The Federal Reserve Board

Remarks by Governor Laurence H. Meyer

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Issues and Trends in Bank Regulatory Policy and Financial Modernization Legislation

It is a pleasure to be here today, and I thank the Bank Administration Institute for inviting me to be a part of your discussions.

When people think of the Federal Reserve, I am pretty sure that most Americans think of monetary policy, interest rates, international finance, and the Fed's macroeconomic responsibilities in all of these areas. And, of course, macroeconomics lies at the core of what any central bank does. However, as everyone at this conference appreciates, another major function of the Federal Reserve is the supervision and regulation of banks and bank holding companies. I would like to use my time this afternoon to discuss some key aspects of this side of the Fed's activities.

I will begin by outlining, very briefly, some of the key trends affecting the banking and financial sector. I will then focus on what I see as the most important challenges that these trends pose for bank supervisors, and suggest some directions that I believe we should consider when thinking about how bank supervision should evolve over time. Lastly, I will discuss current legislative efforts to modernize our banking system.

Key Trends Challenging Bank Supervisors
Surely the most profound force transforming the financial, and for that matter other sectors of our economy, is the rapid growth of computer and telecommunications technology. In finance, a critical and complementary force is the development of intellectual "technologies" that enable financial engineers to separate risk into its various components, and price each component in an economically rational way.

Implementation of financial engineering strategies typically requires massive amounts of cheap data processing; and the cheap data processing would not be useful without the formulas required to compute prices. The combination of the two has led to a virtual explosion in the number and types of financial instruments. Such products have lowered the cost and broadened the scope of financial services, making it possible for borrowers and lenders to transact directly with each other, for a wide range of financial products to be tailored for very specific purposes, and for financial risk to be managed in ever more sophisticated ways.

Financial innovation has been the driving force behind a second major trend in banking -- the blurring of distinctions among what were, traditionally, very distinct forms of financial firms. One of the first such innovations, with which we are all now very familiar, was money market mutual funds. In the 1980s, banks began to challenge whether the Glass-Steagall Act prohibited combinations of commercial and investment banking. Today, both the regulators and the courts agree that Glass-Steagall does not imply a total prohibition. More recently, traditional separations of banking and insurance sales have also begun to fall, with support from the supervisors and the courts.

A major result of the continued blurring of distinctions among commercial banking, investment banking, and insurance is a tremendous increase in competition for many financial services. Greatly intensified competition has also led to increasing pressure for revisions to many of the banking laws and regulations that, despite some successful efforts at relaxation or repeal, continue to exert outdated and costly restraints on the banking and financial system.

Indeed, despite its often frustratingly slow pace, there seems little doubt that deregulation has been a major force for change in the banking and financial services industries. Two decades ago we still had Regulation Q, the Glass-Steagall Act was widely viewed as requiring a virtual prohibition of combinations of commercial and investment banking, and interstate banking and branching, let alone combinations of banking and insurance, were barely fantasies even at the state level.

The fourth major force transforming the banking landscape is the globalization not only of banking and financial markets, but also of the real economy. The interactions of developments in both the financial and real economies have expanded cross-border asset holdings, trading, and credit flows. In response, financial intermediaries, including banks and securities firms, have increased their cross-border operations. Once again, a critical result of this rapid evolution has been a substantial increase in competition both at home and abroad.

The final significant trend I will highlight is the on-going consolidation of the U.S. banking industry. I think that it is fair to say that the American banking system is currently in the midst of the most significant consolidation in its history. In 1980 there were about 14,400 banks in the U.S. organized into about 12,300 banking organizations. By the end of 1997, the number of banks had fallen to just under 9,100, and the number of banking organizations to not quite 7,200. This 42 percent decline in the number of banking organizations was due in part, but only in part, to the large number of bank failures in the late 1980s and early 1990s. A more important factor was mergers among healthy banks. Since the early 1980s, it has not been unusual to see 400 or more mergers among healthy banks each year.

