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Remarks by

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Good afternoon and thank you for inviting me to be in Texas today and to talk about the banking industry. Being in Texas is always special for me, whether in Dallas, Houston, Fort Worth, San Antonio, or Bandara. I mention Bandara because when I was in O.C.S. at Lackland Air Force Base in 1952 we used to go to a dude ranch in Bandara on weekends when we could get a pass. Texas is a special place for me because of my happy memories of all of my visits and sojourns, but also because of the people who have been very kind to me: Lewis Bond in Forth Worth, Bob McTeer, president of the Dallas Fed, Bob Smith who runs the Fed office here in Houston, Stewart Morris and his associates, and most particularly my old friend and former partner in bank regulation, Bob Clarke. Bob's distinguished service to the nation as Comptroller of the Currency epitomizes the best traditions of public service. It was a privilege to serve with him in Washington.

It is far less a privilege to follow him on any public program. He is a gifted public speaker, bound to be well informed on any subject to which he speaks, and he has that additional advantage of an endless inventory of wonderful stories with which to provide humorous leavening to any speech. Bob, on that score I won't even try to compete.

We are discussing today the future of banking in the United States. In a sense that is too narrow a topic, because the United States economy is an integral part of a global economy and financial markets are increasingly globalized and independent of time zones. At any time of day or night Houston time, a sophisticated financial market is open and available somewhere on the globe, capable of handling almost any kind of transaction, and communications technology permits instant contact and instant response. But it is also fair to say that innovation in financial product design and the speed with which transactions can be completed also tends to escalate risk. Any kind of a meltdown in the settlement system for international transactions could create systemic problems and risk a broad financial crisis.

Banks which are operating in these sophisticated markets directly must learn to manage diverse elements of risk on a daily, even hourly, basis and have in place the policies, systems and controls to limit the effects of external events to an aggregate level which capital and reserves can absorb without institutional failure.

In addition, those bankers who participate indirectly must understand every instrument they put on the balance sheet and all the risks inherent in it. They, too, should think about worst-case scenarios and what they might mean to the viability of their institutions.

But, I will try now to put all of these admonitions and alarms in the context of the vision I have for banking over the next several years. It is not a particularly rosy vision, because the recent and current trends in legislation and regulation tend to narrow increasingly the spectrum of opportunity for banks.

Having said that, I hasten to add that commercial banks today are in fine shape. They weathered the worst storm and absorbed the greatest losses during the period 1989-1992 since the catastrophic period 1929 to 1935.

Heroic measures to improve asset quality; deliberate and radical reapportionment of balance sheets; and, with the help of the capital markets, the addition of huge amounts of fresh equity and debt capital have remade the asset and liability structure of the industry. At the same time, like other industries, banking has taken drastic measures to improve productivity through broader use of advanced technology and has enhanced earnings by cutting costs. Downsizing branch systems to eliminate operations which are not cost effective is a standard approach. Marginally profitable businesses have been sold or abandoned. Intra-market mergers like that of Chemical and Manufacturers in New York seek to achieve real economies of scale through back-office consolidation. They also enable the combined institutions to close redundant branches and reduce staff without losing customers. All of this has resulted in a vastly improved earnings performance.

In the 1960s, large banks which could earn a return on assets of only 70 basis points were the darlings of the analysts and the role models for others. For the first and second quarters of 1994 the entire industry -- that is, all insured commercial banks -- had a return on assets of 117 basis points and many banks large and small had returns even better than that.

At the same time, asset quality has improved dramatically and problem loans are down to $42 billion, their lowest level since 1985.

At the same time, recent accounting mandates from the Financial Accounting Standards Board in the form of FAS 115 make it appropriate to mention that investment portfolio positions have weakened. In the fourth quarter of 1993, banks had unrealized gains of $11.5 billion. Changes in interest rates -- for which I admit the Fed bears some responsibility -- have altered that figure materially. Insured banks now show unrealized losses in portfolio of $13.3 billion, a swing of almost $25 billion in market value. Of that $13.5 billion of unrealized loss at the end of the second quarter, $5.9 billion was in the "available for sale" category prescribed by FAS 115. For reporting purposes after taxes, the effect on bank equity accounts would be about $4 billion.

FAS 115 will certainly add volatility to bank balance sheets for reporting purposes. It remains to be seen whether attempts to avoid or neutralize that volatility by bankers will result in irrational portfolio management such as marking everything "to be held to maturity" or conversely marking everything "available for sale" but limiting maturities to 12 to 18 months. Somehow, for an industry heavily dependent on the confidence factor to obtain proper funding, it seems counterintuitive to increase volatility in financial reports when that volatility is wholly a result of accounting practice rather than real events.

In the first half of this year, commercial and industrial loans are up nearly $26 billion or 4.8 percent and loans to individuals increased $19.5 billion, with nearly $17 billion of that in the second quarter.

Equity capital increased $8 billion or 2.8 percent from year-end 1993. Equity for the industry stood at 7.84 percent of total assets at the end of the second quarter and total risk-based capital at about 13.2 percent.

Four banks failed in the first half with aggregate total assets of $230 million. At June 30th, there were 338 problem banks with $42 billion in assets, down from 1,016 banks at year-end 1991 with assets of $528 billion.

That is truly a remarkable recovery in a very short period of time and has undoubtedly contributed to the vibrant current rate of growth in the U.S. economy.

