WHAT'S AHEAD FOR BANKING

Remarks by

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It is a pleasure to welcome you to Washington. Washington is that part of the United States known as "inside the Beltway" and most of us in government, particularly those of us involved in regulation of one industry or another, are accused of having an "inside-the-Beltway mentality" that clouds vision, impairs reason, and puts at risk the very industries we are supposed to be trying to assist. It was not long ago that I was on your side of the table -- one of those regulated. Now I find myself, with some discomfort, on the other side of the table as "the enforcer." Enforcing, to be sure, an incredible burden of federal regulation, much of which has nothing to do with safety and soundness. Much of which is the realization of some legislator's dream to have something to "point to with pride" as his contribution to government. In my opinion, banking today is seriously overburdened with consumer compliance regulations which sound like motherhood and the flag but which accomplish little or nothing for consumers, while imposing an enormous cost and administrative duty on the banks. Once these requirements are imposed it is difficult or impossible to get them lifted, even after their usefulness or purpose has been forgotten. But the Solons on the Hill have legislated, the regulators have made rules, and the banks must comply.

Banking is at an important crossroads and bankers need to consider carefully which fork in the road they will take. Congress has been presented by the Treasury with an omnibus proposal to reform the financial sector of the economy by removing obsolete restrictions on commercial banks and allowing the rejoining of the banking and securities industries in order to provide better service to corporations and government entities in meeting their transactional and credit-related financial needs. The entire thrust of these proposals was to make the U.S. banking system more competitive in rapidly developing world markets and to provide better and probably cheaper service to corporations and consumers.

But the banking industry is haunted by its recent past. It is bedeviled by the spectre of hundreds of bank failures and the prospect of taxpayer funds, for the first time, being used to assist the FDIC in administering the insurance scheme for commercial bank deposits. The press and others often imply that mismanagement, poor judgment, and downright dishonesty have been the causes of the mess. There have certainly been examples of all of those abuses, but they should not be used to generalize about the industry.

Have any of the finger-pointers called attention to the regulatory constraints that encouraged focus on real estate; or the competitive factors that encouraged some bankers to ease credit standards and shave pricing to protect market share; or the economic downturn that caught bankers and developers alike -- victims of over-optimistic forecasting and delusive assumptions about cash flow?

The fact is that the rescue party, epitomized by the Treasury proposals, may be cut off at the pass before it reaches the stranded bankers, and the rationale will be that the banks don't <u>deserve</u> more liberties. Rather, it is argued, they must be <u>more</u> regulated to protect them from themselves.

There is no question there were excesses of overconfidence and reckless risk-taking in the heady environment of the Eighties when it looked like prosperity was here to stay and the only way to go was up. But bankers, badly injured by their mistakes in the Eighties and reluctant to repeat them, are now being blamed for being too timid and for slowing down the recovery of the economy from recession. It seems to me absurd to trumpet safety and soundness in one breath and in the very next to demand more aggressive lending policies. The industry still has a peck of troubles and challenges and some of the remedies for trouble available in the past are not now readily at hand.

With capital markets casting a jaundiced eye at bank securities issues and investment bankers shying away from underwriting new offerings, banks have resorted to negative growth or downsizing to redress capital ratios which have been undermined by massive reserve provisions and charge-offs in the loan portfolio. To turn around runaway growth of expenses, banks have restructured to reduce costs, with all of the attendant upfront charges for severance pay, lease buyouts, and losses on under-depreciated excess equipment.

These kinds of heroic measures would be much applauded in a culture which rewards long-term results, because they cannot help but improve future performance. But, with a press which builds circulation by reporting misfortune and an analyst community preoccupied with quarterly earnings comparisons, banks aren't getting much credit for cleaning up their act.

But cleaning it up is what is happening. LDC problems which were headline fodder for years have been digested pretty well by now and the industry LDC malaise has been reduced to an occasional burp. The full and final effects of LBO and takeover financing will take a while to play out. But, by and large the banks have had preferred positions in these deals and I can't remember a single bank which has been brought down by that kind of lending although it <u>has</u> played an auxiliary role in banks which have basically failed by reason of large real estate losses.

Currently credit card delinquencies and charge-offs are beginning to be worrisome, but this is more a function of general economic conditions than bad credit underwriting.

The category which causes me the most concern at the moment is equity credit lines. They are vulnerable to both economic conditions which affect borrowers' ability to pay and the decline in real estate markets which raises questions about the value of the underlying collateral. It is hard to predict the outcome there, but if the economy continues to recover, as we expect, both repayment ability and collateral value should improve.

Now this is not all just naive optimism on my part. There is hard statistical evidence to support my contention that banking is coming up out of a long dark tunnel into the light again.

-- Item: In 1987, 18.6 percent of banks reported losses for the year. In the first half of 1991, that figure was down to 11.3 percent.

-- Item: Almost one-half of the banks earn a return on assets of better than 1 percent, and they do it year after year. While this is generally more true of smaller banks than the big guys, in the third quarter of 1991 -- a very tough year for banks -- 14 of the 45 largest which have reported thus far, have earned better than 1 percent on assets.

