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Remarks by

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It is a special pleasure for me to be here today to address such a distinguished audience. Many of you represent banks which have had operations in the United States for most of this century or perhaps longer. Others are more recent arrivals on these shores. Whatever your experience in the United States banking market, I am sure you are all somewhat bewildered with the course of recent events. You read daily accounts in the press about the troubles of some banks and journalistic and academic forecasts of imminent doom. In addition, you are eager for clarification of legislative and regulatory trends which may affect the way you conduct business here for many years to come.

Although it may be presumptuous on my part, I would like to share with you my own views of the current condition of the United States banking system and the near-term outlook for legislative and regulatory change. These changes may indeed alter the way you operate in U.S. markets and they may also alter the competitive stance of U.S. banks both here and abroad.

One cannot discuss the condition of the banks without considering the environment in which they are currently operating. Even before the specter of recession loomed, banks in the Northeast, the Mid-Atlantic states, and certain parts of the Southwest were wrestling with the aftermath of the real estate feeding frenzy of the mid-1980s. The bald fact is that much of the United States is over-built and over-priced, particularly in

the category of commercial real estate. Over-optimistic cash flow projections and intense competition for loan opportunities seduced bankers into ever more liberal lending terms. When demand didn't live up to expectations and rent levels retreated, bankers were left with a barn full of under-performing loans and foreclosed real estate.

Commercial real estate values have been further depressed by contracting business confidence in the face of a slowing economy. In addition, home values have been under downward pressures in many local markets. Such downward pressure results from a variety of factors, including stagnant or declining real incomes, lowered expectations regarding the investment value of home ownership, and consumer caution stemming from the recession and the Persian Gulf war. Add to that gloomy picture the overhang of RTC and FDIC inventories, and you have the weakest real estate markets in many parts of the country since at least the early 1980s.

We do expect the economy to return to positive real growth by the third quarter, assuming a prompt end of the Gulf war and no serious impairment of oil supplies. However, the absorption of the excess inventory of commercial real estate and a resumption of stronger demands for residential real estate will take some time to develop.

Meanwhile, the banks, unlike the S&Ls, have aggressively recognized these problems and taken heavy hits to current earnings to charge off expected losses and provide reserves against loans which are clearly in trouble. The worst of that process may be behind us, and, while 1991 may be another year of heavy provisioning, we may not see as much blood spilled as in the fourth quarter of 1989 and the four quarters of 1990. Over the longer run, there will undoubtedly be substantial recoveries on loans as the economy resumes growth and the real estate market gradually recovers.

At the same time, the other bête noire of banks in the 1980s, LDC exposure, has been greatly reduced in intensity. Many banks have reserved aggressively for further losses, and managed positions down through market sales and debt for equity swaps.

One niggling further worry is the category of highly leveraged transactions. While banks are generally in senior positions with their bridge loans and well secured, there is nonetheless the worry that debt service is increasingly difficult to maintain when a slump in the economy has a strong negative effect on corporate revenues. This is particularly worrisome in the cases where cash flow coverage was thin even in the original projections which invariably assumed a continuation of economic growth. A prompt return to growth later this year should make any problems with the HLTs more manageable.

The emergence of these well-documented problems and the resultant investment reluctance of the capital markets has prompted rather heroic response from banks to downsize balance sheets through sale of assets in pursuit of healthier capital ratios. Banks have also excised fat to achieve leaner operations and improve earnings performance. I feel confident that further earnings improvement will come as intra-market consolidation takes place with the attendant opportunities for the elimination of redundant overhead. I expect the 1990s to be characterized by a spate of intra-market mergers similar to those which took place in many markets in the 1950s and early 1960s. In most of those earlier mergers the goal was diversification rather than operating economy. In the coming merger trend, the easiest part will be the numbers. The most difficult part will be blending cultures. But far-sighted bankers, I am confident, will find a way to consolidation, greater efficiency, and improved operating results, because they must if they are to return to favor in the markets and attract the capital to grow and expand into new businesses.

