[Bank Restructuring]

An Address by

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It is a pleasure to visit with you and have the chance to exchange views on topics of mutual concern. While many immediate problems -- the record number of insured bank failures and the financial plight of FSLIC, to name just a few -- have occupied our attention recently, it is important that we do not ignore longer-term issues of equal or even greater import. Today I would like to discuss one of the most important long-range issues facing the American economy and this Association -- the future structure of the U.S. banking and financial system.

I hardly need to tell you that the American banking system is threatened by technological change, foreign competition, archaic government regulation, and its own inability to create legislative change. There's certainly enough blame to go around.

Foreign bankers, investment bankers, even manufacturing and retail firms are all going after banking business. For example, earlier this spring, General Motors Corp.'s finance unit began offering $25 billion in preapproved credit to two million preferred customers nationwide. This is reflective of the trend in recent years, whereby captive finance companies have taken an increasingly larger share of the auto-financing pie -- to the dismay of the banking industry.

Consider a few other statistics. Banks are being forced out further and further on the risk curve to preserve margins -- margins that will quickly vanish in times of economic distress. We have seen this happen today in the Southwest where the effects of the energy slump and, to a lesser degree, agricultural problems have driven profit margins into the negative range overall. One-fifth of all commercial banks operated at a loss during 1986. Industry net income declined last year for the first time in 25 years. Some of the trends are not encouraging.

Commercial banks' difficulties are due, in part, to their inability to enter and offer a wide range of products and services. Of course Congress could help to remedy this situation by enacting legislation establishing new rules for financial institutions which assure that they can be competitive and thus prosper. But the Congress can't act until there is enough political clout put behind the idea to get the needed votes. Bankers have an almost unbroken record of failure in this regard.

There are some encouraging developments. I never cease to be amazed at the ingenuity of man to get around congressional legislative inertia. What is happening today can be called de facto or back door restructuring by private-sector initiative.

The states continue to take the lead in the deregulation of the commercial banking industry. A recently completed FDIC research study found that individual states have significantly expanded the range of permissible activities for state banks far beyond their traditional powers. We have moved to let state non-member banks use these powers particularly if they are done in a subsidiary of the banks. In a similar pattern, some form of interstate banking has become a reality in 37 states and the District of Columbia as a result of state initiatives despite inaction at the federal level.

States' actions permit banks entry into insurance, real estate and securities activities. Perhaps of more significance in terms of eroding the distinctions between banking and commerce, a growing number of states grant their commercial banks broad equity investment authority.

Federally-chartered institutions are starting to cast longing eyes at the opportunities presented by these developments at the state level. Citibank (NY State) NA, based in Rochester, is the first subsidiary of a multinational banking company to ask to leave the Comptroller of the Currency's jurisdiction in more than a decade. Goldome Federal Savings Bank has applied for a state charter partly because of the wider opportunities for financial-services expansion in New York State. Actions such as these could portend a groundswell. Other private-sector initiatives that you are all familiar with include the use of the unitary savings and loan holding company vehicle and the nonbank bank.

Meanwhile, the federal bank regulators are trying to do what they can to give banks more breathing room on the issue of expanded powers. For example, the Federal Reserve is slowly relaxing its securities regulations. Earlier, as I've noted, the FDIC issued regulations that provide guidance to state nonmember banks that wish to set up securities affiliates.

No matter how welcome most of the developments I have cited may be, these initiatives are not a substitute for a comprehensive review by Congress of where our country's financial institutions should be headed. If a comprehensive, rather than a piecemeal, approach were adopted, a lot of land mines could be successfully avoided.

Several industry restructuring proposals have been offered outside of Congress -- including those by the NY Federal Reserve's Gerald Corrigan; your own Association; Federal Reserve Board member, Robert Heller; and all of those listed earlier this year in your report. All of these proposals are a fine contribution to the examination of the problem. Your own views in the letter of May 1987 had the best summary of the writings in this area that I've seen yet.

GUIDING PRINCIPLES

In looking at bank restructuring, we need to test the proposed reforms against our goals. I would suggest the following:

1. Safety and Soundness: Are we confident that the system will not fail depositors, users of the transfer system, and borrowers and traders?

2. Competitiveness: Will it allow banks to compete in the global marketplace?

3. Simplification: Is it the simplest way to achieve our goal?

4. Consumer Orientation: Does it provide the freedom to innovate and increase efficiency which can provide customers with the best of services at the least cost?

5. Monetary Control: Will it provide for effective implementation of monetary policies?

In going about reform, first, we all must recognize that banks do play a special role in our economy. They are one of the major factors in the intermediation process, and the primary private-sector source of liquidity. They also provide a liquid safe haven for the savings of the public at large. They are the major conduit through which monetary policies are implemented.