While mergers have occurred, and continue to occur, among banks of all sizes, I would emphasize three aspects of the current bank merger movement. First is the high incidence of "megamergers," or mergers among very large banking organizations. Several mergers of the last few years have been either the largest at the time, or among the largest bank mergers in U.S. history. And, of course, that trend continues.

Second, despite all of the merger activity, a large number of medium to small banks remain in the United States. Moreover, by most measures of performance these small banks are more than a match for their larger brethren for many bank products and services. When a megamerger is announced it is not uncommon to read in the press how small banks in the affected markets are looking to take advantage of the business opportunities created thereby. Research seems to support their optimism.

Lastly, while the overall number of banking organizations has fallen since 1980, this does not mean that new, or *de novo,* entry has not occurred. From 1980 through 1997 some 3,600 new banks were formed in the United States.

In large part because of the continued viability of smaller banks, while the national concentration of banking assets has increased substantially since 1980, measures of local market banking concentration have remained essentially unchanged. Indeed, the stability of local market concentration in the face of such a large consolidation of the banking industry is remarkable, and bodes well for the competitive vitality of local banking markets.

While the reasons for bank mergers are varied, the bottom line is that the United States is well on its way to developing a truly national banking structure for the first time in its history. We are not quite there yet, but I do not think it will take too many more years.

Future Directions in Bank Supervision
What do all of these changes mean for how we supervise and regulate banks?

Analysis of Competition
Clearly, as the banking industry consolidates we need to maintain competitive markets. Competitive markets are our best assurance that consumers receive the highest quality products at the lowest possible prices. As I discussed earlier, there are many reasons to believe that in recent years competition has increased greatly in markets for a large number of financial products and services. This is true for many products purchased in local, regional and national markets. However, in some cases we still observe potential competitive problems with a proposed bank merger. Fortunately, the antitrust laws, as written into the banking statutes, give us the means to maintain competition in such situations. These laws require that the Board approve only those mergers that are not expected to substantially harm competition.

Over the past year or so, quite a few applicants have pushed very hard at the Board's frontier for approving merger applications. In response, the Board has occasionally felt compelled to remind applicants, especially those proposing a merger that would affect a large number of local markets, that substantial changes in market concentrations will receive careful review. Moreover, when mergers would exceed the screening guidelines, "mitigating" factors must be present. By mitigating factors I mean conditions that tend to create a more competitive market than is suggested by market concentration alone. The greater the deviation from the screening guidelines, the more powerful and convincing the mitigating factors must be.

I have personally been particularly concerned with cases where a large number of local markets are affected. In such cases, even if the adverse effect is fairly small in each of several local markets, it seems to me that the cumulative, or total, adverse effect might be significant. When a large number of markets are affected adversely, I believe that we should be especially careful to assure ourselves that there are substantial mitigating factors. In addition, when a merger would cause a large change in concentration in a market that is, or becomes, highly concentrated, I think we need to give special attention to the impact on competition.

Assessing Safety and Soundness
Technological change, financial innovation, the acquisition of new powers by banking organizations, the increasing geographic scope of banks, and the globalization of financial

markets all challenge our ability to examine and assess the safety and soundness of individual banking firms. One way that examiners are adapting to this changed world is to focus much of their attention on the information and risk management systems of banks. The key question they ask is: How effectively are these systems measuring and controlling an institution's rapidly changing risk profile? The emphasis on risk management is most critical at our largest, most sophisticated, and most internationally active banks. Many of these banks use advanced economic and statistical models to evaluate their market and credit risks. These models are used for a variety of purposes, including allocating capital on a risk adjusted basis and pricing loans and credit guarantees.

The development by some banks of increasingly accurate models for measuring, managing, and pricing risk has called into question the continuing usefulness of one of the foundations of bank supervision -- the so-called risk-based capital standards, or the Basle Accord. The Basle Accord capital standards were adopted in 1988 by most of the world's industrialized nations in an effort to encourage stronger capital at riskier banks, to include off-balance sheet exposures in the assessment of capital adequacy, and to establish more consistent capital standards across nations. The Accord was a major advance in 1988, and has proved to be very useful since then. But in recent years calls for reform have begun to grow. I will outline briefly one of the key problems we are currently facing with the Basle Accord.

