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"Problems in the U.S. Banking System"

Remarks by

John P. LaWare

Member, Board of Governors of the

Federal Reserve System

at the

National Banking Convention

sponsored by the

KINZAI Institute for Financial Affairs

Tokyo, Japan

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It is a great pleasure for me to be once again in this great city of Tokyo after too long an absence. You do me a great honor by asking me to address this distinguished audience. Thank you for inviting me to be with you and for the opportunity to share with you my views about the current banking situation in the United States. In my remarks I will try to explain the origins of the problems which are presently troubling banks in my country, and I will also suggest some of the solutions to those problems which I believe will be considered over the next year or so.

The most significant event in recent United States financial history was the cataclysmic collapse of the savings and loan industry. As many as a third of the federally insured S&Ls may fail before the mess is finally cleaned up, and the remaining

institutions, for the most part, are only modestly profitable. Many of the survivors are under-capitalized and may not be able to achieve satisfactory capital ratios as required by law. Retained earnings will not be sufficient and the capital markets are not anxious to try to float issues for discredited institutions. The entire industry, will shrink significantly in numbers. Many savings and loans will only survive as subsidiaries of other kinds of financial institutions after being driven to sale or merger by the need for capital.

The root causes of this disaster are several:

First, rapid deregulation of interest rates at a time when market rates were high which destroyed the profitability of portfolios of fixed-rate mortgage loans.

Second, a relaxation of supervision by the Federal Home Loan Bank Board just at a time when increased supervision would have been more appropriate.

Third, state legislators and federal and state regulators relaxed rules governing the operations of the S&Ls allowing them to make commercial loans, equity investments in securities (junk bonds, for example) and real estate. The historic operation of thrift institutions simply had not prepared managers to venture

into these new activities and the results were predictably unfavorable.

Fourth, the increase in 1980 of deposit insurance from \$40,000 to \$100,000 provided additional stability and insulation from market discipline, encouraging greater risk-taking by managers to offset losses in traditional businesses.

Finally, the traffic in brokered deposits at higher than market rates of interest enabled institutions to grow rapidly but encouraged greater risk-taking in order to offset the higher costs.

These conditions constituted an open invitation to unscrupulous opportunists to move in and milk the institutions through self-dealing, exorbitant salaries and expense accounts, and wildly irresponsible lending and investment practices. At the same time, examination schedules were relaxed and Congress and the administration failed to recognize the emerging crisis. The Federal Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board did not have sufficient funds to examine and supervise the savings and loan associations properly.

The resultant cost to the taxpayers is totally without precedent. By one estimate it will be \$500 billion over a period of several years or \$2,000 for every man, woman, and child in the

United States. To date over \$78 billion of funds for the resolution of failed institutions has been authorized and \$55 billion has been disbursed. By June 30, 1990, 207 failed institutions with \$65 billion of assets had been resolved and 247 institutions with \$142 billion of assets were under conservatorship. Another 270 institutions with about \$170 billion in assets have severely impaired capital and poor earnings and are likely to fail. A whole industry has thus been plunged into disarray by a series of tragic mistakes and miscalculations. It must not happen again.

I have taken this much time discussing the S&L situation because it is an appropriate introduction to my topic of problems in the U.S. commercial banking system. The scope and depth of the S&L mess has prompted re-examination of the banking industry in an attempt to determine whether it has in it the seeds of a similar disaster. If the threat exists, then we need to know what needs to be done to prevent it.

At the very heart of the problem is our unique system of deposit insurance. Federal deposit insurance was conceived by Congress as a way to stabilize the banking system in times of financial uncertainty. The experience of the late 1920's and early 1930's showed that sound banks could fail in a panic, because depositors, unable to judge for themselves whether their bank was solvent, rushed to exchange bank deposits for cash. In

fact no bank can survive a sustained run and many financially sound banks failed in the panic of 1929 and subsequent years. Depositors panicked and the banks could not liquidate assets fast enough to pay depositors on demand. The problem was compounded by the stance of the administration and the Federal Reserve which withheld liquidity from the system just when it was most needed. The resultant destabilization further aggravated the economic downturn and is now believed to have deepened and prolonged the depression of the 1930's.

