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**THE FUTURE STRUCTURE OF THE BANKING INDUSTRY**  
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Good afternoon! I am pleased and honored to be a participant in this conference on Tennessee banking in the 1990s. I have been asked to talk about the future of the banking industry, and particularly about banking in this state and in the Southeast. In my opinion, the industry's future hinges largely on actions at the national level to rationalize our financial system. Thus in looking toward the end of the century, it seems to me that the prospects for banking in any one part of the country are part and parcel of developments in the industry as a whole. For that reason, I will begin by sketching what in my opinion would be the ideal banking system for the evolving financial needs of this country. Then I will outline several obstacles that seem to preclude such substantial banking reform. Finally I will suggest some ways we might make the present system approach the ideal.

**Attributes of the Ideal Banking System**

We all know that technological changes and the increasing merger of national and regional markets into a single global market are rapidly changing the conditions under which banks operate. Globalization and technological advances, along with the general growth and development of our economy, call for an efficient banking system that is competitive both at home and abroad. Such a banking system would, in my view, possess at least three general sets of attributes. It would, first and foremost, not propagate systemic risk. Second, it would also address customers' needs, and, third, it would offer basic protection to consumers, particularly small depositors and less sophisticated borrowers. I shall discuss each of these attributes in turn.

Lack of susceptibility to systemic risk is my first ideal attribute. We must prepare for as yet unknown risks as financial activity assumes worldwide scope and high-tech speed. Moreover, in the past decade we have learned painful lessons about dealing with risk that I would hope we can avoid repeating. For these reasons, I think it is important to make the costs for excessive risk-taking high. I would like to see these high costs exacted by a combination of three forces: the market, supervisors, and insurers.

As I see it, the threat of prompt closure is the sine qua non of risk discipline. In the best of all worlds the market would take the lead in discovering when riskiness reaches unsafe levels and closure becomes warranted. Investors with their money on the line have strong incentives to keep close tabs on bank management and give immediate and easily understandable signals of their displeasure with weak decisions. There may be limits to market discipline, however, especially in smaller banks. Supervisors should supplement market discipline by identifying conditions that require attention. Part of their job is to ensure that directors and management are aware of high risk. Seeing to the replacement of weak management and effecting early and orderly closure are the correct tools for supervisors to use in controlling risk.

I think insurers, too, should build accountability for their risk into their charge for coverage of deposits. In an ideal system they would adjust premiums to reflect the relative risk of insurance loss posed by particular banks' policies and portfolios. This feature would make deposit insurance more like other forms of insurance and reduce the risk incentives of today's flat-rate coverage. Together, a blend of market surveillance, strict supervision, and risk-based deposit insurance of this nature would, it seems, increase the costs of risk sufficiently to control systemic danger.

Second, if I were designing the banking system of the future, I would want it to address all its customers' needs by being flexible, dynamic, and competitive in all markets. To me, flexibility means that banks should be able to do whatever financial business they wish wherever they want to do it. I would therefore not have financial product restrictions in my ideal banking system. There may be synergies in the activities of banking and insurance, for instance. The ability to sell and invest in securities is also harmonious with many of the things banks already do. Broad powers could be a means of diversifying bank portfolios and thereby potentially reducing overall risk.

I also think nationwide interstate banking is essential. Like broader powers, free geographic expansion would allow greater portfolio diversification. Many of the existing problems in the banking industry can be traced to economic downturns in oil-producing areas of the Southwest and agricultural regions of the farmbelt, for example. If banks could maintain business in a variety of areas, the danger of overreliance on one region's --or localities--economic health would be reduced.

Aside from enhancing competitiveness and helping to manage risk, I believe that greater geographic and product flexibility would engender increased competition. This in turn would contribute to a dynamic banking system that continually pushes for better products and services. Users of financial services, including businesses, governments, and consumers, would obviously have their range of choices amplified by new banking options. In addition, it is important that all markets enjoy a high level of competition. Thus, the optimal banking system should be resistant to undue concentration.

The third plank of my idealized system would be adequate protection for small depositors and less sophisticated borrowers. Those of us who deal with financial markets on a daily basis should not forget how complex the range of investment choices can

appear to many average consumers. These choices continue to multiply as technology pushes up the intensity of market activity. In this environment, useful, accurate information is crucial to consumer protection.

