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The Future of Banking: Choosing the Right Model

Address by

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to

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<u>THE FUTURE OF BANKING: CHOOSING THE RIGHT MODEL</u>

It is a pleasure to be here today. Observers of American culture have often noted that one can see the future of America by looking at the California of today. Events of the past few weeks have shown us that the future will not inevitably be brighter than the present. It will require boldness, vision, and innovation to assure that the California of the future - and the America of the future - are places we can be proud to leave to our children.

Your industry is one key to that future. You are in the position to be the financial heart of a more vibrant economy. With an entrepreneurial spirit that is willing to take on new challenges, your future and that of America can be bright. I am an optimist. But we should be clear that a bright, entrepreneurial future is not inevitable. It is one which can only be developed with hard work and a commitment to a broader vision of the mission of your industry.

Today the banking industry faces two very different competing models of the future. The first I shall call the regulated utility model. You are all familiar with the trend toward this model in your daily lives as bankers, particularly in the last few years. It is a model of increasing government intervention in the way you run your banks. You may be expected to be banker, policeman, and social worker all at once. In addition, your profitability may become increasingly determined by fiat as increasing costs are passed along to you based on the political perception of your industry's capacity to absorb those costs.

The second model of the future of banking is the competitive market model. A truly competitive market would involve a much more intense and rigorous form of competition than the industry has experienced to date. While government would continue to stand as ultimate guarantor of the integrity of the system, the taxpayer would be protected by adequate capital rather than intense regulation. Under this model, the industry's success or failure will depend upon its ability to provide a vital service to the economy: efficient evaluation of credit worthiness.

Granted, other financial institutions will be attempting to perform the same function. The bank form of credit evaluation has the unique advantage of a physical presence in the community which it serves. This necessarily also entails higher costs. Your success in the intensely competitive financial market place of the future will require making the most of your community presence.

I do not know which path the industry will ultimately take: that of a regulated utility or that of a community based competitive provider of financial services. I can tell you what I prefer. This is one regulator who fervently hopes that his job's responsibilities do not become any more intrusive than they already are. Turning banks into regulated utilities is not good for the banking industry and it is not good for the country. Unfortunately, neither the public nor their elected representatives seem disposed to easing off on bank regulation.

The battle ahead will be a long one.

Most important, the grounds on which the regulatory battle will be fought are changing. During the late 1980s and early 1990s, the basis for bank regulatory action has been the issue of safety and soundness. In this vein, last year's banking bill established highly prescriptive regulations regarding activities which, in the judgment of Congress, were risky to the banking industry.

The regulatory issues in the 1990s will not be limited to safety and soundness, but will increasingly emphasize fairness: whether or not banks are fulfilling the needs of their communities. Today we all know this as C.R.A. -- the Community Reinvestment Act -- but it is potentially much broader. The existing CRA rules are deliberately non-prescriptive and I support them in their current form. Congress wisely chose to avoid explicit allocation of credit in enacting CRA, letting the local bank define its mission to the community and the means it would use to meet that mission.

It need not remain this way. Under the regulated utility model, Congress could be quite prescriptive in the means by which your institutions comply with their CRA mandates. While I hope it would never come to this, one could envision credit rules allocating the types, volume and location of loans that banks could make. One could also imagine racial, ethnic, income and geographic guidelines regarding the recipients of those loans. A shift in the regulatory framework in this direction is not inevitable, nor, however, is it inconceivable.

Let us consider why. Racial discrimination is not only illegal, it is morally repugnant. Racial discrimination tears at the very fabric of our national ideal. A society in which each individual is evaluated on his or her own worth is what we seek -- not one in which individuals are treated based on the group of which he or she may be a part. This is the basis of a free enterprise system. Allowing discrimination to continue in either spirit or substance is not only antithetical to our political institutions, it is destructive of our economic liberty as well.

Because so much is at stake, our political leaders will take whatever actions they deem necessary to combat it. Those actions may not, by their very nature, necessarily advance our Constitutional ideal of individualism. Those actions may not advance economic liberty or promote economic growth. But they will be taken in spite of their costs because combating racism represents a moral imperative.

In the case of banking, an increasingly prescriptive set of rules regarding lending practices could be the response to the perception that existing lending practices are unfair. That is how the regulated utilities model of banking is likely to emerge. We already have legislative calls to examine the level of small business lending done by banks. Serious legislative concerns have already been raised about the Housing Mortgage Disclosure Act data (HMDA data) regarding differential rejection rates in mortgage lending for different racial and ethnic groups.

Let me add that although I had settled on this as the topic of my speech many weeks ago, the tragic events which started not far from here 13 days ago can only reinforce the message I am delivering this morning. I can assure you that questions will emerge in the weeks ahead, if they have not already, about the roles your institutions have played in the past, and can play in the future in funding economic development of inner city areas.