Deposit insurance, which had been in existence in several states on a limited basis for some time, was seized upon as a way to stop runs and prevent solvent banks from failing in a panic. It has probably worked too well. Bank managers, made bolder by the protection deposit insurance provided, have found it easier to take greater risks and to allow capital ratios to decline. With deposit insurance, capital was less important in protecting depositors from asset risk. The tragic history of the savings and loan industry provides many examples which prove the case.

The current dilemma is how to change the deposit insurance system to eliminate the danger of excessive risk-taking while at the same time retaining the ability to avoid panic-motivated consumer runs.

There is far less evidence of venal exploitation of commercial banks than in the case of the S&Ls. But, there is certainly enough evidence to counsel caution and to raise serious questions about extending deposit insurance protection to a broad spectrum of new businesses which banks are asking to enter. The United States Treasury is now preparing recommendations to Congress on how to reform this system.

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.

Deposit insurance 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 has three components. The first is deposit insurance. The second is emergency liquidity assistance provided

through the discount window at Federal Reserve Banks. (Liquidity assistance was 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 Federal Reserve.

An argument frequently used against spreading the safety net any wider, that is to say, granting additional powers to federally insured banks, is that the safety net provides a subsidy to banks. The assumption is that banks can fund and capitalize 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 reserves member banks must keep at the Fed, the cost of services provided to depositors by banks acting as paying and collecting agents, and the substantial cost of reporting and compliance imposed by regulation.

Unfortunately, we do not have a precise quantitative analysis of this much discussed subsidy. In any case, the numbers would vary widely from bank to bank depending on the deposit mix and which purchased funds markets a particular institution might use. In my opinion, access to the discount window may be the most important element of the safety net,



particularly in this era of widely fluctuating markets and volatile interest rates.

In return for the support to the banking system provided by deposit insurance, Congress assumed for the government a much more aggressive role in regulating and supervising insured banks. Commercial banks or bank holding companies in the United States may be subject to regulation by several different regulators. In a given situation, each of these regulators may have a different objective and the regulations they impose may be contradictory. A bank holding company operating in more than one state may also have elements subject to several different regulators. A state-chartered bank which is not a member of the Federal Reserve System will be subject to state regulation and regulation by the Federal Deposit Insurance Corporation. A state-chartered bank which is a member of the Federal Reserve will be subject to state regulation, regulation by the Federal Reserve, and insurance oversight by the Federal Deposit Insurance Corporation. A nationally chartered bank will be regulated by the Office of the Comptroller of the Currency and insured by the Federal Deposit Insurance Corporation, and, if it or any of the others mentioned above, are part of a bank holding company, they will be subject to overall supervision by the Federal Reserve. If a holding company also has a federally insured thrift institution in its organizational structure, two more regulatory elements may be introduced: the Savings Association Insurance Fund (SAIF) and

the Office of Thrift Supervision (OTS). Is it any wonder that bankers tear their hair and find it difficult to understand what they may do and what they may not do?

Politically, it is probably not practical to change the basic structure of deposit insurance as it is perceived by the public. That is to say, any attempt to reduce insurance coverage below the \$100,000 level would be seen by depositors as a take-away and would not be well received.

One possible way to handle the problem is to require much higher capital levels for banks which want to grow rapidly or expand into new lines of business. Before deposit insurance in the United States, it was not unusual for banks to have capital of ten, fifteen, even twenty-five percent of assets. Those levels of capital did not prevent banks from failing but they did provide an investor cushion to absorb losses before depositors were at risk.

If new higher capital requirements are imposed along with authority for supervisors to intervene in deteriorating situations before banks fail, much of the threat of loss to the insurance fund might be eliminated. And that approach would not be visible to the public; therefore, it would not be seen as a take-away and difficult to achieve politically.