To ensure the availability of such information, consumer-oriented regulations like "Truth in Lending," which help people shop around among competing institutions, should be aggressively enforced. Adequate competition in local markets also helps prevent unethical bankers from duping customers into paying too much or receiving too little. Along with promoting competition and the exchange of information, though, I think it is reasonable and proper for banks to provide safe depository vehicles as part of their lineup of products. This, I believe, requires continuing some form of deposit insurance, but a form free of some of the risk promoted in today's system.

In summary, the ideal attributes are a banking industry with institutions that are competitive in every market including the global market. The market, supervisors would all exercise discipline over the risk undertaken by these institutions. At the same time such banks would enjoy the flexibility of a full range of commercial powers and nationwide interstate banking. Finally, this system would provide adequate protection for small depositors and less sophisticated borrowers.

### **Impediments to Realizing the Ideal System**

Let me now turn to current issues and identify some of the impediments to bringing a system like the one I just outlined into existence. One overriding issue that detracts from efforts to introduce greater risk discipline from the marketplace and to broaden banking powers as well is the overextended deposit insurance safety net. Deposit insurance was established in part to prevent runs on the banking system. With their money guaranteed, depositors had little incentive to pull out of institutions in which they



had for some reason lost confidence. This guarantee has taken on the dimensions of a social compact. However, certain adverse consequences of the system have made insurance in some ways as much a danger as a safeguard.

First, depositors, who could provide some first-line discipline on bank management, have little incentive to monitor banks. They have been relieved of any concern over the security of their funds and have no qualms about doing business with troubled institutions. Indeed, they are often attracted by the higher interest rates such institutions offer. What is worse, the safety net at times extends coverage to all investors' losses and may even make depositors and investors in financial institutions other than banks feel they are protected also. This situation has further reduced equity- and debt-holders' incentive to discipline risk taking by bank management. We have seen such situations escalate rapidly in the S&L industry, where owners of weak thrifts, confident the government would not let them fail, have increased their risk-taking so far that American taxpayers are now funding a bailout whose dimensions are still not fully known.

While pricing deposit insurance to make it commensurate with insurers' risk is a good theoretical approach to this problem, we all know the difficulties in attempting to adjust premia in advance. It is clear, though, that reining in the safety net in some way is a necessary step before reforms on powers and greater market participation will attract a following in Congress.

For this and other reasons, competitive flexibility in banking is still constrained by product regulation and prohibitions against nationwide banking. Nonetheless, the artificial distinctions between banking and investment banking in the Glass-Steagall Act have so obviously outlived their usefulness that piecemeal efforts to breach the wall

separating these activities are under way. Some states now allow banks to engage in insurance and real estate businesses. The Fed, within the limited statutory discretion available to us, has recently taken carefully measured steps to permit banks to underwrite corporate debt as long as adequate safeguards are in place to minimize risk. Within a year we will review the situation with an eye toward allowing bank holding companies to underwrite and trade equity securities.

Nonetheless, the path to Congressional action that would give broader powers to all banks at once is mired in conflicting interests. The various industries that provide financial services are unwilling to yield any of their individual domains. Thus the securities industry opposes banks' dealing in stocks and bonds, and the insurance industry prefers that banks not handle underwriting.

Vested interests--in this case bankers who want to avoid outside competition as long as possible is also impending Congressional momentum toward nationwide banking legislation. Happily, progress has been made on a state-by-state basis. A recent study at the Atlanta Fed documents how far the interstate movement has come in the past 5 years and how far we still have to go. As state laws allowing entry from other states spread, the number of interstate offices doubled between 1983 and 1988, to reach over 14,600. Significantly, the number of full-service offices grew to account for half of the total.

The study also shows, however, that the regional focus of banking laws in southeastern and New England states, which were pioneers in the early days of interstate banking, could dampen further growth by large banks there. Other states have seized the initiative by opting for full nationwide interstate arrangements, and banks in these narrow compact regions will have increasing difficulty finding new merger partners.

### **Reaching Toward the Ideal**

Clearly a number of stumbling blocks stand between our present, imperfect banking scene and what I view as a more ideal way for the industry to function. However, recent developments and innovative suggestions convince me we can come fairly close to my ideal by the end of the next decade.

