Remarks by

John P. LaWare

Member, Board of Governors of the

Federal Reserve System

to the

Association of Bank Holding Companies

Salt Lake City, Utah

May 17, 1990

Good afternoon everybody. You can't imagine how pleased I am to be with you today. Especially you, my colleagues from my previous incarnation in the private sector. My companions in arms in trying to make a buck in what has become one of the world's most competitive industries in the world's most competitive nation. There have been many days when I longed for the profit arena and the satisfaction of seeing my company's ROA or ROE move up another notch or two. More recently, as some of my good friends have dropped or been seriously wounded, I have been glad for federal marbled halls and even for a much more constrained expense account.

The American banking system today is embattled both at home and abroad. At home, traditional customer relationships have eroded as foreign banks and the money markets have offered cheaper access to working capital for U.S. firms, and U.S. firms faced with narrower margins and greater financing needs have made decisions according to price rather than historic relationships.

United States banks find themselves faced with higher capital costs and higher funding costs than many of their competitors. And, domestically, the spectrum of services banks may offer is so narrow as to preclude the "one stop banking" approach that many of us advertised to consumers only a few years ago.

I am not going to recite all the numbers you have heard so many times about how U.S. banks have slipped in terms of their world position measured by the size of the balance sheet. Frankly, I don't think that's a very good index. The Japanese banks, for example, which have had such dramatic growth in the last few years, are very poor performers when measured in terms of return on assets. They struggle to get to 30 basis points. That kind of return would get them little attention from the investment community in this country. And yet! And yet! How do we account for the disproportionate growth of Japanese and European banks in the past 10-12 years?

Are they smarter? I hope not and think not. Are they more innovative? Well, I think the record would support an argument that U.S. banks have been very innovative in lending, investment, and cash management techniques. Perhaps, in fact, they have been world leaders in innovation, but with a rather narrower spectrum in which to apply it.

There is also a case to be made that foreign competitors operate under a lighter and more easily understood burden of regulation and compliance. I can only tell you that we at the Fed wince when we must impose an additional burden on you as the result of well-intended legislation drafted without a full appreciation of the cost to banks of additional reporting and compliance.

It is also fairly obvious to me that the American ethic of short-term profits and matching short-term strategies puts American banks and financial institutions at a great disadvantage. Your foreign competitors at least take a longer view which is condoned and rewarded by their capital markets. Forgoing short-term profits to gain market share by bidding deals at skinny profit margins is considered smart in many countries. In the United States such behavior is punished with lower stock prices and higher interest costs for borrowed capital.

Well, I won't bore you with further description of a situation of which you are all too well aware. My purpose today is to share with you my belief that the opportunity to eliminate some of your competitive disadvantages is at hand. The willingness of most Members in Congress to deal with Glass-Steagall reform was clearly demonstrated by the overwhelming Senate vote for Senator Proxmire's bill in 1988. In my opinion, that legislation would have passed the House in similar fashion

if it had reached the floor. Although I was disappointed at the time that such a significant attempt at reform failed, I now will argue that failure to act then may have been a blessing in disguise. Since then the Congress has become increasingly concerned about the competitive position of our banking system. I believe that concern has survived the shock and dismay surrounding the S&L mess and that we are fast approaching a time when Congress will revisit banking legislation, but on a much broader front than just securities powers.

By the end of this year Treasury will be putting the finishing touches on its FIRREA-mandated study of deposit insurance. That study will undoubtedly contain recommendations for revisions to the system designed to inject more market discipline into the depositor-bank relationship. The thought there is that deposit insurance, originally designed to avoid financial panics and runs on solvent banks, has worked too well. In the past the threat of a run motivated most bankers to stick to safe and sound practices. Experience has shown that deposit insurance has almost totally eliminated consumer runs. Encouraged by the security that experience suggests, some bankers moved into riskier assets, attracted by higher returns. Certainly that pattern emerged time and again in failed S&Ls and in many failed commercial banks as well.

