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THE SHAPE OF REGULATION IN THE 1990s

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Today, I would like to address the issue of bank competitiveness from an international and domestic perspective.

What will it take to get American banks ready for the 21st Century?

We all agree that the health of the American financial service industry needs considerable improvement.

Several speakers have addressed the savings and loan crisis and the plan put forth by the Administration to resolve this problem. I support the Administration's plan and hope that Congress will give it speedy consideration. In particular, I believe the President's proposal to impose capital requirements on savings and loan associations similar to those recently implemented for the banking industry will result in healthier institutions, promote competition, and assist in leveling the domestic playing field.

Now I would like to address the issue of creating a "level playing field", internationally and domestically.

International Regulatory Cooperation

As financial markets around the globe have become increasingly intertwined, regulators worldwide are finding it necessary to cooperate more and more in the coordination of international regulation.

Part of the impetus toward this coordination stems from the concern that differences in national supervisory regimes might place banks from countries with tighter international regulations at a competitive disadvantage. For instance, after U.S. banking supervisors imposed primary capital guidelines in the early 1980s, some internationally active American banks reduced their interbank credit lines because they were required to hold more capital against such lines than their foreign competitors. Given the very thin margins prevailing in the interbank business, these exposures simply could not generate enough of a profit margin to cover the capital requirements.

The new Basle Accord on a risk-based capital framework, which was developed jointly by 12 major industrial nations, should go a long way toward relieving inequities among banks incorporated in different countries. This framework not only establishes uniform capital standards for internationally active banks in the countries that are direct parties to the agreement, but will force banks domiciled in other countries to adhere to the new international standard if they want to have an international banking presence.

The risk-based capital framework constitutes a form of international cooperation that mitigates competitive inequity and is solid proof that such cooperation can work. However, the Basle Accord represents only a first step in the process of coordination among regulatory authorities for international banking organizations. A measure of interest rate risk still needs to be developed and incorporated into the risk-based capital framework. In that connection, I would like to extend a challenge to you. Those of you with an analytical interest may wish to help us develop such an interest rate risk measure. Here is your chance to contribute at the creation rather than being forced to write a critique after the fact.

Reciprocity Versus National Treatment

The planned economic and financial integration of the European Community (EC) member countries in 1992 also creates international regulatory issues of considerable importance. European policy toward banks from outside countries is of critical importance to American banks, who have long been active in this market.

Recently, there have been indications that the EC might impose a policy of reciprocity on banks from outside countries. To be specific, a foreign bank conducting business in Europe would not be granted powers available to EC banks unless the foreign bank's home country granted identical powers to banks from the EC member countries. As an extreme example of how this policy might be applied, a U.S. bank could be denied the right to branch throughout the EC since no banks, domestic or foreign, are allowed to branch through the U.S. Also, the securities activities of American banks in Europe would be restricted because of limitations on banks' securities underwriting activities in the U.S.

Reciprocity would result in different rules for banks from various countries that compete in the same market. Not only is such a situation inequitable, but it could also lead to competitive regulatory leniency as regulators from various countries might attempt to grant their banks the best possible franchise. Just think what reciprocity powers banks from virtually unsupervised off-shore banking havens might be able to exercise.

Furthermore, reciprocity implies the creation of a multitude of bilateral relationships that will benefit no one except banking lawyers. If there are 100 countries active in banking, one can conceive of 10,000 bilateral, reciprocal treaties!

A policy of reciprocity would be detrimental because it also could lead to further protectionist pressures that would be harmful to all. I hope that the EC will apply the international standard of national treatment, rather than establish a new policy of reciprocity.

Within the U.S., the Congress and the federal banking regulators need to continue leveling the playing field by removing restrictions that hamper the ability of U.S. banks to compete with domestic nonbank financial services firms and foreign financial firms. To alleviate the problem, two different types of restrictions -- those that pertain to product-lines and those that are geographical in nature -- need to be addressed.

Glass-Steagall

In my opinion, the Glass-Steagall restrictions that separate commercial banking and investment banking should be repealed. This legislation, which was introduced over half a century ago, has created an artificial distinction between the two types of banking and has outlived its usefulness.

Many of our foreign competitors have the broad ranging rights that U.S. banks are seeking -- to provide universal banking services. In some instances, foreign banks have these rights also in the United States because their activities were grandfathered. As a result, they hold a significant competitive advantage over our U.S. banks. We should cease handicapping our institutions and grant them the same powers.

Banks already have undertaken private placement of corporate debt and commercial paper, loan sales and participations, and interest rate and currency swaps. For many years, banks have participated in a wide range of investment banking activities, including underwriting and dealing in corporate debt and equity, through their foreign subsidiaries and affiliates. In short, virtually all of the activities that banks would like to engage in on a full-scale basis are already permissible abroad or in private placement. The banks' performance in this area has generally been favorable and any difficulties they may have encountered appear to be "start-up" problems. This indicates to me that the Glass-Steagall restrictions are protecting the U.S.

securities market, not the banking institutions.

