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THE SHAPE OF BANKING IN THE 1990'S

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## THE SHAPE OF BANKING IN THE 1990'S

I would like to cover two important topics in my talk today. First, I will briefly review the current state of the American banking industry and will outline some structural reforms that I believe would address these problems. I will then share with you some thoughts on how the shape of the U.S. banking system might change over the next ten years.

### Financial Strain

As we are all aware, serious stresses have developed in the U.S. financial system. Last year alone, 136 commercial banks in this country failed and nearly 20 percent reported losses. By such measures, the performance of thrift institutions also was dismal. This year, I expect the failure rate for banks to be almost 50 percent higher. Although these failures will occur all across the country, the majority will be concentrated once again in farm and energy states. Many of these failures will result from inadequate diversification of loan portfolios. Any reform of our banking laws, therefore, must loosen the strictures that now limit the scope for diversification.

It is not the banks and thrifts alone that are struggling today. The S&Ls' problems have dragged the Federal Savings and Loan Insurance Corporation toward insolvency. The FSLIC's liquid assets are now so meager that the closure of large S&Ls could create considerable problems for the insurance fund. As a result, many S&Ls continue to operate with losses. Although some may recover with time, there is good reason to assume that many will eventually have to be closed or need FSLIC assistance. The swift passage of a FSLIC recapitalization measure by Congress is therefore vital for the health of the savings and loan industry and is needed to maintain the confidence of savers.

### Banking Reform

Comprehensive reform of the nation's banking laws is needed to solve these problems, to improve the stability and soundness of our financial system, and prevent a future recurrence. Already some steps have been taken in the right direction. The deregulation of interest rates, for instance, is now complete, and it has enabled banking institutions to compete successfully for a steady flow of deposits. Credit crunches are a phenomenon of the past.

The focus of reform now has shifted to new fronts. Banks still must contend with barriers to geographic expansion and with limits on the range of services that can be offered. These barriers, erected for what were once perceived to be legitimate reasons, have outlasted their usefulness. They should be removed, so that banks can compete on an equal footing with other types of financial service institutions.

While I certainly agree with the need for careful Congressional consideration of any landmark banking legislation, banking reform is too important to languish much longer.

My own agenda for reform of the American banking system reflects the belief that increased diversification -- both geographic and along product lines -- is the key to strengthening the system. Diversification is one of the basic tenets of finance. Yet, outdated laws prevent U.S. banking institutions from fully using this basic principle to manage their own portfolios.

#### Interstate Banking

There are no truly national banks in the United States. Instead, the banking system is fragmented geographically, and also functionally. The American

banking system is more fragmented geographically than that of any other industrialized nation. This fragmentation exists because the system is structured along state lines rather than on the nation as a whole. The McFadden Act prohibits interstate branching by banks. Likewise, the Douglas Amendment to the Bank Holding Company Act restricts interstate bank acquisitions. In some states, banks are subject to even more restrictive state laws which limit their branching ability within the state.

The effect of the limitations is to make banks dependent upon a narrow geographic area both for raising deposits and for lending money. As a result, many banks find it hard to adequately diversify their loan portfolios. In a small farming community, it may be irrelevant that you have a nominally diversified portfolio containing mortgages, consumer loans, loans to the local automobile and tractor dealer, the grocery store, and the five-and-dime. The fact of the matter is that the soundness of all these loans may hinge on one single variable: the price of wheat. If banks were allowed to diversify geographically, their health would not depend on the economy of a single locality.

The development of a full interstate banking system also would provide international banking

services to a wider range of domestic customers. Outside the major financial centers, small and medium-sized American manufacturers have little access to institutions skilled in export financing. The typical hometown banker in a small American city can not provide the local firm with the financial support or the expertise needed to enter foreign markets. However, American industry competes with manufacturers in Europe and Japan where banks are positioned to provide these kinds of services to businesses regardless of size and location. American industry is clearly at a competitive disadvantage.

Although Edge Act corporations may provide international banking services, they are not perfect substitutes for full-service banking. In contrast, an interstate branch network would place the entire resources of the bank at the disposal of the local businessman.

In the absence of action at the national level, the states have taken the lead in removing the barriers to interstate expansion. Thirty-seven states and the District of Columbia now have laws allowing out-of-state entry by bank holding companies. In most cases, however, the states have severely limited the number of potential entrants by selecting regional

interstate banking plans. Only 18 states have laws providing for current or future entry from all other states.

Beyond the regional interstate compacts, interstate expansion is currently limited to acquisitions of failing banks by strong out-of-state banks. Crisis situations as, for example, in Texas, have made this type of acquisition necessary. When interstate expansion is limited to mergers between healthy and troubled institutions, the scope for capital replenishment is also limited. The resulting institutions are larger, but they are not necessarily stronger. Permitting interstate mergers among healthy institutions could strengthen the resulting institutions.

