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Remarks by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

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BANKING IN THE 21st CENTURY

It is my pleasure to be here today to discuss with you a topic that concerns us all -- the future of the banking industry.

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No one can doubt that the banking environment has changed radically over the last decade. The causal factors are familiar to us all -- technological changes and financial product innovations that have increasingly made it possible for borrowers and lenders to transact directly, deregulation of deposit interest rates, the increasing internationalization of financial markets, the penetration of banking markets by nonbank lenders and issuers of deposit substitutes, and the development of interstate banking through multi-bank holding companies. These developments, while providing benefits and opportunities to banks, have also been instrumental in raising competitive pressures on banks to perhaps the highest level ever. While to date these pressures have generally been focused most intensely on larger depositories, other institutions have not been immune. There is every reason to believe that competitive pressures will continue to evolve in ways that encompass an ever greater proportion of the industry.

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While all these developments have been occurring, key laws and regulations that impose significant costs on many banks have been retained. Moreover, in some cases laws that for many years were benign have begun to seriously affect the ability of banks to compete. The most important examples are, once again, quite familiar -- the McFadden Act's restrictions on interstate branching, the Glass-Steagall Act's constraints on combinations of commercial and investment banking, restrictions on the integration of banking and insurance, and the prohibition against the Federal Reserve paying interest on required reserves. In some cases ways have been found to mitigate the adverse impact of these laws and regulations. However, such strategies are often relatively costly to implement, limiting the public benefits from these efforts to adjust to market realities.

We sorely need to reform our laws and regulations to allow banks to compete more freely in the changed environment.

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But my reading of the banking landscape suggests to me that bankers will make a big mistake if they anticipate that modifications in laws and regulations alone will solve their problems. Banks and bankers must also modify their practices, whatever the regulatory and statutory environment may become.

It is difficult to believe that many of the banks operating over recent decades would have been able to grow so rapidly, with so little additional investment by their owners, were it not for the depositors' perception that, despite the relatively small capital buffer, their funds were secure. In short, the federal safety net -- deposit insurance, the discount window, and access to the payments system -- has so lowered the risks perceived by depositors as to make them, at least in normal circumstances, relatively indifferent to the soundness of individual depository institutions.

A major implication of the current safety net is that some banks with relatively low capital ratios have been willing and able to fund riskier assets at a lower cost, and on a much larger scale, than would have otherwise been possible. The exploitation of this moral hazard has been encouraged by the increasing ability of many banks' prime corporate customers to tap the capital markets directly. As such customers have migrated away from banks, and the traditional value-added from intermediation of such credits has eroded, some banks have sought to boost returns on equity by, in part, reaching for ever more risky credit positions. The result has been a misallocation of our nation's scarce resources toward riskier activities funded by deposits whose costs have been limited by the safety net, and an increase in the probability of failure of many of our banks. It follows that these forces have helped to cause ever greater losses in the deposit insurance funds.

Such considerations have led the Federal Reserve, the Treasury, many members of Congress, and others to focus on capital adequacy as one of the pillars of their deposit insurance reform proposals. From the perspective of taxpayers and regulators, capital has some very appealing characteristics. Strong capital ratios decrease the moral hazard incentives inherent in the safety net, provide a cushion of protection for the FDIC, improve safety and soundness by lowering the probability that a bank will fail, impose a market test on managers who seek to expand the size of their bank, and help reduce the misallocations of credit caused by the safety net subsidy to risk taking.

Clearly, the safety net has provided benefits. In reviewing its deficiencies, we should not lose sight of the contributions it has made to macroeconomic stability, and the protection it has provided to unsophisticated depositors. It has protected the economy from the risk of deposit runs, especially the risk of such runs spreading from bank to bank, disrupting credit and payment flows and the level of trade and commerce. The resulting confidence in the stability of the banking and payments system has been a major reason why the United States has not suffered a financial panic or systemic bank run in the last half century.