A practical problem in such an approach is the difficulty of imposing higher capital standards at a time when the capital markets are not anxious to underwrite bank securities and bank stocks are selling at low multiples of earnings and well below book value. In general, United States securities markets will assign a higher earnings multiple to a bank stock if the return on equity is above 15 percent. If we assume that a 6 percent equity-to-asset ratio and a total capital-to-asset ratio of 10 percent would be highly desirable, then to show a return on equity of 15 percent a bank would need to earn ninety basis points on average assets. Those kinds of returns are relatively common in the United States among super-regionals and even money-center banks in normal times. It might be possible for institutions operating at high capital levels to have much greater freedom in choosing what businesses to enter. On the other hand, banks at or just above the levels required by the Basel accords might have to conform to strenuous application and approval standards. And those whose capital had fallen below minimum risk-based capital standards might be constrained in growth, prohibited from entering new businesses, and required to develop an approved plan for attaining satisfactory capital levels.

On the issue then of insurance reform, I believe there will be changes in the supervision and regulation of banks which will be designed to protect the insurance fund. I think such steps

can be effective and are a more likely approach, for political reasons, than any attempt to change the form or extent of individual insurance coverage.

But no examination of American banking today would be complete without some discussion of competitiveness. And we need to think in terms of competitiveness in a global economy and global capital markets. Capital flows more freely and more swiftly today than ever. As a result, significant changes in one of the major economies are soon reflected in currency values, capital flows, and economic activity in the others.

This new economic interdependence and the institutional competitiveness it fosters are just two of the many factors which suggest it is time to look at the United States financial system with an eye to updating structure and regulation. The last fundamental reshaping of the system came in the 1930's with the Glass-Steagall Act, deposit insurance, and regulation of the securities markets. There were also several measures to stimulate the housing market by bringing home-ownership within the reach of many who, without federal assistance of one kind or another, could never have hoped to achieve it.

The issues raised in any such broad re-examination of the financial system are complex and not generally well understood. Unfortunately, any legislative solution considered will be

influenced by some who remain emotionally committed to now discredited historic ideas. The most prominent of these discredited notions is the one which blamed securities activities of the banks for the market crash of 1929 and the resultant Depression. The error of that judgment led to the Glass-Steagall Act and the separation from commercial banking of the brokerage and underwriting of securities. But Glass-Steagall is only one of the issues with which we must deal.

American banking 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. businesses, and U.S. businesses 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 banks advertised to consumers only a few years ago.

I will not recite all the numbers to show how U.S. banks have slipped in terms of their world position measured by the size of their balance sheets. Frankly, I don't think that's a

very good index. Japanese banks, for example, which have had such dramatic growth in the last few years, are modest performers when measured in terms of return on assets. Many struggle to get to 30 basis points. U.S. banks commonly earn at 90 to 100 basis points. And yet! How do we account for the disproportionate growth of Japanese and European banks in the past 10-12 years?

Are other bankers smarter? Perhaps, but I think not. Are they more innovative? Well, I think the record would support an argument that U.S. bankers 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 of U.S. banks operate under a more benign and easily understood burden of regulation and compliance. For American banks these burdens are the result of well-intended legislation drafted without a full appreciation of the cost to banks of additional reporting and monitoring. And, aside from cost considerations, the constraints of regulation seriously limit managers in making business decisions.

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. Foreign competitors take a longer view which is apparently 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.

Much has been made in the press and other media of the asset quality problems of United States banks: Loans to lesser developed countries are a common problem with banks around the world; leveraged buy-outs which are closely related to junk bonds and require expert lending skill with special attention to cash flow; and, more recently, commercial real estate loans -- particularly construction loans. These are large problems, but I would argue that United States banks are far better able to handle the challenge they present today than they would have been only a few years ago.