The Basle Accord capital standards divide bank on- and off-balance-sheet assets into four risk buckets, and then apply a different capital weight to each bucket. These weights increase roughly with the riskiness of the assets in a given bucket. However, the relationship is rough. Perhaps most troublesome, the same risk weight is applied to all loans. Thus, for example, a loan to a very risky "junk bond" company gets the same weight as a loan to a "triple A" rated firm.

This aspect of the Accord clearly gives banks an incentive to find ways to avoid the regulatory capital standard for loans that their internal models say need less capital than is required by the Basle Accord. Conversely, banks should want to keep loans which their models say require more capital than does the Basle standard. And, guess what, banks have been doing just that. This so-called "regulatory arbitrage" may not be all bad, but it surely causes some serious problems as well. For one thing, it makes reported capital ratios--a key measure of bank soundness used by supervisors and investors--less meaningful for government supervisors and private analysts. Finding ways around this problem is a high priority at the Federal Reserve.

The arbitraging of regulatory capital requirements is but one of a host of similar conflicts between banks and bank supervisory rules and regulations. Indeed, one can view much of the long history of bank supervision and regulation as something of a contest between supervisors who want to deter excessive risk taking and banks who seek ways around sometimes inefficient, or just plain uneconomic, regulations. This long history leads me to seek supervisory strategies that are, in the economist's jargon, incentive compatible. By incentive compatible, I mean supervisory policies and procedures that give banks strong internal incentives to manage their risks prudently and minimize the exploitation of moral hazard. Put differently, we need to design strategies that encourage banks, in their own self-interest, to work with us, not against us.

When designing supervisory policy, we should always remember that the first line of defense against excessive risk-taking by banks is the market itself. Market discipline can be, and often is, highly effective at deterring excessive risk. Indeed, a primary goal of many of the bank regulatory reforms implemented in the wake of the banking and thrift crises of the 1980s and early 1990s was either to increase market discipline or to make supervisors behave more like the market would behave. Market discipline was increased, for example, by raising capital standards and by mandating greater public disclosure by a bank of its financial condition. Prompt corrective action rules that require supervisors to impose increasingly severe penalties on a bank as its financial condition deteriorates, and the adoption of risk-based deposit insurance premiums are examples of encouraging supervisors to act like the market.

The reforms of the early 1990s were a good start. But I believe that there may well be more that we can do. Such comments may sound out of place today. Times are good, and almost everyone seems quite satisfied with the current deposit insurance system. But good times may be precisely when we should develop ideas for an even more effective system. The crucible of a crisis is not always the best time to think up reforms -- witness the error we made in passing the Glass-Steagall Act, an error we have yet to correct after 65 years! Indeed, it is in part for this very reason that the Board continues to urge Congress to pass financial modernization legislation. So, in the spirit of being forward looking, let me attempt to give you the flavor of one idea that seems worth considering.

It may be possible to increase market discipline by requiring large, internationally active banks to issue a minimum amount of certain types of subordinated debt to the public. An appealing aspect of this approach is that subordinated debt holders, so long as they are not bank "insiders," face only downside risk, and thus their risk preferences are very close to those of the FDIC. Subordinated debt holders would therefore be expected to impose market discipline on the bank that is quite consistent with what bank supervisors are trying to do, including encouraging banks to disclose more information about their financial condition. Observed risk premiums on subordinated debt could perhaps be used to help the FDIC set more accurate risk-based deposit insurance premiums, and such debt would provide an extra cushion of protection for taxpayers. An additional benefit of having subordinated debt traded on the open market is that price movements would provide a clear signal of the market's evaluation of the bank's financial condition that, even if it were not used to help price deposit insurance, could serve as an early warning aid to supervisors.