But what does the future hold for banking? There are no current indications that another asset quality crisis is impending. The capital markets and rating agencies have a generally favorable attitude toward the industry. The increasing access of banks to secondary markets by securitizing assets has enabled bankers to substantially lay off risks related to carrying longer term fixed-rate loans. And, this development has given banks greater flexibility in managing balance-sheet items against risk-based capital standards, while at the same time increasing fee income by continuing to service the collection of interest and principal on those loans.

Banks have proven over and over that they can adapt to changing times and conditions. But there is a limit, and I believe we are fast approaching it. The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) have enormously increased the burden of federal regulation and reporting. They are the products of over-reaction by Congress, believing that more and more regulation and restriction on the things which banks can do and how they do them will keep banks from failing and protect the insurance funds. Indeed, prompt corrective action is a valuable tool which enables supervisors to step in early in a deteriorating situation with the authority to mandate steps to avoid failure. But much of the rest of this recent legislation will just result in expanding and complicating bank reporting and compliance obligations with little potential enhancement of safety and soundness.

Add to that recent efforts to expand the use of bank capital and deposits to engineer social programs. This is particularly disturbing in the context of bank competitiveness with other financial institutions. In fact, the current proposals to revise the enforcement of CRA constitute social engineering by administrative fiat. That seems to me to be highly questionable from a public policy point of view.

The brouhaha about derivatives is only the most recent example of this dangerous trend toward more and more regulation. The prophets of doom who are calling for legislation act as though derivatives were new phenomena invented by some evil banker hellbent to take advantage of naive investors. In fact, many of these critics wouldn't know a derivative if they saw one.

Exhaustive disclosure and well-informed supervision can insure prudent use of derivatives, even the super-sophisticated ones of recent vintage. But legislation to regulate and restrict the use of derivatives, undertaken unilaterally here in the United States, could well result in our market for these important financial instruments being exported to London, Frankfurt, Tokyo, Hong Kong or Singapore. This would be a significant lessening of the importance of U.S. financial markets which are perhaps our most important competitive advantage in the global economy.

Returning to our basic question: What will banking look like in the year 2000? Well, here are some guesses. And please keep in mind that the thoughts I have already shared with you and those I am about to enunciate are mine alone and do not necessarily represent the position of the Federal Reserve or the views of my colleagues on the Board.

First -- Consolidation. I believe that the balance of this decade will see a continuation of the strong trend toward consolidation. This will be driven by the desire of many banks to increase their geographic reach and diversification. But it will also be driven by the need for greater efficiency. Intra-market mergers offer immediate opportunities to eliminate inefficient branches and reduce staff. This can be just as true for two $100 million banks in the same market as for two $50 billion banks like Chemical and Manufacturers.

Second -- Interstate branching will dramatically change the way some banking organizations look, but I doubt very much that it will significantly change the basic structure of banking in the United States. I think we will always have seven or eight thousand commercial banks. Perhaps fifteen or twenty of them will aspire to an essentially national network of banks and branches. But there will also be large super-regional banks which choose to remain in a regional posture because a franchise with a more homogeneous market may be easier to manage. Smaller regionals or sub-regionals will operate in two or three states, usually contiguous. And the great majority of banks will be local.

You know Tip O'Neill once said "all politics is local." Well, I contend that all banking is local. Some banks will try to be local, using branches and encouraging branch management to be actively engaged in the community. That may be local enough for some customers, but there will always be those who want to deal with folks they know -- bank managers and directors whom they know and who clearly are identified with what is good for the community. There are still a lot of people who like to be able to talk to the president of the bank and get quick answers based as much on the character of the customer as on his balance sheet. For those reasons, community banking will continue to thrive even in the age of full interstate banking. If I were active in bank management today, I would love to run a bank in a small town that was in competition with the branch of a money-market bank headquartered 1,000 miles away. I'd beat their socks off.

Third -- Banks will continue to see their share of market for commercial and industrial loans erode. Investment bankers, finance companies and insurance companies have taken dead aim at this market. They have the advantage of less regulation of that business than banks have. That translates into lower costs and more leeway to be creative in the kinds of financing and other services they can provide. At the other end of the market spectrum, banks are going to have ever-tougher competition for consumers' patronage. Mutual funds offer better returns for deposit-like funds with enough of a differential to override concerns about deposit insurance. In the credit-card field, an area where banks once had a near lock, AT&T, General Motors and GE, to name a few, will make big inroads over time on this highly profitable business. Banks won't be eliminated as competitors, but competition will be tougher and margins thinner.

Fourth -- Here I return to optimism: I believe that Members of Congress who recognize the importance of banks to the economic health of the nation will begin to realize that a more integrated financial system with comprehensive supervision but much less restrictive formal regulation is desirable if we are to maintain our leadership in global financial markets and provide support for a burgeoning economy at home. Before the end of the decade I expect Congress will consider in detail, and enact, broad reform measures to permit the integration under common ownership of commercial banks, investment banks and insurance companies. This has been a recognized format in Europe for some time and is now permitted in Canada. Japan is also moving in that direction. A key issue in the debate that will surround that revolution will be whether or not to maintain the present legal barrier between commerce and banking, thereby continuing to prohibit commercial enterprises from owning banks. But perhaps that is a topic for another conference.

Thank you for listening to my concerns and my interpretation of what images appear in my crystal ball.

If there is time, I will be delighted to answer questions or engage in debate.