Since 1982 U.S. banks have absorbed huge charge-offs in their LDC portfolios, have encountered and managed problems with highly leveraged transactions, particularly leveraged buy-outs, and dealt with fundamental changes in real estate markets and construction lending. During this same period in which major challenges have appeared banks have significantly strengthened their capital ratios while at the same time prudently reserving against loss exposure. From the standpoint of capital, American

banking organizations are stronger today than they have been for decades. And, interestingly, the best capitalized banks are often among the most profitable. Perhaps the era of maximizing leverage is past. Experience shows that adequate capital builds market acceptance and also provides the best protection for depositors.

I would suggest to you that United States banks are aware of the competitive environment, eager to compete, acceptably profitable, reasonably capitalized, and not yet so disadvantaged as to size that they cannot provide a competitive challenge. What then needs to be done to enable them to compete fully both at home and abroad in the financial services markets?

The answer is diversification. The United States banking system needs the ability to diversify geographically by branching across state lines. The United States is the only country to impose geographic boundaries on its banking system. Just imagine what Bank of America, Citibank, Chase, and Chemical would be today if they enjoyed nationwide branching privileges as their international competitors do. Nationwide branching not only reduces funding costs, but it also diversifies credit risks -- both important factors in profitability.

Another element of diversification is product diversification. Banks or bank holding companies should be



allowed to offer a full spectrum of financial services for businesses as well as households. Investment banking services for businesses and securities brokerage for individuals are keystones of this diversification, but there are many other financial services now foreclosed to banks which are a natural extension of a banking franchise. These include: sales of insurance, insurance underwriting, and real estate brokerage. As a general principle, banks -- or bank holding companies -- ought to be able, in my opinion, to provide any financial service to their customers.

But, in the United States there will be important questions raised about the structure of the banking system which would permit diversification geographically and by product line consistent with safety and soundness considerations and protection of the safety net.

It is my opinion that the S&L mess and concerns about additional risks in federally insured banks will result in the adoption of the financial services holding company model for the financial system rather than the universal bank model which is common in Germany and other European countries.

In this model the insured bank in a holding company structure is isolated from the risks of nonbanking activities by firewalls which block financial transactions and capital flows

from the bank to the nonbank affiliates. In this way the holding company is prevented from using insured deposits to finance nonbank activities and the risk inherent in those activities is not assumed by the deposit insurance fund.

In the interest of competitiveness the so-called firewalls could be minimized and limited simply to financial transactions, even permitting financial transactions if they are fully secured with unquestionable collateral such as U.S. government securities. Product cross-selling and management and director interlocks might be allowed without compromising the insurance fund.

But, United States banks have other competitive disadvantages which also demand attention. While the states individually are slowly moving to remove barriers to interstate banking, the process needs to be speeded up. Federal legislation to amend the McFadden Act which prohibits branching across state lines is badly needed. This would enable banks to gather deposits more efficiently, would promote consolidation of the industry, and permit elimination of redundant organizational elements which are costly and not needed. These moves would help to improve the profitability of commercial banking. In addition, we need reform of our regulatory structure to eliminate the redundancy and confusion caused by three different federal

regulators and 50 different state regulators whose policies and regulations are often contradictory and confusing.

One deposit insurer for all federally insured deposit-taking institutions, one regulator for all federally chartered banks, and one for all bank holding companies and state-chartered banks would be an improvement over what is now in place.

True to the title of my address today, I have tried to describe some of the problems faced by United States banks and I have suggested some possible solutions to those problems. Change will not come easily. There are many political and emotional hurdles to be overcome, but I believe there is now general acceptance in my country of the need for massive legislative, regulatory, and financial restructuring of the banking system. None of the present problems are fatal, but, if we don't deal with them soon in an objective and imaginative way, American banks will fall behind their Japanese and European competitors in seeking a rewarding share of the dynamic global financial market which is emerging.

Thank you again most sincerely for the privilege of sharing these thoughts with you.