What you will be defending are not the policies of your banks. Discrimination need not be overt or even conscious. If it was, your task would be obvious. What you must address is largely subjective or a matter of perception. This does not make it any less real. But it does make it harder to both identify the problem and devise the solution. It will require exceptional diligence, commitment, and creativity on your part.

You may argue that it is asking a lot to fight something that is already against the stated policy of your organization and perhaps not even real. You are right. But, the mere perception of unfairness, not to mention its reality, may drive policymakers to take action. The likely outcome may not be good for you, good for the country, or particularly fair. I therefore mention four ideas for combatting the perception of unfairness, not to dictate to you how to run your institutions, but to suggest ways that may help you solve the problems you face.

Let me begin with the subject of perceptions. You are a service business. In other service businesses, such as hotels, restaurants, and retail stores, management often hires employees to shop and report back on the level of customer service. Indeed, this practice is not unknown to banking. How else do you tell whether your tellers give reliable information to your customers in a pleasant manner?

Specifically, you might have minority individuals try shopping for credit and other services at a bank branch where they are not known, then report back. The anecdotal reports we have are that the different treatment that does take place is not overt, but subtle. It involves loan officers not extending the same courtesy, or keeping minority applicants waiting longer than non-minority customers. It may involve loan officers putting forth less effort to provide qualifying tips to minority applicants or mentioning to those applicants fewer loan products and options. This is important information for you to find out as a service business.

Let me say that there have been a number of calls for the Fed and other bank regulators to perform this shopping function as a part of our enforcement activity. I think that it would be unfortunate if it came to that. The Federal Reserve has enumerated a number of reasons for its reluctance. Key among these is efficacy. As a regulatory body, our evidentiary techniques could not rely on anecdotal evidence, but would most likely entail the gathering of a statistically significant sample. This is not only expensive for us as a regulator, it would also involve a substantial burden on you.

In addition, we are dealing with information which is inherently subjective and not easily quantified. As an enforcement agency we cannot easily measure whether subtle variations in conduct occurred a statistically significantly number of times, for different applicants. On the other hand, the impression that your shopper gets is valuable to you as a bank. That impression is by its very nature of great proprietary value and relatively little regulatory value.

One concern that has been expressed about shoppers is the potential liability banks might suffer in having the reports subject to discovery in class action suits. I think that Congress might be well advised to consider some sort of safe harbor protection in this regard. But, even absent such a safe harbor, shopping can still be done profitably by your institution to report back non-quantifiable impressions. These impressions could prove very valuable to your organization in a proprietary sense.

I therefore commend shopping by your own employees as a way of gathering important information about the way you treat your customers from different backgrounds. Such activity could go far in removing the perception of unfairness by attacking it at its roots. It is likely that your employees may not even be aware that they act in a manner which is considered discriminatory or offensive. Simply providing information to these employees may prove to be a very important consciousness raising step. Shopping may prove an important adjunct to your other training and educational techniques. Let me also say that it could prove to be a very profitable step in improving customer relations and creating new lending opportunities.

A second idea I would like you to consider gets to the heart of the subject of mortgage discrimination. I believe this is particularly important to deal with because of the vital role homeownership plays in our society. In my travels throughout the country to neighborhood reinvestment projects, I am repeatedly struck at the difference home ownership can make to the individuals in a community. Advancing homeownership is something that is good both for your customers and for the communities in which you do business.

One idea that has worked in other communities is the idea of mortgage review boards. These organizations are completely voluntary and can be totally private sector in nature. Two models of mortgage review boards are now working. In Boston and Detroit rejected mortgage applicants may forward their applications to the board to appeal that outcome. Members of the review board are banking and thrift institutions who are active in the local mortgage lending market as well as representatives from local community organizations. Rejected applicants who meet acceptable criteria are provided loans by board members on a rotating basis. This approach not only provides homeownership opportunities for those who might not otherwise have them, it also enhances the perception of fairness in the eyes of the public. An opportunity for appeal is created and that appeal is based on a willingness to reassess applications as agreed upon by a large number of reviewers.

A second approach to the mortgage review board process is practiced in Philadelphia. There, a group of mortgage lenders including local banks and thrifts targets key neighborhoods where more flexible lending standards could have a substantial impact. Applicants for mortgages in these neighborhoods whose applications are likely to be denied, have their application automatically reviewed by this committee of lenders. The application is forwarded directly by the lending institution and requires no effort on the applicant's part. More flexible criteria regarding employment stability and credit history are used. This process avoids the stigma of an initial rejection and represents a more direct, proactive approach to mortgage lending.