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I believe, however, that the pendulum of safety net protection has swung too far, and pushed too many banks too far from market principles. We must remember that the ideal system is one that induces banks both to hold adequate capital and to be managed substantially as if there were no safety net. We now stand at a crossroads that will determine how we position our financial system for the 21st Century. An important choice at this juncture is whether we will maintain or even expand the safety net, or whether we will contract it in ways that maintain the safety net's key benefits, while minimizing its costs

The current debate over how to recapitalize the bank insurance fund is just the most recent indication that we stand at this crossroads. There have been others -- most notably the past and continuing crises in the thrift industry. Indeed, the massive losses that are reflected in these developments alone -- the thrift crises and the need to recapitalize the BIF -- assure, in my view, that a <u>contraction</u> of safety net protections will emerge from the current controversy.

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Political forces are not the only ones telling us that safety net protections have gone too far. There is growing evidence that the market is also saying that some banks have been too enthusiastic in their efforts to minimize capital-to-assets ratios, and to take on excessive asset risk in search of higher return. This evidence suggests that it may well be in some banks' self-interest to increase capital and cut back asset risk, <u>even if there were no changes in the safety net</u>.

One indication that many banks have gone too far is embedded in what has been called the "credit crunch." True, the slowing of credit flows over the past year is in large part due to decreasing demand and supply brought about by the recession and the uncertainties associated with the Persian Gulf War. And, in some cases bank regulators may have applied excessively rigorous examination standards.

But there is more to the credit crunch than weak demand and possibly overzealous regulation. Through a variety of channels, the recent tightening of credit standards has many of its roots in the credit excesses of the 1980s. Many of the weaker credits extended voluntarily by depositories during that period have come back to haunt their holders.

To be sure, when you go from excess credit creation and overly optimistic reserving to more normal practices, it can feel like a tightening. And there is no doubt that this tightening is imposing real costs on many individuals and businesses in our economy. Not least among these are the owners and managers of the banks and thrifts that have failed. In the long-run and for the nation as a whole, this tightening of credit standards will leave the financial system on a sounder footing and promote economic stability. But the real costs of the transition should emphasize to all of us that every effort should be made to avoid such mistakes in the future. In assuring this result bankers, as well as regulators, have both a lot at stake and a role to play.

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Two ways that bankers can and in some cases are playing a role is by raising their capital ratios and lowering their asset risks. It is usually thought that such actions are very costly. The conventional view posits a negative relationship between a bank's return-on-equity, or ROE, and its capital-to-assets ratio. That is, other things equal, a lower capital ratio implies a higher ROE. In part for these reasons, the pursuit of ever greater leverage often seems to have been one of the fundamental tenets of modern banking. In addition, conventional wisdom holds that firms that take on additional asset risk normally earn higher ROEs in order to compensate stockholders for the larger risk of loss.

However, the data appear to contrast rather sharply with the conventional wisdom. Even a cursory look at the time-series data challenges the view that a reduction in a bank's capital ratio <u>necessarily</u> implies an increase in its ROE. For example, over the last 120 years the equity-to-assets ratio of the average bank has declined markedly -- from almost 40 percent in the 1870s to about 18 percent prior to World War I, and to about 6 percent in the 1970s and 1980s. But, with the exception of the Great Depression, ROE has remained remarkably stable over this entire period. For instance, the average bank's ROE in the 1870s was about 8 percent, was still around 8 percent before World War I, and in the 1980s was around 10 percent. Correlation analysis of these time-series also suggests only a weak, if any, inverse relationship between capital and ROE.

The most serious challenge to the conventional wisdom comes from the experience of the 1980s. Recent research conducted at the Board suggests that during this decade many banks proceeded too far down the road of minimizing capital and taking on excessive portfolio risk. More importantly, it suggests that these banks may be able to become both safer <u>and</u> more profitable by increasing their capital and reducing their asset risk profiles.

Our analysis, conducted on all banks in existence from 1983 through 1989, suggests that in general banks increased their ROE <u>after</u> increasing their capital ratios. Of perhaps even more interest is the finding that this positive relationship between capital and returns occurred most often among banks with the riskiest portfolios In other words, it appears that the riskiest banks actually increased their ROEs after decreasing their leverage.