Subordinated debt is not, however, without its problems. For example, the risk preferences of such creditors are aligned with those of the FDIC only when the bank is clearly solvent. At or near insolvency, subordinated debt holders may be willing to "bet the bank" in order to increase the chances that they will not suffer a loss. The fact that the bank closure decision is still in the supervisor's hands is another complicating factor. In addition, it is unclear just how deep and liquid a market in bank subordinated debt would be, although limiting any requirements to the largest banks would ease this concern. For example, at the end of last year only one-half percent of banks with less than $50 million in assets issued subordinated debt, but 83 percent of banks with total assets of $10 billion or more did so. However, it appears that much of existing bank subordinated debt is held by the bank's parent holding company, not independent third parties. Thus, the question of how deep and liquid a market might evolve remains. For these and other reasons, an operationally feasible program for mandatory subordinated debt would require a considerable amount of careful thought. Still, in my judgment it is thought that might prove very worthwhile.

The Need For Financial Modernization

Technology and globalization are changing markets all over the world, but perhaps none have been more affected than the financial markets. Yet in the United States much of our legal framework has essentially not changed since the 1930s. The resultant pressure on financial institutions to be able to compete has thus been reflected in the search for loopholes and in efforts by regulatory authorities to find ways within their charter to permit new activities. The process is not only inefficient, but creates new inequities, institutions that may be producing unintended risks, and the misallocation of resources. That is why my colleagues and I are such strong supporters of H.R. 10, The Financial Modernization Act of 1998, which the House passed last month and the Senate Banking Committee will be discussing next week.

This bill brings our financial institutions into the 21st century in a framework that minimizes risks and inequities. The task it sets for itself is not easy. Each set of our financial institutions--and their regulators--have special privileges and advantages that they wish to maintain and limits and restraints that they wish to shed. Balancing these realities results in provisions in the bill that no one--including me--can say that they like completely. But the balancing in H.R. 10 is, I think, the best that is possible; indeed, in many respects it is so balanced that most adjustments to address the concerns of one set of institutions would probably eliminate the support of another set of institutions. What is critical, it seems to me, is that the bill not only does a fine balancing job, but it is in the public interest, something that I am sorry to say that all too frequently we lose sight of. Let me share with you the specific reasons why I think this is a bill that deserves support.

First and foremost is that the bill would finally let financial institutions get into each other's businesses, and thus widen the scope and range over which institutions can compete for the public's business. Mind you, this is not a statement that says financial supermarkets and/or large institutions will be better or more successful than specialized and/or smaller institutions. But the benefit is that the public, not regulators, will decide which will prosper as competitors all bend their efforts to serve the consumer.

That is the bottom line. It's the reason why there should be financial modernization. But the structure that the bill establishes is consistent both with efficient resource allocation and with minimizing risk to the stability of the economy and the taxpayer. Let's take a closer look at that structure.

The most critical element is that H.R. 10 would permit banks to conduct in their own subsidiaries (so-called operating subsidiaries or "op subs") only the same activities that they may already conduct in the bank and financial agency activities, which by their nature require minimal funding and create minimal risk. These limitations, it seems to me, are crucial for several reasons. Banks have a lower cost of funds than other financial entities because of the safety net--the name we give the collection of deposit insurance, access to the discount window, and access to the payments system. This subsidy is provided by the government in order to buy systemic stability, but it has a cost: increased risk taking by banks, reduced market discipline, and consequently the need for more onerous bank supervision in order to balance the resultant moral hazard. The last thing we should want is to extend that subsidy over a wider range of activities, which is, I believe, exactly what would happen if bank op subs could engage in wider nonbank financial activities. Not only would that increase the moral hazard--and the need for bank-like supervision--but it would also unbalance the competitive playing field between bank subs and independent firms engaging in the same business, a strange result for legislation whose ultimate purpose is to increase the competition for financial services.

