Remarks by

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Good afternoon ladies and gentlemen. It is a privilege for me to be with you to share with you my views on some of the issues in banking today.

One of the central phenomena of the 1990's is that the United States increasingly finds itself a participant in a highly competitive global economy. United States political isolation ended with World War I, and even the possibility of economic isolation ended with World War II. Indeed, the United States can be said to have created the postwar reindustrialization of Western Europe and Japan. Today the economy of West Germany is the keystone of European economic unification and Japan has written a whole new chapter about industrial and financial competitiveness.

A prominent feature of the new global economy is the development of 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 revamping of the system came in the 1930's with Glass-Steagall, deposit insurance, and regulation of the securities markets.

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 in Congress who remain emotionally committed to now discredited historic conclusions. The most prominent of these discredited conclusions 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. 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 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 aspire to.

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. 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. In fact, U.S. banks have been 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 more benign and easily understood burden of regulation and compliance. I can only tell you that we at the Fed wince when, to implement legislation, we must impose an additional compliance burden on banks. These burdens are the result of well-intended legislation often drafted without a full appreciation of the cost to banks of additional reporting and monitoring.

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.

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 it is time to eliminate some

of these competitive disadvantages. 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 ever reached the floor. But, failure to act then may have been a blessing in disguise. Recently the Congress has become concerned about the competitive position of our banking system. I believe that concern has so far survived the shock and dismay surrounding the S&L mess and when Congress revisits banking legislation, it will be 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 contain recommendations for revisions to the system designed to protect the integrity of the insurance fund. Deposit insurance, originally designed to avoid financial panics and runs on solvent banks, has worked <u>too well</u>. In the past the threat of a run motivated bankers to stick to safe and sound practices. Experience has shown that deposit insurance has almost totally eliminated consumer runs. Encouraged by security from runs, 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 visible changes in a system which, after 55 years, is deeply imbedded in our commercial culture.

Deposit insurance is, of course, 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, as you know, 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 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 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, and the numbers would vary widely from bank to bank depending on the deposit mix and the purchased funds markets which 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.

It may be fair to assume that any proposal to change the basic structure of deposit insurance would be doomed to an early political demise. In my opinion, the public would see any reduction in coverage as a significant take-away -- particularly against the backdrop of the S&L catastrophe. I think the public

clamor would force Congress to stay with the present coverage. In that case "reform" is likely to be legislation to protect or insulate the safety net from poor management decisions or asset deterioration caused by external factors rather than alteration of the basic format of insurance coverage.

There are several ways to protect the safety net.

-- First, good supervision by the regulatory agencies -- a factor that was conspicuously absent in the case of the thrifts. This would include thorough asset quality examinations at least once a year and more often in the case of banks with problems.

-- Second, higher capital requirements for banks which want to expand rapidly, enter new businesses de novo or pursue aggressive acquisition programs. Capital, after all, is the best protection for depositors and other creditors against loss. Indeed, higher capital requirements may prove to be appropriate even for banks pursuing "business as usual" strategies.

-- Third, statutory authority for supervisors to intervene in a troubled bank before it becomes brain dead or capital insolvent. Why let the patient die before you make a house call? Preventive medicine can often avoid the need for radical surgery and save on funeral expenses. For example, the authority to demand restoration of satisfactory capital when levels drop below

minimums or to replace management and directors when compliance is not forthcoming.

Strong medicine? You bet! But what is the alternative? Can we afford even the remote possibility of another calamity? I think not!

I am persuaded that only if it is satisfied that we can avoid an S&L kind of mess will Congress move in the direction of further deregulation and structural reform. And, I believe that such deregulation and restructuring will still be done with protection of the safety net in mind. In that case, Congress is likely to turn to the financial services holding company as a preferred structural solution. The holding company concept is seductive in that it permits the isolation of the insured deposit-taking bank from 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 banks which will probably continue to develop as so-called universal banks. Also, Japanese banks are likely to be given securities, brokerage, and trust powers in the near future as part of a revamping of their system currently being studied by the Bank of Japan and the Ministry of Finance.

But, it is not yet clear whether they will adopt a universal bank model to assure competitiveness in Europe or a holding company model similar to ours.

In the United States, competitiveness arguments taken alone 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, and regulation could be minimal. Capital in sufficient quantity to be competitive might be difficult to raise. On the other hand, the broader opportunity available to such an entity might make the investment very attractive.

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 could 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 substantially insulate the insured institution from any additional risks involved in the subsidiary's operation. Further insulation could

be achieved by limiting intercompany transactions between the bank and its subsidiary to those sanctioned under Sections 23A and 23B of the Federal Reserve Act.

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 a steel company or an automobile manufacturer be allowed to own a bank or financial services holding company? Is there in that relationship an inherent threat to the country or the financial system? 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 entity 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 third largest thrift. Thrifts and banks are operationally more like each other every day, although the capital sections of their balance sheets may be somewhat different.

I should hasten to add at this point that we can find no correlation between nonfinancial ownership of S&Ls and failure rates. Why then do we accept the relationship for thrifts and not for banks? 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 if we find that ownership by a commercial enterprise would significantly improve access of banks to capital. But, we should not rush this one. Congress needs to be sure it understands all of the implications before it acts.

CRA performance of banks has become an increasingly contentious factor in the approval of applications made by banks and holding companies, adding measurably to the time to process applications and to the cost of compliance. Recent amendments to the Home Mortgage Disclosure Act impose a data collection, collation, and publication burden on banks and regulators which will result in the generation annually of about one million seven

hundred thousand pages of charts, tables, and statistics. I mention this just to illustrate the magnitude of the burden.

In the context of these remarks this afternoon, I would suggest that any comprehensive reform of the financial system might well include a real look at the possibility of simplifying and lightening the compliance and reporting burden on financial institutions. Simplification alone, without changing regulatory requirements, could save the industry and the government substantial costs.

Turning to another issue, interstate banking on a nationwide basis is rushing at us, and whatever our individual feelings are about that development, the trend is not going to be reversed. By the mid-1990's we will have de facto nationwide interstate banking without the de jure blessing of Congress or 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 would face if he or she had banks in ten different states.

First, an interstate operation 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 and price the same transaction.

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

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

-- And, if the operation is in more than one Federal Reserve District, where is that friendly, helpful, fatherly central banker? Is he or she in Boston, New York, Atlanta, Dallas, or San Francisco?

And

-- Given those 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 bankers are federalists or states-righters they will all be calling for reform to achieve more efficient interstate operations by the mid-1990's. 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 branching in order to make operations more efficient. The states rights debate around that issue will be a hot one.

Finally, an issue which has not had enough serious attention is the structure of federal regulation. We have the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the National Credit Union Administration, and the Federal Reserve -- all operating in addition to banking regulators in each state. 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, but 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 considered 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-1930's. It will be a big debate. Let us not hesitate to participate, keeping in mind that what is right for the United States as a whole should override any and all parochial interests which various groups might have.

These issues are important to the banking system and to the future of the United States. The efficient operation of domestic financial markets is vital to the health of the economy. And a

strong, fully competitive banking system is vital to U.S. participation in world markets. We need to adapt our system to the new realities of a global economy, and we need to do it now.

Thank you for inviting me to be with you. I would be delighted to try to answer your questions.