Since banks are at the heart of the economic system, their continued functioning is necessary for the system to operate. Through the government's guarantee of deposits, involvement in the transfer system, and the Fed discount window, the government, in turn, is positioned in the heart of the financial system. This position has provided an important part of the safety and soundness and credibility which undergird the system. Any proposed reforms must be tested to ensure that the government's role is not jeopardized.

Second, having asserted the government's regulatory role, it appears proper to seek the least burdensome way for government to regulate. To me this means not regulating more than is necessary, i.e., avoid regulations beyond the bank wherever possible. Can a bank be insulated from those who might misuse or abuse it? Can a "wall" be erected around a bank to provide an adequate level of protection for the system?

Reasonable persons have disagreed on whether this insulation can be achieved. Discussions of expanding bank powers or allowing banks to be affiliated with a wider range of business organizations almost invariably degenerate into a discussion of the intractable and uncontrollable potential for "conflicts of interest" that would be created. The concerns related to this issue come in two forms. First, there is the concern that banks will be able to exploit their position in the credit-granting process at the expense of their customers. Such things as tie-in arrangements between credit and other services, unauthorized use of confidential information gained in the credit-evaluation process and manipulation of security prices to support an offering are cited as potential problem areas. I would assert that these same types of potential conflicts exist today in a wide variety of industries and are effectively controlled by a combination of reasonably competitive markets, antitrust laws and SEC and FTC rules.

As evidenced by the recent disclosures relating to trading on insider information, potential conflicts of interest sometimes result in actual abuses. However, I have heard of no serious suggestion that people involved in mergers and acquisitions should be held incommunicado until the transaction is consummated. The point is that no matter what precautions are taken, some abuses will take place. As long as the system can be protected, individual abuses can be tolerated -- and no system will eliminate them.

The second set of concerns that falls under the general conflict-of-interest heading relates to the potential use of bank assets to "bail out" troubled nonbank affiliates or that the courts would view banking assets as being available to satisfy claims on nonbanking subsidiaries. Although not of significant concern when the Bank Holding Company Act became law, the idea that it is necessary to regulate the corporate owners of banks to ensure the safety and soundness of subsidiary banks has become, in some circles, a primary justification for the Act.

The weight of regulatory thought, at least in our shop, seems to support the idea that related organizations can be effectively patrolled so that the assets of the bank will not be used in a manner that would jeopardize its financial position. This applies to both subsidiaries of the bank and holding company affiliates. In addition, most legal authority supports separation of liability and, of course, Congress can make this specific and clear.

Bank regulators must be concerned that resources not be shifted out of the bank in a way that jeopardizes its financial position. Profits can be used as long as their use does not endanger the solvency of the insured bank. The issue is not whether supervision can provide complete protection for every bank, but whether it will keep the system safe and sound. This is a question for regulators and supervisors. They have the experience and professional training necessary to make a meaningful evaluation.

FDIC supervisory experts, as well as my own experience as a CPA, tell me that we can move toward a system that will provide the required insulation of the bank to protect the system. To do so, supervisors will need the power to:

1. Prohibit excessive dividend policies, or other ways of jeopardizing bank capital.

2. Regulate intercompany or affiliate transactions -- that is, set reasonable lending restrictions and enforce an "arms' length" requirement.

3. Look at both sides of any intercompany or affiliate transaction.

4. Require clear consumer-oriented public disclosure of the lack of federal deposit insurance protection at affiliates.

5. Provide the regulators the flexibility to determine what activities can take place inside the wall and which ones belong outside.

6. One other that should be explored would be to restrict access to the large dollar payment systems to regulated banks.

If this insulation can be achieved, then regulation of a bank is the primary governmental responsibility -- affiliates, subsidiaries and holding companies can operate in the private sector with little governmental supervision. The government's main interest in holding companies or other owners might be to charge them with certain responsibilities, both financial and behavioral, if they wish to own a bank. All banks -- large and small -- can be under the same cost-effective system. I would suggest that we proceed with all deliberate speed toward this goal.

SUMMARY

In summary, I believe that what goes on inside a bank should be subject to close scrutiny by the bank regulatory agencies. On the other hand, what goes on in affiliated organizations should be of interest to the bank regulators only to the extent that interactions with affiliated banks affect their safety and soundness. If it is appropriate to regulate nonbank affiliates because of the type of business they conduct, the agencies that have been created to perform this function should have responsibility.

In our view, it clearly is not necessary to build the financial structure proposed by Mr. Corrigan in order to protect the payment system. Also, we are far from convinced that the tiered holding company system envisioned by your Association is necessary or desirable. Wouldn't it be nice if we could simplify the regulatory system, reduce its cost, and increase the flexibility of the banks to operate while keeping the system safe and sound? We believe these goals are achievable and we will be publishing our detailed support for our views in the near future.

Thank you.