The subsidy that is so integral to the op sub would surely induce banks and other financial institutions to organize in a form that would maximize their use of that subsidy. Indeed, stockholders would have every reason to be critical of management that did not avail itself of the opportunity to raise low cost funds. The profits of bank subsidiaries would surely benefit the bank parent since GAAP accounting, economic and legal reality, and common sense all call for consolidation. But losses, too, would consolidate into the bank parent and such losses would fall directly on the safety net, and ultimately the taxpayer. These safety and soundness and safety net risks ultimately would bring with them the need to regulate op subs the way banks are regulated, creating inefficiencies and reductions in innovation, let alone conflicts with functional regulators.

The legislation I support would require that organizations that conduct both banking and other financial businesses organize in a holding company form where the bank and the other activities are both subs of the holding company. Profits and losses of the business lines accrue to the holding company and thus do not directly benefit nor endanger the bank, the safety net, or the taxpayer. The safety net subsidy is not directly available to the holding company affiliates and competition is thus more balanced. Moreover, traditional regulators like the SEC and the state insurance commissioners still regulate the entities engaged in nonbank activities as if they were independent firms. Functional regulation is desirable not only for competitive equity, but is a political necessity and a practical reality in the process of balancing that is required to move financial regulation. In principle, functional regulation could also be applied to op subs, but the safety net, I submit, would soon create regulatory conflict with that structure.

Importantly, the bill passed by the House would prohibit commercial affiliations with banks. There is no doubt that it is becoming increasingly difficult to draw a bright line that separates financial services from nonfinancial businesses; it will only become more difficult to do so. But, the truth is that we are not sure enough of the implications of combining banking and commerce--potential conflicts of interest, concentration of power, and safety net and stability concerns--to move forward in this area. Better, I think, to digest financial reform before moving in an area that will be very difficult to reverse. The bill, by the way, would shut down new unitary thrifts that can affiliate with non-financial firms, but grandfathers the rights of the over 700 existing unitary thrift holding companies to acquire or be acquired by commercial enterprises. I would hope the Senate would instead freeze such activities in place until the banking and commerce issue is addressed directly; the fact that the House did not simply reinforces my point on how hard it is to reverse such powers once gained.

Finally, I support H.R. 10 because the holding company framework would keep the Federal Reserve--the central bank of the United States--as the umbrella supervisor. I believe that the Fed has an important role to play in banking supervision *in order to carry out its responsibilities for monetary policy, economic stabilization, and crisis management.* I cannot grasp how we could possibly understand what is happening in banking markets, what innovations are occurring and their implications, and the nature and quality of the risk exposures and controls so critical for crisis management and policy formulation without the hands-on practical exposure that comes from supervision. An umbrella supervisor is needed for complex organizations in order to assure that the entire organization and its policies and controls are well managed and consistent with financial stability. At least for the large organizations, I believe that supervisor should be the Federal Reserve so that we can play our role as a central bank and international crisis manager. Many people are surprised to hear that the Fed directly supervises only 5 of the largest 25 *banks*--the state members. Our window into banking is through our umbrella supervision of bank holding companies.

Unfortunately, but understandably, the view that the Fed wants new activities to be in a bank holding company is often construed as a "turf" issue. I believe that there are two separable arguments. I would prefer the holding company--for reasons I have discussed--even if the Fed were not the umbrella supervisor. But I also think that we have to be involved in bank supervision--again for the reasons I have discussed. Who should be involved in what activities, and who should supervise the resultant organization and its component parts are genuine and important policy issues that should be debated and decided by the Congress. To simply dismiss them as turf issues misses the point, I think, and chokes off that debate.

Conclusion
In conclusion, I hope that my remarks have helped you to better understand the forces affecting our banking and financial system. Equally important, I hope that I have given you a good feel for the challenges these forces have created for bank supervision, how we are meeting these challenges today, and how we may deal with them in the future. Even more importantly, I hope that I have convinced you to support enthusiastically H.R. 10! In all seriousness, it really is time that we modernized our financial system and got on with the business of serving consumers and maintaining a healthy, stable, and competitive banking system.

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