However, pre-occupation with the troubles the industry is working its way through should not be permitted to delay legislation to address the urgent needs of the deposit insurance system and the antique regulatory constraints which seriously handicap U.S. banks both at home and abroad.

The FIRREA-mandated study which has just been released by the Treasury accurately identifies the issues with which Congress should deal. It also suggests a pattern of reform designed to limit the spread of the federal safety net, defend the deposit insurance system from loss and at the same time significantly broaden the business opportunities of banking organizations. It also suggests a rationalization of the federal regulatory structure which deserves study and debate.

In the spirit of preferring industry solutions to industry problems, the Treasury has left it to the FDIC and the banking industry to develop proposals to refinance the Bank Insurance Fund.

The concept of the insurance reserve fund is to absorb final losses on the disposition of assets of failed institutions. In the last several years those losses have been heavy and the reserve balance is well below what most observers would feel is a prudent level. Part of the problem derives from the use of the fund for working capital as well as final losses. This aggravates liquidity problems for the Bank Insurance Fund when asset liquidations at acceptable prices are slow in being realized.

The concept of separating working capital funds and final loss reserves is suggested by the industry approach agreed upon

by the trade associations recently. The industry has proposed that $10 billion in bonds be issued by the BIF to be purchased by the banks. These bonds would carry a market rate of interest and would be paid back over time by a special assessment on the banks at a fixed percentage of assets. In addition, the current insurance premium would be capped at 19.5 basis points.

While this approach certainly heads in the right direction, it has some flaws which need to be addressed. Ten billion dollars may not be enough to relieve the pressure on the fund, particularly if the regular premium is capped. Furthermore, a best-efforts underwriting of the BIF bonds by the trade associations is weak and raises questions about the ultimate funding of the commitment.

The banking industry might want to consider strengthening its proposal by asking Congress to authorize an open-ended put to the banks pro-rated on the basis of deposits or assets or some other fair measure. The securities might be intermediate-term notes or bonds with a Treasury rate of interest. If they were not marketable, but rather had to be held by the banks to maturity, bankers could deflect the inference of a taxpayer bail-out by pointing out that the funding for the BIF is being provided by borrowing from the banks alone and repayment of the borrowings would come from assessments on the banks. By not

capping current premium assessments at present levels, the BIF would be able to assess the banks to cover final losses. Meanwhile, working capital would be provided by the banks themselves but through the medium of an earning asset rather than a permanent hit up front to earnings.

Once the BIF is properly funded, the major concern should be to protect the fund from losses. In that respect the Treasury proposals offer a solid program which should go a long way in avoiding a recurrence of the present problem. There is a strong and appropriate emphasis on capital as the first line of defense against failure and claims against the insurance fund. Proposals to authorize regulators to intervene aggressively in troubled banks before they become insolvent, and mandating in-depth examinations of banks on a timely basis set up a framework for assuring a safer and sounder banking system.

In my opinion, Congress will want to act on the imperative issues of refinancing the BIF and deposit insurance reform before turning to some of the other issues raised in the Treasury study. Restructuring the insurance system itself may be the most difficult of all politically, as well as conceptually. Deposit insurance has become an integral part of our commercial culture and a firmly entrenched consumer entitlement. Certainly it has prevented consumer runs on sound commercial banks. The contagion of consumer panic which ran rampant in the 1920s and 1930s has

virtually been eliminated. On the other hand, the protection from runs has lulled bank managements in some cases into such a sense of security that they developed an appetite for greater risk-taking and allowed once robust capital ratios to erode.

Some argue that more market discipline on risky banks would be exercised if insurance coverage were reduced and depositors exposed to greater risk. Indeed corporate depositors with large accounts have often run on banks which were acquiring a shaky profile. But, will consumers have the same discernment or the inclination to learn enough about their bank to make an informed judgment about its condition? I doubt it. I am personally persuaded that if consumers see the safety net, in which they have great confidence, contracting too much, they may lose their nerve and stay off the high wire, opting to put funds beyond household operating needs in Treasuries or other liquid financial assets. If that is a reasonable possibility, the FDIC study recommended by Treasury of the feasibility of moving to a limit of $100,000 of coverage per depositor across all institutions will need to be undertaken with great care and thoroughness. At a time when confidence in the banking system is under pressure, a further threat to that confidence could be seriously counterproductive.