The difficult part of deposit insurance reform will be to strike the right balance. Any re-introduction of market discipline by exposing depositors to more risk will have an offsetting effect of somewhat less stability for the system. And perhaps most difficult of all will be any effort to make significant changes in a system which, after 55 years, is deeply imbedded in our commercial culture.

I have spent what may seem an inordinate amount of time on deposit insurance because it is the centerpiece of the so-called federal safety net mechanism. The pivotal issue in consideration of new powers and the future structure of the banking system will be whether to extend the protection of the safety net to new financial activities of banks. Depending on how that issue is resolved, the future structure of the banking system will be determined.

The safety net is essentially of three parts. The first is deposit insurance. The second is emergency liquidity assistance provided through the discount window at Federal Reserve Banks. Liquidity assistance was, of course, an important reason for creating the Federal Reserve in the first place. The third element of the safety net is access to the payments system through clearing and settlement services of the Fed.

An argument frequently used against spreading the net any wider, that is granting additional powers to federally insured banks, is that the safety net provides a subsidy to banks. The assumption is that banks can fund themselves at lower cost than other financial institutions because the insurance of deposits and access to emergency liquidity insulate them from failure. But whatever advantage is gained in funding cost is at least partially offset by the opportunity cost of the sterilized noninterest-bearing reserve accounts member banks must keep at the Fed.

Unfortunately, we do not have a definitive quantitative analysis of this much discussed subsidy, and the numbers would vary widely from bank to bank depending on the deposit mix and the purchased funds markets a particular institution might use. In any case, access to the window may be the most important element of the safety net, particularly in this era of widely fluctuating markets and volatile interest rates.

If after dealing with deposit insurance reform there is still an overriding desire to prevent further extension of the safety net, Congress is likely to turn to the financial services holding company as a structural solution. The holding company has seductive appeal in that it permits the isolation of the insured deposit-taking bank from the risks inherent in any new powers and facilitates functional regulation of new businesses.

One urgent question is: Can U.S. financial institutions forced into a holding company structure, with all of the attendant inefficiencies of funding and management, compete effectively with European and Japanese banks which will probably develop as so-called universal banks. As yet, no one has successfully quantified what the trade-offs are, but I suspect that Congress will be reluctant to spread the federal safety net under an unlimited number of new services given the disastrous outcome in the thrift industry.

Competitiveness arguments will favor the universal bank, but defense of our unique federal safety net will clearly favor the financial services holding company. One compromise might be to permit the formation of un-insured bank subsidiaries of holding companies. These un-insured banks could operate as universal banks either domestically or internationally with independent funding or funding from the parent. Regulation could be minimal. Capital in sufficient quantity to be competitive might be a problem, but the opportunity available to such an entity might attract capital.

Another compromise which might be considered would allow new powers -- securities, for example -- to be carried on in a subsidiary of the bank but with the stipulation that the sub be capitalized as though it were free-standing and its capital not be counted with the parent bank's capital in calculating capital

adequacy of the bank for regulatory purposes. This approach would address some of the competitive weaknesses of the holding company alternative and at the same time partially insulate the insured institution from any additional risks involved in the subsidiary's operation.

An issue closely related to structure is the issue of commerce and banking. Whether Congress adopts the holding company structure or the universal bank alternative or some other structure, the question of ownership will arise. The United States has long held that commerce and banking should be separate; that commercial enterprises should not own and operate banks and banks should not substantially own or manage commercial entities. But should an insurance company or an automobile manufacturer be allowed to own such a company? Well, Ford and G.M. and Chrysler are operators of huge finance companies and G.M. has a large insurance operation as well. Is there an inherent threat to the country if one of them or all of them were to own a bank? And what about G.E. or Sears or Gulf & Western and so on? By the same token, would it be wrong in some moral or economic sense for a large bank or bank holding company to also own a life insurance company, an investment banking company, a computer company and a real estate development company as long as the insured deposit-taking company was insulated from whatever additional risks might exist in those other businesses?