#### Product Diversification

An area that requires just as much attention--and liberalization--is the range of services that U.S. banking organizations are permitted to offer domestically. The Glass-Steagall Act provides for the separation of banking and commerce and stipulates that banks can not be engaged principally in the securities business. These legal strictures were intended to make banks safer by separating them from presumably risky

commercial and other financial endeavors. But at the same time, the benefits of diversification were lost. Furthermore, with advances in technology and communications, it has now become possible for the customers with the best credit ratings to bypass the banks, and the banks are left with a shrinking and probably more risky customer base.

Securities activities are nothing new for U.S. banking organizations. Since the Board determined years ago that Glass-Steagall does not apply outside the United State, U.S. banking organizations are active players in the securities markets overseas. U.S. banking organizations are quite prominent in the Eurobond and Euronote markets in London. In 1986, six U.S. commercial banking organizations were among the top 50 lead underwriters for all Eurobond issues. In Japan, U.S. bank holding companies have recently been permitted to deal in corporate securities, through 50 percent owned affiliates. U.S. banking organizations are able to engage in securities activities overseas without encountering unmanageable risks or conflicts of interests. Why, then, should they not be permitted to engage in these same activities in the United States?

#### Market-Determined Structure

If we remove the barriers to interstate banking in the United States, and allow the market to determine the shape of our banking system, its future structure might more closely resemble banking structures currently in place in the other major industrial countries. A common feature of those countries' systems is the existence of 4 or 5 large banks that offer their services on a nationwide basis. For example, as of year-end 1985, the five largest banks in Canada had total assets ranging from 11 percent to 20 percent of Canada's GNP. For the four largest British banks, the range was 12 percent to 20 percent of GNP; for the four largest French banks--16 percent to 20 percent of GNP; and for the five largest German banks--7 percent to 13 percent of GNP. For the five largest Japanese banks, the total asset range was 8 percent to 10 percent of GNP.

Looking at this evidence from other countries, how large might comparable banks in the U.S. be if we were to permit nationwide banking organizations to be established? On the chart entitled "Bank Assets as a Percent of GNP", the assets to GNP ratios of the four or five largest banks in each of six countries are plotted. The evidence presented in this chart points to the important conclusion that the ratio of bank assets to GNP tends to decline as GNP increases. A

trend line based on the data for the five countries excluding the United States has also been drawn. Projected out, the trend line shows that the largest U.S. banks could be expected to have assets to GNP ratios averaging around 4 to 5 percent. In fact our largest banks are only slightly smaller than this number would suggest.

On the chart entitled "Size of the Largest Banks", bank total assets in dollars is plotted against GNP for each of the four or five largest banks in each of the six countries. A trend line has again been drawn based on the data for the five countries excluding the United States. Projected out, this line shows that the four or five largest U.S. banks could be expected to have total assets averaging about \$175 billion. Based on the evidence that can be garnered from countries that allow nationwide banking, one might conclude that the fears of some observers that a few giant superbanks might dominate the entire U.S. banking scene are therefore probably unjustified. If we were to permit nationwide branching, several institutions in the \$150 to \$200 billion asset range might well develop. That is not all that different from the current size of our largest banking organization. But the increased diversification would add stability to the banks and the banking system.

## Double Umbrella

We need Congressional action to remove the current restrictions on interstate banking and to expand the product powers of U.S. banking organization. To strengthen the banking system, I also believe that it should be legal for commercial banks to associate with other firms in a larger entity that offers a variety of financial services.

One may want to start with the existing institutional structure of bank holding companies and banks. The concept of a bank holding company with greatly expanded powers has much to commend itself. Bank, thrift, insurance, investment, securities and real estate subsidiaries could co-exist under the umbrella of a single holding company. Thus, a full range of financial services could be offered by one organization.

The various subsidiaries could be regulated along functional lines by the existing authorities. Thus, the nature of bank regulation would not change greatly.

The federal "safety net" in the form of the discount window and deposit insurance would continue to protect banks and their depositors. Therefore, certain

restraints should be placed on banks to make sure that their resources are not abused. As bank affiliates are permitted to engage in a broader range of activities, the structure of the bank holding company takes on greater importance. From an institutional and regulatory viewpoint it may be easiest to conduct the securities activities not in the bank itself, or in subsidiaries of the bank, but rather in separate subsidiaries of the holding company. Strict limits would be placed on the extension of credit by the bank to the associated subsidiaries, and all transactions would have to be on an arm's-length basis.

The Federal Reserve Board has recently reaffirmed its long-standing policy that a bank holding company should serve as a "source of strength" to the bank by pledging to maintain the bank's capital. I would go one step further and argue that the bank should not be allowed to fail as long as the holding company has a positive net worth. This assurance would constitute a first protective umbrella for the bank.

I would also favor permitting commercial firms to own financial service holding companies. Many of these firms have substantial capital resources that could support the banking and financial service affiliates. I believe that adequate safeguards could be developed

to prevent problems in the commercial operations from adversely affecting the bank's depositors.