But, let's move on to some other elements of the Treasury proposal which have tremendous implications for the future of banking in the United States.

In my judgment, the time is over-ripe for federal action on interstate banking. In the past, Congress has been unwilling to tamper with the historic rights of states to regulate banking within their borders. But times have changed dramatically. States first adopted regional compacts permitting bank holding companies to acquire banks across state lines consistent with the Douglas Amendment. More recently states have established so-called trigger dates for entry of out-of-state banks either on a reciprocal or a fully open basis. In short, the states themselves have recognized the desirability of eliminating geographic constraints. The problem now is that banks are forced by the McFadden Act to operate interstate in a holding company mode rather than a branching mode. This is cumbersome and expensive. The Treasury proposals for repeal of both Douglas and McFadden with modest conditions is appropriate and deserves prompt and favorable consideration by Congress.

The Treasury has also proposed a significant broadening of business opportunities for banking companies while at the same time recommending a structure which protects the insured deposit-taking bank from whatever additional risks are inherent in the new activities.

It is clear that the universal bank model is the most efficient structure for a financial conglomerate, since it permits financing diverse businesses directly with bank raised liabilities. It also has a simple, more unified management structure and distribution system. In a universal bank, conventional lending, insurance sales, and underwriting, real estate brokerage and securities underwriting and brokerage could all be conducted in departments of the bank itself. Or, alternatively, the nontraditional businesses might be assigned to separate direct subsidiaries of the bank.

In the United States, current public policy favors more distinct separation of traditional banking from new nonbanking activities as a way to protect the federal safety net (particularly the deposit insurance system) from whatever additional risk is undertaken in these new businesses. For that reason, the Treasury has proposed a financial services holding company structure which encompasses many of the management and marketing advantages of the universal bank, but insulates the insured deposits from additional risk by restricting the financial transactions between the bank and its nonbank affiliates. In addition, functional regulation of nonbank subsidiaries of the holding company assures expert supervision of each set of business risks. Here again there is heavy emphasis on capital. Financial services holding companies with very well capitalized banks would be permitted more freedom to expand into

new businesses and grow more rapidly while those whose banks were less well capitalized would be restrained. These are well thought out concepts which provide Congress with a statutory framework for a broader based financial services industry which at the same time protects the safety net from abuse.

The modest entry of banks into the securities business permitted by the Federal Reserve's Section 20 decisions has been successful. I would argue that, in the context of the proposed financial services holding company, repeal of Glass-Steagall is appropriate in order to enable banks to provide securities services to customers and securities companies to provide full banking services to their customers. Insurance and real estate brokerage are other diversification opportunities which should be considered. Banks in other countries are already making these kinds of affiliations and to deny U.S. banks those opportunities is to further disadvantage them competitively.

Additional pressure for permitting ties between banks and insurance companies is mounting as the result of the growing number of such affiliations abroad between companies which also have operations in the United States. Under present laws we are compelled to require the divestiture of either the banking or insurance activities in the United States since U.S. law does not permit such linkages, and we operate under the concept of national treatment. The continuation of this barrier could open

the United States to criticism from abroad, particularly from an integrated Europe, that we do not permit free entry to our markets.

Finally, the Treasury has raised the momentous issue of commerce and banking by suggesting that commercial firms might own financial services holding companies with a system of thick firewall constraints on financial transactions between the bank and all of its nonfinancial affiliates. It is good to have this major issue defined and it deserves careful analysis and consideration. It would mean a major change in our commercial culture, and at this point I am personally undecided.

We are at a critical juncture for our financial system. The rest of the industrialized world is evolving financial systems faster and more imaginatively than we are. The Treasury has taken the initiative to define the issues and make concrete suggestions for reform. The debate will be intense and hopefully the outcome will restore U.S. banks to a more competitive position at home and abroad and open new opportunities for foreign banks wishing to participate in U.S. financial markets.

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