The time has come to level the playing field by removing the artificial obstacles that fragment our domestic markets. The Federal Reserve Board, within the limited regulatory discretion available to us, has recently taken carefully measured steps in that direction. We are permitting banks to underwrite corporate debt while insuring that proper safeguards and "firewalls" are in place. However, the ability to engage in this activity depends upon whether the banks achieve an adequate level of capital, have an experienced management, and are implementing proper controls and systems. The Board has mandated that banks meet these criteria prior to engaging in the activity because new ground is being broken in the U.S. market and we wish to minimize potential start-up problems.

Securities activities will be monitored and supervised in such a way that risk to the bank will be minimized. It is particularly important that adequate capital be maintained to absorb unexpected losses and to provide appropriate prudential incentives to management. In addition, an institutional and legal structure should be in place to limit the degree of securities risk which can be passed to the bank.

The Board of Governors believes that the repeal of Glass-Steagall can be done in such a way as to neither jeopardize the safety and soundness of banks nor impose any risk on the federal safety net. The Board has recommended that expanded bank powers be conducted in a subsidiary of a bank holding company and that Congress place limits on transactions between a bank and its securities affiliate. These institutional "firewalls" will help insulate the depository institution from the risk of its securities affiliate.

In addition, it is my personal view that commercial enterprises should be permitted to own financial institutions. In fact, numerous commercial firms have already purchased financial institutions, buying failed thrifts or banks. In addition, the non-bank loophole allowed commercial firms to establish financial institutions similar to banks. We should regularize the rules as to who can acquire financial institutions instead of taking a piecemeal approach.

In my opinion, the repeal of Glass-Steagall restrictions would benefit both investors and borrowers, resulting in greater access to the securities markets. Regional as well as small banks could offer depositors a wider range of products, such as mutual funds. Their securities affiliates could underwrite debt and equity of local and regional firms as well as revenue bonds of local governments. This would grant local and regional firms and governments the same kind of access to the capital markets that today is enjoyed only by large corporations.

Interstate and National Competition

We need to build a strong and diversified banking system that can withstand regional and sectoral economic problems. Interstate banking would make it easier for banks to diversify both their loan portfolios and deposit bases and thereby reduce the chance that a bank might fail. Clearly, one way a bank can diversify its loan portfolio is to hold loans from different regions of the country. An economic downturn in the energy or agricultural sectors, for example, would have less of an effect on the financial health of a bank that also has loans in New England than on a bank that does not.

This point is illustrated by the problems encountered by insufficiently diversified banks in the agricultural and energy producing regions of our country. One cannot help but be impressed by the contrasting Canadian experience. Like the United States, Canada experienced severe agricultural and energy problems in the early eighties. However, Canada did not experience a similar rash of bank failures largely due to the greater geographic diversification of risk resulting from nationwide banking.

The gradual dismantling of interstate banking barriers has been due to the initiative of the states, nearly all of which have passed legislation permitting at least some form of interstate banking. However, many of these states restrict entry, usually to banks from their own geographic region or from other states which allow entry on a reciprocal basis.

Interstate banking also poses increasing problems for bank regulators, particularly in regard to state-chartered institutions. For instance, state regulators are now beginning to conduct consolidated examinations of banking organizations that are located in several different states. Such examinations require extensive coordination among the various state banking agencies. While carrying out examinations in this manner is necessary, it is also very inefficient.

Although the growth of interstate banking is encouraging, it is necessary to expand the scope of existing regional agreements until no bank is precluded from competing in any part of the country. The state laws are by no means uniform, and as I mentioned, many states restrict free competition by limiting entry to banks from a specified list of states. In addition, the reliance on reciprocity to determine the states in which banks may compete is inefficient. Individual states are limited in how far they can advance interstate banking. I believe Congress should pass legislation extending interstate banking to all states. This would help to create a level playing field for all banks and do away with our balkanized banking system, finally moving American banking into the 20th Century - hopefully before the 21st Century dawns.

The creation of a single national banking market is also necessary for American business to remain competitive internationally. American businessmen across the nation should be able to rely upon international banking services provided by their hometown banker. At the present time, this advantage is offered only to businessmen in a handful of states, where internationally active money-center banks are located. It is alarming to see to what extent even the Edge Act network is shrinking - largely because it can provide only specialized banking services and not offer a full range of banking activities.

For all of these reasons, there is a need for a national policy with respect to interstate banking. It is my belief that the interstate commerce clause, which has brought us prosperity and a competitive marketplace, should be applied to banking as well.

Conclusion

Many challenges and opportunities confront American banks in the global financial marketplace. To be competitive in the coming years, American banks must be free from the restrictions currently placed upon the types of products they may offer and the markets in which they may compete. The regulators have taken action to begin leveling out both the international and domestic playing fields, as well as making international regulatory cooperation a reality. However, Congressional action is needed before the competitive inequalities confronting American banks are eliminated and American banks can once again rank among the top two dozen banks in the world.