The key merit of both approaches is their voluntary nature. No quotas are being filled. No institution is required to take a mortgage which objective criteria indicate is not likely to be repaid. This seems like an idea worth looking at. Whether it might work for you in California is for you to decide. Again, the emphasis of my comments today is on finding creative, voluntary, and private sector-oriented actions you might take to end unfairness, both real and perceived.

A third idea I'd like to mention is consumer education. I am increasingly aware from consumer education surveys that many Americans -- especially young Americans -- have little understanding of the basics of consumer credit: what a debt-to-income ratio is or what the consequences of defaulting on a department store bill a few years ago may have when they decide to purchase a home. Many Americans also have little understanding of the implications of repayment with interest. Too many Americans feel that they have met their financial responsibilities if they are able to cover the minimum payment on their credit cards each month. Little thought is given to the concept of long term saving to finance consumer purchases.

In addition, innovations in consumer education could be used to diminish some of the perceptions about mortgage lending and other banking activities and ultimately to help more consumers be successful home purchasers and customers. Consumers who are familiar with the lending process are more likely to be at ease during a loan interview and less apt to misunderstand an explanation of their eligibility for a particular mortgage, or for credit with the lender at all.

I firmly believe that our country's consumers must be educated for success, by learning at an early age the most critical areas of personal finance that will determine whether credit doors are opened or closed in their future. I hope that you will work actively with local community groups and particularly the schools in your communities to promote basic financial education and understanding. That educational effort, along with other efforts, such as I've outlined today, will go a long way to helping future consumers be creditworthy. Helping these customers own their own homes and fully participate in the economic life of the country is good civics. It is also good business. From an industry perspective, consumer education will go a long way to increasing the number of customers who are active users of banking services.

A fourth and final idea I would like you to consider is a much more active role in lending to small business, particularly minority small businesses. Let me be candid. The nature of the banking franchise has changed and will continue to change in the years ahead. Direct access to capital markets will become an increasing fact of life as securitization of business loans by the financial market and the process of deepening of the commercial paper market continues. These developments will inevitably shrink the size of your traditional lending markets.

For the banking industry to survive and prosper, it must do better than other financial intermediaries at credit evaluation and allocation. Some argue that banking is at a disadvantage because it is a high cost financial intermediary. Those costs are reflected in the physical networking into communities that is not done by say, a discount broker or underwriter of commercial paper. The higher costs are also the result of the maintenance of a large credit evaluation staff. You will survive in a competitive environment only if the physical network of branches and the large staffs at your disposal provide advantages which offset their costs.

Let's face it. Institutions with high operating costs simply cannot profitably compete in low margin businesses such as the commercial paper market or in the government securities market. However, you can be profitable in retail banking. This involves not just consumer lending, but lending to small businesses who do not have access to the lower cost markets. The physical presence of branches and loan officers within the community give you the advantage in determining the credit worthiness of the individuals in that community. The lack of non-bank competition in this market assures that the margins exist for you to compete profitably in that community. That is where opportunities for growth lie.

In the 1990s America will continue to rely on new businesses and small businesses as the engines of economic progress. We are probably unique in the world in having the vast majority of our net new jobs created by such businesses. Entrepreneurship is not only our engine of economic growth, it is also the means our economy has provided for climbing the economic ladder.

The Wall Street Journal called the 1980s the decade of minority capitalism. Between 1983 and 1987 there was an 83 percent increase in the number of Hispanic owned businesses. There was a 50 percent increase in the number of businesses owned by African Americans. More black owned businesses were created from 1982 to 1987 than in any other comparable five year period in our history -- and by a wide margin. More Asian Americans and more women went into business than at any other time.

These new businessmen and women need your help. They are your natural customer base. They are also your natural allies in combatting the impression that the system is unfair. Each minority owned business which gets its capital from your bank stands as a living refutation of the notion that the system is unfair. These businesses are also the vehicle by which economic opportunity is brought both to individuals and to the communities in which they live.

Reaching out to those new entrepreneurs is not going to be easy. It may require a change in the way you do business. It will require you to go out of your traditional market and find new markets. But, that is the essence of free enterprise. You must find and develop new markets for the survival of your institutions. That is your competitive challenge for the 1990s. These new customers are your opportunity if you have the competitive capacity to rise to the challenge.

Remember, the alternative to meeting these challenges may be becoming a regulated utility. In some ways the political challenge to meeting the perception that banking is unfair to minority groups augments the economic challenge you face to reach out and develop new markets and new customers. As a regulator who doesn't want more regulations I want you to succeed. Furthermore, as an American who believes in this country and the concepts of individualism and free enterprise that America represents, I hope that you do succeed. The alternative is a future that none of us want.