This issue of commerce and banking will also arise because of the recent history of the thrift industry where the ownership of thrift institutions by insurance companies and industrial and commercial enterprises is well established. For example, Ford owns the nation's second largest thrift. Thrifts and banks are operationally more <u>like</u> each other every day, although the <u>capital</u> sections of their balance sheets may be somewhat different. Why then do we accept the relationship in one case and not in the other? It is high time we re-examined this ancient issue; and all of us, whichever side we are on, should be vocal participants in the debate.

It may well be that pragmatic considerations will override philosophy in the resolution of this issue, if we find that ownership by a commercial enterprise would significantly improve access of banks to capital. But, we should not rush this one. We need to be sure we understand <u>all</u> of the implications before we act.

Turning to another issue, interstate banking on a nationwide basis is rushing at us like a fast freight train, and whatever our individual feelings are about that development, the trend is not going to be reversed. By the mid-1990s we will have <u>de facto</u> nationwide interstate banking without the <u>de jure</u> blessing of Congress <u>or</u> repeal of the McFadden Act. But, absent clarifying federal legislation, we may be creating a whole army of severely

handicapped institutions in the form of multi-state bank holding companies.

Consider for a moment some of the nightmare problems the manager of a bank holding company faces with banks in ten different states.

First, he is forced into a holding company or multi-holding company organizational structure because the McFadden Act effectively precludes branching across state lines.

-- That means ten different management teams; at least ten boards of directors; and compliance with applicable state banking regulations which may dictate ten different ways to handle the same transaction.

-- To the extent that there are state-chartered banks in each state, there will be ten different examination standards to be managed to, and ten different examinations to be endured.

-- Advertising, marketing, pricing, etc. may be subject to ten different standards or sets of regulations and limitations.

-- And, if you are in more than one Federal Reserve District, where is your friendly, helpful, fatherly central

banker? Is he in Boston, New York, Cleveland, Dallas, or San Francisco?

And

-- Given those operating constraints, can the multi-state holding company really achieve the operating efficiencies that were promised to analysts and investors as justification for the high price paid to put the company together in the first place.

I predict that whether you are federalists or states-righters you bankers will all be calling for reform to accommodate more efficient interstate operations by the mid-1990s. One approach which will probably be proposed will be legislation to create a whole new class of federally chartered financial institutions -- multi-state banks or holding companies which would be federally regulated, overriding state authority entirely. In order to deal with redundancy, repeal of McFadden will be considered to permit nationwide <u>branching</u> in order to make operations more efficient.

Finally, an issue which has not had enough serious attention is the structure of federal regulation. We have the OTS, the FDIC, the OCC, the NCUA, and the Federal Reserve -- all operating in addition to regulations imposed by the individual states. No matter how diligently the agencies strive through mechanisms

like the Exam Council to coordinate policies and procedures, there are inevitable differences and inconsistencies which create confusion and error on the part of regulated companies. It is particularly troublesome in multi-bank holding companies with a mixture of national, state member, and state nonmember banks.

The Fed regulates bank holding companies and state-chartered member banks. The OCC, national banks; the FDIC, state-chartered nonmember banks; the OTS, federally chartered thrift institutions; and the NCUA, credit unions.

Simple logic tells you that there must be a better way. I would hesitate to speculate in this area. There may be too many turf considerations ever to reach a sensible solution. But a system where there was one insurer for all deposit takers, one regulator for federally chartered institutions, and one for state-chartered federally insured institutions sounds simpler and more logical to me.

I think all of these issues will be visited by the Congress in the next 12 to 18 months. The debate and ensuing legislation may be as important to the future of banking and of the country as the National Banking Act of 1863, the Federal Reserve Act of 1913, and the several pieces of banking legislation in the mid-1930s. It will be a big debate. Let us not hesitate to participate, keeping in mind that what is right for the United

States overrides any parochial interests which any of us might have.

Thank you for inviting me to be with you.