franchise. This is important not because it is our job to worry about bank shareholders, but because laws and regulations that reduce the ability of banks to bring value-added to the risk management process also happen to reduce the value of the banking franchise. I would like to conclude my remarks by commenting on these issues, beginning with some observations on the current state of the banking industry.

As we all know, earnings were at record levels in 1992, banks have been extremely successful at raising new equity in recent years, and asset quality seems to be improving. In short, while a portion of the industry is still under substantial stress, the industry has generally made major progress in recovering from a very difficult period.

Indeed, the immediate future of banking is anything but bleak. Unlike some observers, I am not overly concerned about the possible impact on bank earnings should interest rates eventually rise. First, while the last several years have seen a general

substitution of securities for loans in bank portfolios, banks do not appear to have lengthened significantly the effective maturity mismatch of their assets and liabilities relative to earlier years. In other words, banks do not appear to have significantly increased their interest rate risk in recent years. To be sure, interest margins have widened, perhaps only temporarily, both because deposit rates have fallen relative to loan yields at similar repricing intervals, and because the yield curve has steepened. However, as the economy continues to improve, loan demand presumably will rise and banks will tend to reverse the move into securities, the higher spreads associated with loans will help support earnings. Finally, short of a significant weakening in the economy, loan loss provisions can be expected to continue to decline as problem assets recede. A reduction in provisions would buffer to some extent any decline in net interest margins.

While the short- to intermediate-term prospects for the industry should not give us cause for concern, I am less sanguine about the long run. Bank commercial and industrial lending as a percentage of total borrowing by nonfinancial businesses has been declining for several decades. This trend is disturbing for reasons that go beyond contemporary concerns about the causes of the recent credit crunch. American businesses increasingly are borrowing directly from investors in the form of commercial paper and other debt obligations, or they are borrowing from nonbank financial institutions. Viewed in this light, the issue becomes one of the future role of U.S. banks in the overall provision of financial services, not just loans.

This challenge to banks has occurred largely as a result of the technological changes that have permitted investors to make their

own evaluations regarding credit and market risk, thereby allowing investors to lend directly to larger borrowers. To some extent, banking organizations have responded to these changes by participating themselves in the increase in direct investor-borrower deals. The Board has acted, within the confines of existing law, to allow banks to evolve along with technological change. Nevertheless, the restrictions of Glass-Steagall, in the absence of significant reform legislation, imply that the challenge to banks' role in financial intermediation will continue to be driven to a substantial degree by artificial legislative constraints, not market conditions. Besides Glass-Steagall, other legal impediments to needed structural reform in banking -- such as restrictions on interstate branching -- remain firmly in place.

Public policy, in my view, should be concerned with the decline in the importance of banking. To the extent that market forces are displacing the intermediation functions of banks, economic efficiency is not being impaired, but to the extent that unnecessary laws and regulations are responsible for the decline, there is a significant reduction in allocative efficiency associated with preventing banking companies from fully exercising their abilities to underwrite and manage risk. As the nonbanking sector expands relative to the banking sector -- because of artificial legal barriers to bank expansion -- human resources, physical assets, and capital must be reallocated to the nonbank sector. The "transaction costs" of this reallocation are not trivial. Further, the banking sector loses the opportunity to fully diversify its activities in a way that may permit it to move toward the risk-return frontier rather than remain inside it. Finally, and most importantly, the consumers of financial services are denied the lower prices, increased access, and higher

quality services that would accompany the increased competition associated with permitting banking companies to expand their activities

The debate over the repeal of Glass-Steagall provides an interesting and instructive case study of the difficulty in achieving legislative reform. The possibility of repeal of Glass-Steagall has been raised many times over the last two decades, but, each time, the opponents of repeal have mustered arguments to defeat such proposals. Recently for example, in 1991, when the recommendations of the Treasury Department regarding expanded powers were being considered (and ultimately rejected in the final FDICIA legislation), a popular argument against reform was that banks were in trouble with low earnings and high loan loss provisions. Expanded powers at that time, it was argued, would only lead to additional risk that could cause more bank failures. Now, in 1993, opponents of reform argue that bank profits are at historically record levels, therefore, expanded powers are not needed by the banks to maintain their profitability.

Apparently, there is no good time for reform. This line of argument is disturbing. We cannot afford to be complacent regarding the future of the U S banking industry. The issues are too important for the future growth of our economy and the welfare of our citizens. I trust that the Congress will see FDICIA, the subject of this conference, not as an end in itself, but as providing a vehicle for allowing needed restructuring of our banking industry. Equally important, I would hope that our experiences with the portions of FDICIA that impose excessive burdens on banks have taught us that existing and proposed banking laws must be evaluated to determine their likely impacts on the soundness and competitiveness of our banking system. And, once legislation is passed it must be

implemented in a way that preserves the value-added of the banking system, by not confining banks in a regulatory straitjacket that stifles innovation and prudent risk management. Further, this must be done in a way that properly balances the banks' role as risk-takers and risk managers with the public policy concerns of bank safety and protection of the taxpayer. By doing this, we can greatly assist in the process of achieving a healthy and dynamic economy.

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