This result was quite robust across the three measures of risk that we used -- the ratio of risk-weighted assets as defined by the Basle Accord to total assets; the ratio of nonperforming loans to total assets; and the ratio of net chargeoffs to total assets. In addition, while the conventional inverse relationship between capital and ROE tended to hold at the moderate to low risk banks, it should be emphasized that the positive relationship was so strong that when all banks were pooled together the positive correlation dominated the combined results. Moreover, if deposit insurance premiums had been risk-based over this period, it seems reasonable to assume that the positive correlation would have been even stronger. This is because under risk-based deposit insurance, the lowest capital banks would have paid the highest premiums, further reducing their ROE and reinforcing the positive correlation between capital and ROE.

Our research suggests that the ROE benefit of holding more capital seems to derive primarily from reduced interest rates paid on uninsured liabilities. Banks that have been increasing their capital ratios have also been reducing their asset risk, and the combination of the two appears to be convincing uninsured creditors to lend to these safer institutions at significantly lower rates. Put another way, the market appears to be telling the riskiest banks that higher costs implied by holding more equity can be substantially offset by the lower risk premiums that uninsured creditors will demand for lending the banks their money.

From a policy perspective, the research I have just outlined suggests that the costs imposed on banks by either risk-based capital or risk-based deposit insurance premiums may not be as large as some have thought. Under either risk-based system, the riskiest banks would be required to hold the most capital or pay the highest premiums. But our research indicates that it is these riskiest banks that would receive the largest benefit from increased capital in terms of lower interest costs. On net, the cost of either risk-based capital or risk-based premiums would be reduced the most for the riskiest banks. Thus, the total cost of either system would be considerably lower than that implied by just looking at the higher capital or the increased premium alone.

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Let me conclude by summarizing my view of how the factors I have discussed are shaping the definition of a successful bank in the 21st Century. First, it seems clear that the competitive pressures I outlined at the start of my presentation -- technological change, financial innovation, internationalization, and the deregulation of interstate banking -- will persist. These pressures will continue to emphasize the need for operating efficiency in all aspects of a bank's operations. In addition, the distinctions between commercial and investment banking will continue to blur, providing increasing opportunities for banks' customers to access directly the capital market. Thus, banks will have an on-going need to evolve new ways of serving such customers, ways that will very likely continue to imply a contraction of traditional lending activities among larger business customers

Second, the massive costs imposed on taxpayers by losses in the thrift and possibly the bank deposit insurance funds will result in a legislatively mandated shrinking of the safety net. While the exact means by which this will be accomplished are still unclear, strong public policy arguments can be made in favor of higher capital ratios in the longer run being a major component of policies designed to prevent future safety net abuse. I say in the longer run because it is apparent that the current period of credit crunch and unwinding of the consequences of the lax lending of the mid-1980s is not the appropriate time to add to capital adequacy worries. Nonetheless, as we approach the end of the decade, markets will likely be pressuring banks to raise their capital levels if they wish to optimize their rate of return on equity.

In short, there is persuasive evidence that I suspect will become increasingly evident in the markets that both higher capital ratios and decreased asset risk are in the self-interest of many bankers, independent of legislative and regulatory reforms that might occur.

But we should not be fooled. Higher capital and decreased risk will also imply fewer lending opportunities for banks over the longer run, as riskier borrowers are forced to search elsewhere for funds. Other things constant, this, plus the continuing migration of creditors to the capital market, will mean that the bank of the future will be smaller than would otherwise be the case. Put somewhat differently, while mergers and consolidation of the banking industry may well lead to larger individual banks, each consolidated bank is likely to be smaller than the sum of the original merger partners. Thus, the banking industry of the future is likely to be smaller in relative terms than the banking industry of the present.

In brief, the bank of the future will generate its profits not only from offering the technology of the future, but also from using its knowledge and credit evaluation abilities to extend credit at profitable margins to customers with only limited, if any, direct access to capital markets, but with acceptable risk profiles. These criteria are the only ones consistent with a smaller safety net, higher capital, and lower risks. In this sense, the bank of the future will make its money, as John Houseman used to say on T.V., " the old fashioned way." And it will do so without the substantial taxpayer support that, in the end, has proven to be a curse as well as a blessing.