At this second level, the owners of the parent enterprise would also agree to maintain the capital of the financial services holding company. Thus, assistance in emergencies could flow only in a downward direction, first to the holding company and then to the banking subsidiary. The resources of the nonfinancial parent, therefore, would provide a second umbrella of protection for the subsidiary bank.

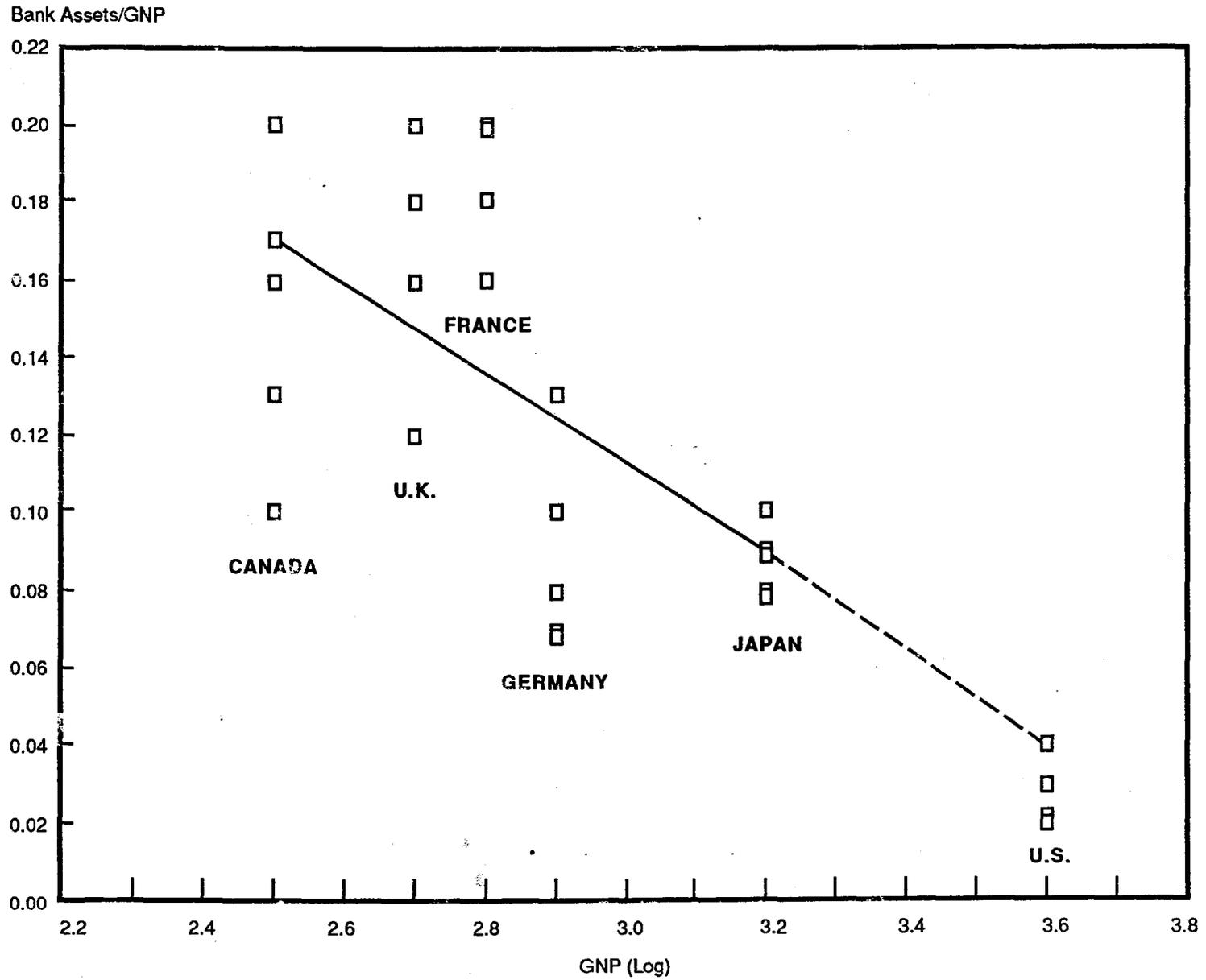
The Federal Reserve Board and the other regulatory agencies will continue to do what we can to maintain the national and international competitive position of the U.S. banking industry. Of course, such regulatory actions have to be guided by safety and soundness considerations as well as the existing legal framework. But we can not afford to wait much longer to adopt laws that address the realities of today's financial markets.

I believe that the reforms that I have discussed would contribute greatly to the strength and soundness of the banking system. They would also enhance the ability of U.S. banks to support American industry in its push for greater competitiveness in international markets. Time

will not stand still. It is therefore imperative that we move forward in a constructive manner.

Chart 1

### Bank Assets as a Percent of GNP 4-5 Largest Banks as of 12/31/85



### Size of the Largest Banks 4-5 Largest Banks as of 12/31/85

Bank Assets (\$ Billions)