In order to create an environment in which progressive reform can take place, we must do something to introduce greater market discipline. The trick is to find a way to do this while still insuring deposits, which, as we have seen, can work against risk discipline in general. I might mention two proposals for achieving a balance between market forces and the desire to insure deposits. One idea aims for a minimal degree of insurance coverage by segregating insurable deposits into what I have called a failsafe depository. By this I mean essentially an insured transactions account, although other types of deposits might also be included as demanded. The failsafe depository would be kept separate from a bank holding company's other activities, all of which would be uninsured. If adequate insulation to keep the holding company from drawing on these deposits in an emergency could be devised, the failsafe depository could offer protection to the small depositor while also encouraging the introduction of greater market discipline. Consumers who desire insurance would have it, and other activities could be carried on in response to market dynamics.

A second approach, one that would allow for relatively broad deposit insurance coverage, has been advanced by Larry Wall, one of our economists at the Atlanta Fed. Wall has suggested the creation of a class of puttable subordinated debt. He would like to see large banks in particular be required to issue bonds whose payment is subordinated to all other liabilities but whose owners are allowed to request redemption. Banks would

be required to maintain a minimum amount of this debt to stay in operation. If investors began to exercise their put option in large numbers, the bank in question would have to issue new debt or perhaps sell assets to remain in compliance with regulations. Wall's barometer of market judgment would make regulators more effective in their jobs of identifying troubles in their early stages and effecting timely closure when necessary.

Of course, I do not expect the market to do the entire job of risk control. Fortunately, an important feature of the regulatory framework undergirding further product deregulation is already in place, namely, the risk-based capital standards adopted by international regulators last year. These standards convert on- and off-balance-sheet exposures into on-balance-sheet equivalents, and in this way provide a better assessment of an institution's overall riskiness. They also raise the minimum standard of capital to risk-weighted assets to 8 percent by 1992. Risk-based capital standards are not a complete picture of an organization's capital adequacy, of course. Interest-rate risks, asset quality, and other conditions must still be considered by examiners. However, the definitions of capital in the standards provide a more objective basis for determining when a regulator's authority should be invoked.

In terms of expanded powers, I expect to see much of the Glass-Steagall distinction between banking and commerce disappear over time. Individual states are providing some evidence that insurance and real estate powers do not necessarily destabilize banking. U.S. banks have also engaged in investment banking practices through their foreign subsidiaries without overwhelming problems. In these ways we are accumulating experience that favors broader powers, and I think that at some point in the next ten years these privileges will be extended to all institutions by Congressional action.



In 1992, we will reach the point where more than half our states have laws in effect allowing interstate acquisition by bank holding companies from all other states under certain conditions. Thus, the move toward interstate banking should reach fruition and provide new options for portfolio diversification for banks and greater competition for consumers. Even so, we still might have a patchwork of 51 bodies of banking laws that do similar things but nevertheless contain enough discrepancies to make interstate banking far more complicated than it needs to be. Because of this potential disparity, I would still hope that Congress would give us nationwide banking in one decisive gesture.

Another incentive to broaden banks' powers and geographical options comes from the intention of the European Community to permit intercountry banking expansion as part of the economic integration scheduled for 1992. European banks already have broader commercial powers than their U.S. counterparts. If they can branch freely across national boundaries after 1992 as well, a relatively restricted U.S. banking industry would fall further out of step with global developments. Banks in post-1992 Europe are likely to gain in size also. Size alone may not be a factor in winning the business of multinational firms, but the one-stop shopping such banks provide seems likely to give these banks a competitive edge over our larger institutions.

## **Conclusion**

In conclusion, I feel that in several important ways we are moving toward a stronger banking industry from all three perspectives I identified at the outset: lack of susceptibility to systemic risk, responsiveness to customer needs, and adequate consumer protection. However, a good deal of thought and effort will be required to synthesize these elements into a full framework for banking in the global marketplace of the 1990s and beyond. Policymakers and industry leaders will need to work together to ensure that the industry's future structure promotes both the public good of safety and soundness in

banking and the private goal of efficient and profitable banking. Many of you involved in this conference can play a leadership role in the evolution of banking, and I look to you to apply your experience and your foresight to keeping the industry on track toward fuller realization of these twin goals.