-- Item: 96 percent of all banks currently meet the risk-based capital guidelines imposed by the Basle accord for 1992 and 75 percent of the banks have risk-based capital in excess of 12 percent.

-- Item: Pure equity in the industry as a whole is now 6.7 percent -- the highest level in twenty years.

-- Item: Banks who meet the 1992 Basle standards have $67 billion of capital in excess of the minimum. Parenthetically: the 4 percent of banks who don't yet meet the standards have an aggregate shortage of only $4 billion.

-- Item: In spite of lukewarm capital markets, certain of the 50 largest banking companies have raised $5 billion in new equity capital and $3 billion in new subordinated debt this year and the year still has two months to go.

Not bad, I'd say, for an industry which is regularly reported to be on its deathbed.

I am not suggesting that there are not some sick puppies out there and that there won't be more failures, including, perhaps, some sizeable institutions. What I am saying is that the vast majority of U.S. banks are well capitalized, profitable and in good shape to fund the legitimate credit needs of the recovering economy. I am confident that the so-called credit crunch is more a phenomenon of confidence and slack demand than it is one of credit constipation. It is my guess that those who cry most bitterly about the unavailability of credit are either the ones who didn't pay back their loans last year or those whose borrowing credentials have deteriorated as a result of the economic slowdown.

I mentioned earlier that banking is at a fork in the road and I want to emphasize how important I think it is that the industry go down the right fork rather than the left fork. The right fork can only be negotiated if Congress enacts comprehensive reform legislation along the lines proposed by the Treasury last winter. In that direction lies appropriate refinance of the insurance fund, modest limits on the insurance coverage available to depositors, authority for supervisors and regulators to <u>prevent</u> bank failures rather than just <u>preside</u> over them, permission to branch across state lines, broad powers to engage through affiliates in securities dealing and underwriting, and permission to establish close relationships with insurance companies. On that road the lighting is bright, the surface is smooth, the curves are well marked, and the opportunities for a profitable trip are greater.

The left fork is a continuation of the status quo or, worse, a rollback of insurance and securities powers for the banks which have not only been prudently managed but have resulted in better service to corporations and greater convenience and lower prices to consumers. The same competitive constraints which presently hobble U.S. banks in their ability to compete with nonbank domestic financial institutions would be allowed to stand and a new panoply of costly consumer compliance burdens would be added. The left fork is badly lighted, dotted with axle-breaking potholes and unmarked mountain roads without guard rails. It is a dangerous route to take.

If Congress in its wisdom chooses to endorse the Treasury proposals, banks will flourish, albeit in a highly competitive environment, both domestically and internationally. If reforms are not enacted, U.S. banks will continue to be at a material competitive disadvantage, not only to foreign banks and in foreign markets, but also to domestic nonbank financial institutions which freely encroach on banking markets but which operate from business lines in which banks are forbidden to participate. If that scenario is played out for a decade or so, banks will become public utilities like the post office, and just about as exciting.

The fork in the road for banks is an important one and the future well-being of the industry which finances commerce is at stake. You must hope and pray that in the political process of committees, mark-ups, rules, floor debate, conference committees, and final action, Congress recognizes the importance of a strong and competitive banking system, and finally enacts much needed legislation to modernize the banking system.

Assuming that our democratic process will work for the best as it so often has in the past, I think the Nineties will be an era of enormous change.

-- Today there are 12,400 banks in 9,500 separate banking organizations. My guess is that by the year 2000 there will be 7,000 banks in 4,000 banking organizations.

-- Intra-market mergers will be the landmark events of the Nineties. The trend is already under way. The results will be startling in that the new companies emerging will be leaner, meaner, better capitalized, better managed, and much more profitable than their predecessors.

-- Capital will become the common measurement of safety and soundness and the ability to earn a market rate of return on higher capital levels will be the standard measurement of management performance as well as the key to the capital markets.

-- Only sound, well managed and profitable banks will be permitted to embark on rapid growth patterns, aggressive acquisition plans, or entry into newly permitted nonbank activities.

-- Banks slipping into substandard capital positions or serious asset quality problems will be intervened early on and corrective action will be required. The risk of noncompliance will be dividend suspension, management replacement, or even director dismissal. Sound public policy simply cannot tolerate another period of disruption, failure, and clean-up cost like the one we have just been through.

-- By the end of the decade there will be in place several nationwide systems of subsidiary banks or branches, but there will also be powerful regional banks and thousands of community banks, not just hanging on, but earning circles around their bigger counterparts.

-- A handful of U.S. banks will be active in international markets and giving a good competitive account of themselves.

-- And the financial industry will have become more integrated as banking concerns, insurance companies, and securities firms combine into financial services holding companies which will supply a full spectrum of financial services to corporations, governments, and individuals, and supply them more conveniently, more efficiently, and at less cost than ever before.

Most of you will be a part of that Brave New World. It will be an exciting and challenging environment in which to find your way. I only wish I were young enough to be a participant and not just an observer.

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